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Risk Retention for Collateralized Loan Obligations (CLOs): Re-Proposal Fact Sheet.

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On August 28, 2013, the federal agencies (the "Applicable Regulators") responsible for implementing regulations under Dodd-Frank re-proposed rules for risk retention requirements in ABS transactions, including CLO transactions. The re-proposal comes more than two years after the original proposed rules, which contained only one reference to CLOs and CLO managers. The re-proposal, however, contains significant provisions regarding CLOs that could fundamentally alter the shape of the CLO market.

Public comments on the re-proposal are due October 30, 2013.

Effective Date

Absent a change by the Applicable Regulators, the risk retention requirements with respect to CLOs will become effective two years after final rules are adopted.

Basic Retention Requirement

The re-proposal confirms a 5% risk retention obligation for CLO sponsors, other than for CLOs comprised entirely of "CLO-eligible loan tranches" or "Qualifying Commercial Loans," as discussed below. The re-proposal also confirmed the view of the Applicable Regulators that the manager of a CLO (a "CLO Manager") is a "securitizer" for purposes of Section 15G of the Exchange Act.

The CLO Manager is a "Securitizer"

The Applicable Regulators confirmed their view that the CLO Manager is a "securitizer" for risk retention purposes because it "selects the commercial loans to be purchased by the CLO-issuing entity for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure". CLO Managers, therefore, are eligible risk retention entities. The re-proposal notes that a qualifying "CLO Manager" must be a registered investment adviser or an affiliate of a registered investment adviser that is managed by such registered investment adviser.

The Applicable Regulators based their conclusion regarding CLO Managers as "securitizers" on the language of the statute, which defines a "securitizer" as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer". The Applicable Regulators state that since a CLO Manager "typically organizes and initiates the transaction" (by having control over the formation of the CLO collateral pool) and 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

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purchase and sell those assets". In addition, the Applicable Regulators reinforced this position by stating their belief that exempting CLO Managers (and open market CLOs) "could enable market participants to evade the operation of the statute by employing an agent to select assets to be purchased and securitized. This could potentially render section 15G of the Exchange Act practically inoperative for any transaction where this structuring could be achieved."

Risk Retention by CLO Manager or Other Sponsor

Under the re-proposal, therefore, the retention entity for a CLO may be a CLO Manager. In addition, the retention entity may also be any other entity that qualifies as a sponsor by "selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity"[1] or any majority-owned affiliate of either. Any such entity may satisfy the retention rules by retaining, unhedged and for the life of the deal, 5% of the unpaid principal balance of the ABS interests issued by the CLO issuer. This retention can be in the form of a 5% vertical slice of the entire capital stack, a 5% horizontal piece of the first loss (equity) tranche or any combination of these two horizontal and vertical retention structures that adds up to 5%. The prohibitions on hedging include purchasing CDS or any specific instrument that reduces the financial exposure of the sponsor to the credit risk of the retained CLO securities (although hedging based on an index, such as LCDX, is permitted). In addition, the retention entity cannot transfer the retention to any entity other than a majority-owned subsidiary and cannot finance the retained interests except with full recourse to itself.[2]

Open Market CLOs

The Applicable Regulators recognized that most CLO Managers lack the financial capacity to purchase 5% of each CLO they manage. As an alternative, the re-proposal states that "**Open Market CLOs**" may satisfy the risk retention obligation by purchasing and holding nothing but "**CLO-eligible loan tranches**".

An "**Open Market CLO**" is a CLO (1) whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in **Open Market Transactions** and of servicing assets, (2) that is managed by a CLO manager, and (3) that holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO. Under the re-proposal, an "**affiliate**" is any entity that, directly or indirectly, "controls, or is controlled by, or is under common control with" any specified entity.

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[1] These sponsors will be entities, such as middle market originators or other existing funds, that are using CLOs as financing sources for existing assets and to fund origination activity. Such balance sheet CLOs are easily distinguishable from open market structures by their true sale and non-consolidation structuring.

[2] The anti-hedging restriction falls away at the latest of (1)the date the securitized assets are below 33% of the total closing date amount, (2) the date the outstanding balance of issued debt falls below 33% of the total unpaid principal amount issued on the closing date of the CLO and (3) two years.

To qualify for the alternative risk retention proposal, such Open Market CLO must meet the following criteria:

- It may acquire and hold only CLO-eligible loan tranches and "servicing assets"[3].
- Its governing documents require it, at all times, to own only **Senior, Secured Syndicated Loans**[4] that are CLO-eligible loan tranches (and servicing assets).
- It may not invest in ABS interests or in credit derivatives (other than hedging transactions that are servicing assets to hedge its payment risks).
- It may purchase assets only in open market transactions on an arms-length basis.
- Its CLO Manager is not entitled to receive any management fee or gain on sale at the time the CLO issues its notes.[5]

An "**Open Market Transaction**" is either (1) an initial loan syndication transaction or a secondary market transaction in which a seller offers senior, secured syndicated loans to prospective purchasers in the loan market on market terms on an arm's length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller, or (2) a reverse inquiry from a prospective purchaser of a senior, secured syndicated loan through a dealer in the loan market to purchase a senior, secured syndicated loan to be sourced by the dealer in the loan market.

A "**Senior, Secured Syndicated Loan**" is a loan made to a commercial borrower that: "(1) is not subordinate in right of payment to any other obligation for borrowed money of the commercial borrower; (2) is secured by a valid first priority security interest or lien in or on specified collateral securing the commercial borrower's obligations under the loan; and (3) the value of the collateral subject to such first priority security interest or lien, together with other attributes of the obligor (including, without limitation, its general financial condition, ability to generate cash flow available for debt service and other demands for that cash flow), is adequate (in the commercially reasonable judgment of the CLO manager exercised at the time of investment) to repay the loan in accordance with its terms and to repay all other indebtedness of equal seniority secured by such first priority security interest or lien in or on the same collateral, and the CLO manager certifies as to the

[3] "Servicing assets" are defined as assets designed to "assure the timely distribution of proceeds" to the noteholders and "assets that are related to or incidental to purchasing or otherwise acquiring or holding" these CLO-eligible loan tranches. While the Applicable Regulators provided no guidance to identify specific servicing assets for CLOs, such assets should include typical eligible investments and interest rate hedges designed to ensure payment on payment dates and will presumably also include work-out assets and other items received as a result of mere ownership of the eligible loans. However, given the lack of specific guidance from the Applicable Regulators, this definition has many possibilities for broad expansion. For one example: an arranging bank could mandate taking a piece of a revolving tranche as a condition of buying a term tranche, arguing that ownership of such revolving piece is "related" to owning the term piece. Given that CLOs are not registered investments, it remains an open question whether anyone would ever bring such a practice to the attention of any regulator.

[4] The re-proposal limits "Open Market CLOs" to only senior secured loans, eliminating the typical 5%-10% bucket for second lien loans, unsecured loans and fixed rate bonds. The Applicable Regulators have requested comment regarding the dangers of such 100% concentration and the wisdom of including a *de minimis* allowance for assets other than "CLO-eligible loan tranches".

[5] While there is no discussion on this point and the language could be read to prohibit management fees entirely, it seems more logical that the proposal is merely intended to ban management fees during the warehouse period. However, it is entirely unclear what the Applicable Regulators hope to accomplish by this provision of the rule.

adequacy of the collateral and attributes of the borrower under this paragraph in regular periodic disclosures to investors."[6]

CLO-Eligible Loan Tranches
A "**CLO-eligible loan tranche**" is a term loan tranche of a syndicated loan that meets (at all times) the following criteria:

- "A minimum of 5 percent of the face amount of the CLO-eligible loan tranche is retained by the **Lead Arranger** thereof until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of such CLO-eligible loan tranche." Such 5% interest must be retained un-hedged in accordance with the same anti-hedging, transferring and pledging restrictions that apply to ABS risk retention, as discussed above.
- The "lender voting rights within the credit agreement and any intercreditor or other applicable agreements governing such CLO-eligible loan tranche are defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of such applicable documents, including but not limited to, adverse changes to money terms, alterations to pro rata provisions, changes to voting provisions, and waivers of conditions precedent".
- "The pro rata provisions, voting provisions, and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any intercreditor or other applicable agreements governing documents such CLO-eligible loan tranches are not materially less advantageous to the obligor than the terms of other tranches of comparable seniority in the broader syndicated credit facility".

A "**Lead Arranger**" is an institution (term undefined) that:

- "is active in the origination, structuring and syndication of commercial loan transactions and has played a primary role in the structuring, underwriting and distribution on the primary market of the CLO-eligible loan tranche";
- "has taken an allocation of the syndicated credit facility under the terms of the transaction that includes the CLO-eligible loan tranche of at least 20% of the aggregate principal balance at origination, and no other member (or members affiliated with each other) of the syndication group at origination has taken a greater allocation"[7];
- is clearly identified in the underlying loan credit;
- represents in the underlying credit agreement that such lead arranger and the CLO-eligible loan tranche satisfy the requirements of the re-proposed rule; and
- covenants in the underlying loan agreement to undertake the required 5% retention as set forth in the definition of CLO-eligible loan tranche.

[6] Note that this definition matches the standard definition of "Senior Secured Loan" in a CLO.

[7] Note that this 20% allocation requirement raises significant concerns regarding funding limits at most syndicated loan desks.

Securitization of Qualifying Commercial Loans

The re-proposal confirms the existing proposals relating to risk retention for static pool CLOs of Qualifying Commercial Loans. For CLOs comprised entirely of Qualifying Commercial Loans, there will be no risk retention requirement. For CLOs partially comprised of such loans, the risk retention requirement of such CLO will be reduced by up to 50% based on the ratio of the unpaid principal balance of qualifying versus non-qualifying commercial loans in the pool.

Many of the underwriting standards for Qualifying Commercial Loans are very stringent. For example, such loans be originated within 6 months prior to the closing of the CLO; such loans may have a maximum 5-year term (based on straight-line amortization); and each obligor must have a total leverage ratio of 3.0x or less, a debt service coverage ratio of 1.5x or greater and a total liabilities ratio (total liabilities divided by total liabilities plus equity minus intangible assets) of 50% or less.[8]

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions regarding this Memo.

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[8] Given the strictness of the underwriting standards for Qualifying Commercial Loans and the limitations on the CLO structure, it seems unlikely that this exemption will be widely utilized.