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CLO RISK RETENTION – OPPORTUNITIES FOR SOME?

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Despite what some might call naive optimism by numerous CLO industry participants (including the author of this article) that rationality might prevail over politics, the portions of the final U.S. risk retention rules (the "Final Rules")[1] applicable to collateralized loan obligation transactions ("CLOs") remained largely unchanged from the second notice of proposed rulemaking, with a couple of notable exceptions described below. Rather than ushering in relief—ideally in the form of the well-crafted "Qualified CLO" proposal for open market CLOs jointly submitted by the LSTA, SFIG and SIFMA—the Final Rules have instead created considerable challenges for the CLO marketplace.

Nevertheless, disillusionment with U.S. regulators needn't necessarily translate into pessimism regarding the future of CLOs as a viable investment instrument. Challenges beget opportunities, and the Final Rules are no exception. It is our view that capital vehicles should, and will, emerge in the coming months that will not only satisfy the letter and spirit of the Final Rules and curtail the widespread consolidation of CLO managers that many in the industry are forecasting, but will also provide a number of investors and fund managers with intriguing new business opportunities.

What we're working with: The Final Rules

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed into law in 2010 in an effort to avoid a recurrence of the consequences experienced by investors, consumers, financial institutions, and the financial system during the recent financial crisis. Section 941 of Dodd-Frank added Section 15G to the Securities and Exchange Act of 1934 and directed six federal regulatory agencies (collectively, the "Agencies")[2] to adopt rules requiring the "securitizer" to retain at least 5 percent (the "retention interest") of the credit risk of the assets that serve as collateral for asset-backed securities ("ABS").[3]

[1] Credit Risk Retention: Final Rule, available at < http://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-139b.pdf> (hereinafter "Final Rule").

[2] The Agencies are as follows: the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, U.S. Securities and Exchange Commission, Federal Housing Finance Agency, and Department of Housing and Urban Development.

[3] *See* Final Rules at 7.

The Agencies released the first proposal of the risk retention rules for public comment in April 2011 and a second proposal in August 2013. On October 21, 2014, the Agencies jointly adopted the Final Rules. Unfortunately, the Final Rules as they relate to CLOs remained largely intact from the second proposal, with the notable exception that they eliminated the so-called "cash throttle" requirement, which would have required distributions on a retained horizontal CLO equity interest to be made in proportion to the rate of amortization of the related CLO liabilities.

In general, the Final Rules require a sponsor or a majority-owned affiliate[4] of the sponsor to retain some credit risk of the securitized assets. This can be accomplished by a menu of options. The eligible holder of a retention interest can hold:

(a) an "Eligible Vertical Interest": an interest in each CLO-issued tranche equivalent to 5% of the face value of each such tranche or a single security representing the same;

(b) an "Eligible Residual Horizontal Interest": an interest in the CLO equity (i.e., the most subordinated tranche in the CLO capital structure) equivalent to least 5% of the fair value of the CLO, determined in accordance with U.S. GAAP;

(c) a cash reserve account in lieu of the Eligible Residual Horizontal Interest; or

(d) any combination of the Eligible Vertical Interest or Eligible Residual Horizontal Interest.[5]

A CLO sponsor choosing to avail itself of the Eligible Residual Horizontal Interest option will be required to make extensive disclosures regarding the calculation of the "fair value" of such retention interest during both a reasonable period of time prior to the sale of the related CLO securities and a reasonable period of time after the CLO closing date.[6] Notably, the Final Rules do not specify how such reasonable period of time is to be measured.

CLO Manager as Sponsor

The Final Rules define a sponsor as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[7] Despite numerous public comments to the effect that a CLO manager is not a sponsor—and therefore not a "securitizer"—because it neither sells nor transfers any assets to the CLO issuing entity, the Agencies ultimately disagreed, predicating their conclusion on the controversial view that the CLO manager "indirectly transfers the underlying assets to the CLO issuing entity typically by selecting the assets and directing the CLO issuing entity to purchase and sell those assets".[8]

[4] A majority-owned affiliate is an entity that, directly or indirectly, majority controls, is majority controlled by, or is under common majority control with the sponsor. *See* Final Rule § __.2 at 424. Majority control means owning 50% or more of the equity or maintaining a controlling financial interest (as determined under GAAP). *See id.*

[5] *See* Final Rule § __.2 at 423-24; § __.4 at 427.

[6] *See* Final Rule § __.4(c)(1) at 429-433. While disclosures are also required in connection with the other risk retention options, including the lead arranger and originator options, such disclosures are less onerous than those required in connection with the Eligible Residual Horizontal Interest. *See* Final Rule § __.4(c)(2) at 433-34; § __.9(d)(1) at 466-67; § __.11(a)(2) at 473.

[7] *See* Final Rule at 426.

[8] *See* Final Rule at 214-20; § __.2 at 425-26.

The Agencies' adopting release did, however, provide some additional clarity surrounding what it means for a sponsor to "organize and initiate" a securitization transaction, namely that a sponsor must have actively participated in activities that impact the quality of the securitized assets, such as underwriting or asset selection.[9] The Agencies also provided color as to the types of entities that would *not* meet the organization and initiation criteria. Such entities include: pass-through conduit entities for assets that are transferred into a securitization vehicle, entities that purchase assets at the direction of an independent asset or investment manager, and entities that only pre- or post-approve the purchase of assets.[10] The Agencies further noted that "negotiation of underwriting criteria or asset selection criteria or merely acting as a "rubber stamp" for decisions made by other transaction parties does not sufficiently distinguish passive investment from the level of active participation expected of a sponsor."[11]

The Lead Arranger Option

The Final Rules retained, largely as originally proposed, the much maligned "lead arranger" option—whereby an "open market CLO"[12] meeting certain criteria could satisfy the risk retention requirements if the lead arranger for each loan purchased by the CLO has taken an allocation of at least 20% of the funded portion of such loan at origination and retains, without hedging, a minimum of 5% of the face amount of the loan tranche purchased by the CLO. Market feedback both prior to and following the adoption of the Final Rule, however, would indicate that arranging banks are unlikely to utilize this option going forward, since doing so would involve an obstacle-laden departure from current market practice and could potentially raise a host of regulatory compliance problems.[13]

Originator Option

If an "originator" has originated at least 20% of the underlying assets of a CLO, the Final Rules permit a CLO manager to offset its retention interest by selling it to such originator at closing.[14] The Final Rules define an originator as "a person who, through an extension of credit or otherwise, creates an asset that collateralizes an [ABS]; and sells the asset directly or indirectly to a securitizer or issuing entity."[15]

While the originator must retain at least 20% of the retention interest, such interest cannot exceed the percentage of assets sold or transferred by the originator to the CLO as compared to the total securitized assets in the CLO, measured by unpaid principal balance.[16] The originator must also hold the retention interest in the same manner and proportion, and be bound by the same restrictions for holding such retention interest, as the sponsor.[17] It is the sponsor's obligation to monitor the originator's compliance with the Final Rules, and to notify CLO investors in the event of originator noncompliance.[18]

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[9] *See* Final Rule at 32-34.
[10] *See id.*
[11] *See id.*
[12] An Open Market CLO is defined as a CLO (a) whose assets primarily consist of senior, secured syndicated loans that were acquired by the issuing entity directly from sellers in open market transactions and servicing assets, (b) is managed by a CLO manager, and (c) that holds less than 50% of assets in loans syndicated by CLO affiliated or CLO manager affiliated lead arrangers or originators. *See* Final Rules § __.9 at 463.

[13] See "Hedging or Transferring Retention Interest" infra; *See* Final Rules at 22.
[14] *See* Final Rule § __.11 at 471-73.
[15] *See* Final Rule § __.2 at 424.
[16] *See* Final Rule § __.11 at 471-73.
[17] *See id.*
[18] *See id.* at 473-74.

Transferring or Hedging the Retention Interest[19]

Under the Final Rules, a sponsor may only transfer its retention interest to a majority-owned affiliate. Although a sponsor may finance the acquisition of its retention interest, any pledging thereof must be with full recourse to the sponsor or affiliate, as applicable.

The Final Rules generally prohibit a sponsor from any hedging materially related to the credit risk of the retention interest, or that would reduce or limit the financial exposure of the sponsor to the retention interest. Only two types of hedging are permitted under the Final Rules: hedging related to interest rate risks or certain index instruments that include the issuing entity. In effect, hedging is not particularly useful to the holder of the retention interest under the Final Rules, which is a primary reason why lead arranger banks are unlikely to be interested in acting as sponsors.

The transfer and hedging restrictions imposed by the Final Rules are required to remain in place until the *latest* of (a) the date on which the total unpaid balance of the CLO assets is reduced to one-third of the original principal amount, (b) the date on which the total unpaid principal amount of outstanding CLO securities are reduced to one-third of the total principal amount of securities issued at closing, and (c) two years after the transaction closing date.

Effectiveness

The Final Rules will go into effect two years after the publication thereof in the Federal Register.[20] Such publication is expected to occur in late 2014; accordingly, the Final Rules will likely be effective prior to the end of 2016. While CLOs issued prior to this date will be grandfathered and exempt from the Final Rules, certain refinancings, certain re-pricings and additional note issuances occurring after the effective date in respect of grandfathered transactions are precisely the sort of "organizing and initiating" activity that could bring the CLO manager within the purview of the Final Rules. Thus the impact of the Final Rules on grandfathered CLOs is of immediate concern to market participants.

It should be noted that the Final Rules will also be applicable to non-U.S. CLOs[21] unless they fall under the Foreign Transaction Safe Harbor.[22] The safe harbor is available to non-U.S. CLOs that do not sell more than 10% of the dollar value (based on fair value) of all classes of ABS interests to "U.S. Persons" in the applicable offering.[23] Importantly, secondary market resales to U.S. Persons will not be counted toward the 10% threshold.

Open Issues

Not surprisingly, the Final Rules raise a number of open issues for industry participants to grapple with in the months ahead. For example:

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[19] *See* Final Rule § __.12 at 474-78.

[20] *See* Final Rule at 2.

[21] CLOs that are not registered under the Securities Act and whose sponsor or issuing entity is neither incorporated in the US, nor has an unincorporated branch or office in the U.S. *See* Final Rule § __.20(b) at 520-21. In addition, the sponsor or issuing entity must not have acquired more than 25% of the CLO assets, as determined on unpaid principal balance, directly or indirectly, from a majority owned affiliate incorporated in the U.S. or with an unincorporated branch in the U.S. *See id.* Furthermore, compliance that is "part of a plan or scheme to evade the requirements of Section 15G and [the Final Rules]" will not have the safe harbor available. *See id.* at 521.

[22] *See id.*

[23] *See id.*

- While a sponsor is clearly permitted to finance the acquisition of retention interests on a full recourse basis, it is unclear whether recourse to a newly-formed majority owned or controlled subsidiary that has no other assets other than the retention interest it acquired with the loan would suffice.

- A sponsor is permitted to pledge its retention interest to secure the financing thereof; however the effect of a financing provider foreclosing on such pledged retention interest on such sponsor's risk retention compliance is not clear.[24]

- There is a lack of clarity surrounding how refinancings after the effective date of the Final Rules involving the utilization of a loan facility to take out the refinanced tranche or tranches will be treated in respect of grandfathered CLOs.

- It is unclear whether the removal or replacement of a CLO manager/sponsor would affect compliance with the Final Rules.

The EU Risk Retention Experience: Lessons Learned

A number of lessons can be gleaned from the CLO market's response to the capital requirements regulation of the European Union (the "EU") and the accompanying directives, which became effective on January 1, 2014 (the "EU Retention Rules"). While the EU Retention Rules and the Final Rules are far from precisely aligned, analyzing the various structures that have been implemented in an effort to achieve compliance with the EU Retention Rules is a useful starting point for evaluating potential action plans in response to the Final Rules.

Generally speaking, the EU Retention Rules prohibit European Economic Area institutions (namely credit institutions and investment firms) and certain of their consolidated group affiliates from becoming exposed to the credit risk of a securitization unless the "sponsor", "originator" or "original lender" of such securitization retains an interest of not less than 5% of the related securitized exposures.[25] Investors who fail to comply with the EU Retention Rules face substantial penal risk weights against their relevant securitization positions.[26]

While there are several similarities between the Final Rules and the EU Retention Rules, the differences between the two rules create significant challenges when it comes to devising a structure aimed at satisfying both. For example, in contrast to the Final Rules, a "sponsor" under the EU Retention Rules must be an "investment firm,"[27] and therefore must hold various authorizations and permissions from its EU home country, as required by the Market in Financial Investments Directive ("MiFID")[28]—a significant obstacle for any U.S. CLO

[24] Note that the first and second proposal state that such a foreclosure would be deemed an impermissible transfer. *See* Proposed Rule: Credit Risk Retention, at 96, available at <https://www.fdic.gov/news/board/29Marchno2.pdf>; Reproposed Rule: Credit Risk Retention, at 175, available at < https://www.fdic.gov/news/board/2013/2013-08-28_notice_dis_a_res.pdf>.

[25] *See* Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013, Article 405 at 238 (hereinafter "EU Risk Retention").

[26] *See* eg. Directive 2009/111/EC of 16 September 2009, Article 122(a)(5) at 302 (failure to comply resulting in additional risk weight).

[27] *See* EU Risk Retention, Article 4 at 18-19 (definition of sponsor and institution).

[28] *See generally* Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004.

manager that wishes to qualify as the retention holder under the EU Retention Rules. In addition, the concept of "originator" under the Final Rules is considerably narrower than its EU Retention Rules counterpart.[29] Importantly, for any entity to qualify as an originator under the EU Retention Rules, such entity must either be involved in originating obligations in the primary markets or acquiring obligations in the secondary markets for its "own account" prior to securitizing them.[30]

In response to the EU Retention Rules, a number of CLO managers have sought to establish or acquire entities that would qualify as a "sponsor". Several permanent capital vehicles have also been established to qualify as an "originator"; however, the aggressive approach taken by certain of these vehicles with respect to the duration and nature of the seasoning required to acquire assets for their "own account" before securitization has drawn some unwanted scrutiny from EU regulators.

Other CLO managers have funded the acquisition of their retention interest with a full recourse loan facility. Such facilities have generally only been made as an accommodation to large CLO managers by banks affiliated with the related CLO arranger. Although many of these loan facilities have favorable interest rates, they generally also require:

- the related loan to fund no more than 75% (25% overcollateralization) of the purchase price of the related retention interest;

- the retention interest to take the form of a vertical strip of each CLO-issued tranche; and

- full recourse to both the CLO manager/borrower and its creditworthy affiliates.

In sum, the EU risk retention experience has effectively confirmed two very basic premises: that overly-ambitious workarounds that fail to address both the letter and the spirit of risk retention will likely draw unwanted regulatory attention; and that traditional bank financing of the retention interest will be largely relationship-based, and thus available primarily to the bigger CLO managers on customary credit terms. Since the Final Rules place the onus of risk retention compliance on the CLO manager sponsor rather than the investors, it can likewise be expected that early risk retention structures will be quite conservative in nature.

Impact on the CLO Market: Opportunities for Some

It is generally feared that the Final Rules will result in widespread CLO manager consolidation and a correspondingly dramatic decrease in the role of CLOs in supporting the leveraged loan market. The degree to which these fears will be realized, however, will depend upon the ability of industry participants to develop viable risk retention-compliant structures. Fortunately, the removal of the controversial cash throttle trap and the ability of a "majority controlled" subsidiary to be an eligible holder of the retention interest would seem to have afforded market participants the necessary leeway to develop workable structures that comply with both the spirit and underlying purpose of the rules.

Drawing from the lessons learned from the EU Retention Rules, it is clear that a CLO sponsor entity wishing to achieve compliance with both the EU Retention Rules and the Final Rules will require

[29] *Compare* Final Rule § __.2 at 424 *with* EU Risk Retention, Article 4 at 19.
[30] *See* EU Risk Retention, Article 4 at 19.

significant capitalization, and can expect a protracted process when obtaining the requisite approvals and authorizations required by the MiFID. Moreover, it would appear that financing the retention interest through a traditional bank loan facility will only be an option for large CLO managers who are willing to bring guarantees from their creditworthy affiliates to the table.

However, we are very excited about a unique type of loan facility we have been working on that can be provided by non-traditional lenders with an understanding of the CLO market and an appetite for higher yield, which we hope will play an important role in sustaining those small-and mid-sized CLO managers who wish to remain in the marketplace. One of the unique aspects of this structure is the flexibility it affords the parties to essentially trade off levels of enhanced returns for principal protection in the form of overcollateralization and recourse. We believe that this type of structure will be particularly critical to those CLO managers that are receiving less than the traditional 50 basis point senior/subordinate management fees for their CLOs and cannot afford the levels of yield enhancement that permanent capital vehicles and equity investors may be demanding to finance retention interests.

Seward & Kissel's Risk Retention Task Force is in the process of developing several structural alternatives that can not only be utilized to enable risk retention compliance, but may also prove to be a viable new line of business for certain asset managers or investors.

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