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U.S. RISK RETENTION IN THE CLO MARKET

The risk-retention rule jointly issued by federal agencies requires that, after the Compliance Date (December 24, 2016), sponsors of securitization transactions retain 5% of the credit risk of the assets being securitized. The authors discuss the basic requirements of the rule, and its application to refinancings and indenture amendments of CLO notes. They then turn to the financing and structuring of the retained interest, and options for U.S. CLO managers to participate in the EU CLO market.

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Open market collateralized loan obligations (“CLOs”) differ significantly from the “originate to distribute” model, which the credit risk-retention rules were generally intended to address. The collateral supporting the securities issued by an open market CLO is a managed pool of commercial loans to operating companies originated by many different lenders; CLOs are generally not transactions where an entity transfers loans it owns into a securitization vehicle in a true sale in order to remove the loans from its balance sheet. The fundamental difference in the structure and management of open market CLOs as compared to balance sheet securitizations, however, poses challenges in applying the mandate of Section 941 of the Dodd-Frank Wall Street Reform Act to this sector of the market.

This article will focus on the general application of the U.S. risk-retention requirements to open market CLOs and some of the issues that have arisen as the

industry prepares for the effective date of the rule in December 2016. It will not revisit the arguments that have been raised as to whether Section 941 was intended to be, and rightly was, applied to CLOs that do not fit the “originate to distribute model” or discuss the related pending litigation.

In December 2014, the U.S. Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and, as the rule would relate to a securitization of any residential mortgage asset, the Federal Housing Finance Agency and the Department of Housing and Urban Development (collectively, the “Agencies”) adopted a rule implementing Section 941 of the Dodd-Frank Act (the “Rule”) to require that sponsors of asset-backed securitizations retain a portion of the risk

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of assets that they securitize.¹ Proponents of this mandate have argued that significant informational gaps and misaligned incentives between sponsors of and investors in residential mortgage-backed securities (“RMBS”) led to and promoted excessive risk-taking in the origination of mortgages that were packaged into RMBS in the years leading up to the financial crisis. Lawmakers believed that “originate to distribute” business models adopted by some mortgage lenders — particularly non-bank lenders funded almost exclusively by the securitization of mortgages — with new loans being originated for practically immediate sale to a securitization vehicle, created incentives for lenders to loosen underwriting standards because they would retain little or no post-securitization exposure to the underlying mortgages. The requirements for sponsors to retain exposure to a portion of the credit risk otherwise borne by investors in securitizations is intended to better align the incentives of those transferring the assets to an asset-backed securities (“ABS”) issuer and those investing in the ABS issuer’s securities. The required credit risk retention is sometimes referred to as “skin in the game.” While RMBS was clearly the market of greatest concern, Section 941 also required risk-retention rules to be promulgated for other asset classes.

The Agencies’ first proposed rulemaking to implement Section 15G of the Exchange Act was the joint notice of proposed rulemaking in March 2011.² Over 10,500 comment letters were submitted in response from all corners of the financial markets, many heavily criticizing core aspects of the rule. Due to the extensive comments, the Agencies issued a revised proposal in August 2013, which was further revised in certain respects in connection with adoption of the final rule in late 2014. Compliance with the rule is currently required for securitization transactions collateralized by residential mortgages and will be required beginning December 24, 2016 in the case of securitization

transactions (including CLOs) collateralized by any other asset classes (such date, the “Compliance Date”).

THE BASIC RETENTION REQUIREMENTS OF THE RULE

The Rule generally requires that the person organizing and initiating a securitization transaction (the “sponsor” of the transaction) retain 5% of the credit risk of the assets being securitized. Throughout the rulemaking, the Agencies were unflagging in their assertion that the CLO manager is a sponsor under the Rule 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.”³ The Agencies assert that the CLO manager transfers assets to the CLO because it “selects” and “manages” the open market CLO’s assets.

The retention requirement may be satisfied by retaining a “horizontal interest” — an interest that is subordinated to all other asset-backed interests of the issuer (“ABS interests”) — or a “vertical interest” — an interest that receives a portion of the payments made to each class issued by the securitization.⁴ A vertical interest is sufficient if it is at least a 5% portion of each class of the securitization (*i.e.*, it receives at least 5% of the payments made to each class).⁵ A horizontal interest must be the first not to be paid if funds from the assets are insufficient to make payments on all ABS interests, and the horizontal interest must represent at least 5% of the fair value of all of the ABS interests issued as part of the securitization transaction.⁶ The Rule does not specify a particular method for determining the fair value of the ABS interests issued, but requires that it be determined using a fair value framework under GAAP and that the sponsor disclose the valuation methodology used and information relating to the valuation of each class of ABS interest (including prices).⁷ The Rule permits the risk-retention requirement for a sponsor of an “open market CLO” to be satisfied if the open market CLO purchases only syndicated term loan tranches where the lead arranger has committed to retain at least 5% of the face amount of the loan.⁸ However, this

¹ Codified at 15 U.S.C. §78o–11. All citations are to the common text of the rule. The Rule was published at 79 Fed. Reg. 77602 at 77740 (Dec. 24, 2014) (the “Rule Release”). An industry trade group has challenged the Rule. See *Loan Syndications & Trading Association v. SEC*, No. 14-1240 (D.C. Cir. Filed Nov. 10, 2014)(consolidated with *Loan Syndications & Trading Association v. SEC*, No. 14-1304 (D.C. Cir. Filed Dec. 30, 2014)).

² Credit Risk Retention, 76 Fed. Reg. 24090 (Apr. 29, 2011). *Loan Syndications & Trading Association v. SEC*, No. 14-1240 (D.C. Cir. filed Nov. 10, 2014) (consolidated with *Loan Syndications & Trading Association v. SEC*, No. 14-1304 (D.C. Cir. filed Dec. 30, 2014)).

³ Rule §__.2 (definition of sponsor).

⁴ Rule §§__.5(a); __.2. The Rule also permits a combination of a vertical interest and a horizontal interest totaling 5%.

⁵ Rule §__.4(a)(1).

⁶ Rule §__.4(a)(2).

⁷ Rule §__.4(c).

⁸ Rule §__.9.

option is incompatible with the current structure of the syndicated loan and CLO markets, and is not expected to be used.

The sponsor may not transfer the required interest other than to a majority-owned affiliate until the transaction is winding down and certain thresholds have been satisfied, and neither the sponsor nor its affiliates may hedge the credit risk exposure of the required interest.⁹

The Rule also imposes certain disclosure and administrative requirements that are not addressed in this article.

TRANSACTIONS CLOSING BEFORE THE COMPLIANCE DATE

Retention Obligations for Certain Actions after the Compliance Date

Although the risk-retention requirements of the Rule apply to securitization transactions issued on or after the Compliance Date, there are certain actions that may be undertaken by a CLO issuer that was not subject to the rule initially, which, if such actions occur after the Compliance Date, would trigger the requirements. For example, an additional issuance of securities by the CLO issuer would clearly satisfy the Rule's definition of a securitization transaction: "a transaction involving the offer and sale of asset-backed securities by an issuing entity."¹⁰ Similarly, a refinancing of one or more classes of CLO notes by issuing "replacement" notes after the Compliance Date and applying the proceeds to fund the redemption of the securities being refinanced would, except in specific circumstances, subject the sponsor to the retention requirements of the Rule, at least with respect to that issuance.

In addition, amendments of material terms of the CLO notes may in some cases be viewed as an offer and sale of a new security for purposes of the Rule. For example, the Agencies have indicated that a reduction of the interest rate or "repricing" of one or more classes would be considered to be an offer and sale of asset-

backed securities. The Exchange Act, under which the Rule was promulgated, does not address when an offer or sale of securities by an issuer has occurred. However, it is reasonable to expect that the Agencies will look for guidance to similar questions that have arisen under the Securities Act of 1933. Among these questions have been whether requests for consent to amendments to an indenture governing outstanding bonds should be treated as an offer of a new security.¹¹

Uncertainty regarding the extent to which this "new security" analysis would apply to indenture amendments for purposes of Section 15G has led in recent transactions to more extensive consent rights of the CLO manager over amendments of the indenture, particularly if such amendments would result in the imposition of a risk-retention obligation.

Because retention obligations would result from certain actions of the CLO issuer after the Compliance Date, participants in recent transactions have focused significant effort and attention on these actions and the related conditions are often heavily negotiated. Some participants, particularly equity investors, in order to protect their option of directing a refinancing or a repricing of certain classes after the Compliance Date, have been successful in requiring the CLO manager (or a majority-owned affiliate) to retain CLO securities in an amount that would satisfy the Rule as if the Rule were already in effect. Other transactions have included incentives to the CLO manager to consent, such as a reduction in subordinated management fees should the CLO manager withhold consent (and, in some cases, an increase in the fee if consent is given) to a refinancing, subject to certain specified conditions. For securitizations after the Compliance Date, these concerns will largely fade into the background for refinancings, repricings, and most amendments, as discussed below, but will remain an issue for additional issuances.

⁹ Rule § __.12. In general terms, the retention interest is not permitted to be transferred except to a majority-owned affiliate until the later date on which the principal balance of the securitized assets has been reduced to one-third of the initial principal balance, the principal amount of the ABS interests has been reduced to one-third of their initial principal amount, or two years after closing.

¹⁰ Rule § __.2 (definition of securitization transaction).

¹¹ See *Abrahamson v. Fleschner*, 568 F.2d 862, 868 (2d Cir 1977) (holding that before changes in the rights of a security holder can qualify as the "purchase" of a new security, there must be such significant change in the nature of the investment or in the investment risks as to amount to a new investment); *Leasco Corp.*, SEC No-Action Letter (September 22, 1982) (no-action position taken on the basis that the proposed amendments would not affect the basic economic terms of fixed income securities, which include the "payment of principal and interest, interest rate, interest payment date, maturity date, [or] redeemability").

SEC No-Action Relief for Certain Refinancings

On July 17, 2015, the staff of the SEC issued a no-action letter to Crescent Capital Group LP granting relief from the risk-retention requirements that would otherwise apply to a refinancing of CLO notes issued in a CLO transaction that priced prior to the publication of the Rule.¹² As the basis for its request for no-action relief, Crescent Capital argued that, because the CLO it managed priced prior to the publication of the Rule, neither Crescent Capital nor the investors in the CLO transaction expected risk-retention requirements to apply to a refinancing, and, as such, the CLO's refinancing feature was not structured to accommodate risk retention.

Pursuant to the no-action letter, a refinancing of securities of a CLO transaction that priced before the Rule was published on December 24, 2014, will not be subject to the Rule if the following conditions are satisfied:

- the refinancing must be completed within four years after the original closing date of the CLO;
- the interest rate applicable to the replacement notes (the "Refinanced Notes") must be lower than the interest rate of the notes being refinanced (the "Original Notes");
- other than the reduction of the interest rate of the Refinanced Notes, after giving effect to a refinancing: (i) the CLO issuer's capital structure must be unchanged, (ii) the principal amount of the Refinanced Notes and the Original Notes must be the same; (iii) the priority of right of payment of the Refinanced Notes and the Original Notes must be the same; (iv) the voting and other consent rights of the Refinanced Notes and the Original Notes must be the same; and (v) the stated maturity of the Refinanced Notes and the Original Notes must be the same;
- the CLO issuer's investment criteria must not change as a result of the refinancing;
- no securitization of additional assets can be effected by a refinancing (*i.e.*, proceeds from the issuance of the Refinanced Notes must be used only for the redemption of the Original Notes), it being understood that the CLO manager will continue to actively manage the collateral obligations on the CLO issuer's behalf;
- no additional subordinated interests can be issued in connection with a refinancing;
- the refinancing must not cause the identity of the holders of subordinated interests to change;
- the refinancing of different classes of secured notes may occur on different dates; however, each class of secured notes must be subject to only one refinancing and the supplemental indenture executed in connection with refinancing each class must prohibit any further refinancing of the Refinanced Notes; and
- the offering document for the Refinanced Notes must, among other things: (i) include a prominent statement (*e.g.*, on the cover of the offering document) that the sponsor is not retaining a risk-retention interest contemplated by the Rule in connection with a refinancing or the Refinanced Notes; (ii) describe the interest rates of the Refinanced Notes, and confirm that all other legal and economic terms of the Refinanced Notes will be the same as the Original Notes; and (iii) include a statement in a section entitled "Credit Risk Retention" to the effect that reliance on the no-action letter does not preclude the availability of any applicable private rights of action for any violation of the federal securities laws.

MEASUREMENT OF THE RETENTION INTEREST FOR REFINANCINGS

When a class of CLO notes is refinanced, the redemption of the Original Notes is funded using the proceeds of the issuance of Refinanced Notes of the same class. The issuance of the Refinanced Notes constitutes a new securitization and, therefore, if it occurs after the Compliance Date, will be subject to the Rule unless it satisfies the criteria set forth in the no-action letter described above. Some market participants expressed concern as to whether the retention interest would be measured based on the full initial capitalization of the CLO transaction or the principal amount of the Refinanced Notes being issued, and whether the required

¹² *Crescent Capital Group LP*, SEC No-Action Letter (July 17, 2015), available at <https://www.sec.gov/divisions/corpfm/cf-noaction/2015/crescent071715-reg-rr.pdf>. The SEC noted in the no-action letter that "[i]n reaching this position, the staff has consulted with the staffs of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation."

retention interest could be satisfied through the sponsor's holding of an eligible horizontal interest.¹³

The rule defines a securitization transaction as the offer and sale of asset-backed securities by an issuing entity.¹⁴ In the case of an issuance of Refinanced Notes to fund a refinancing, the issuance and sale of the Refinanced Notes would be the issuance and sale that triggers the retention requirement. As a result, the amount required to be retained would logically be based on the principal amount of the Refinanced Notes.¹⁵

If, at the time of the refinancing, the CLO manager held Original Notes of each class being refinanced, the CLO manager could satisfy the retention obligation by applying the redemption price received for the Original Notes to the purchase of 5% of each class of Refinanced Notes being issued. These notes would qualify as an "eligible vertical interest."¹⁶

If, after giving effect to the refinancing, the CLO manager will hold 5% of the fair value of the Refinanced Notes being issued under the refinancing, in the form of ownership of the most subordinated class of notes of the CLO issuer, these notes would qualify as an "eligible horizontal interest."¹⁷ Importantly, the definition of

eligible horizontal residual interest does not require that such interest must be issued in the specific securitization transaction triggering application of the risk-retention requirements — only that such securities are an "ABS interest in the issuing entity." Thus, subordinated notes held by the CLO manager on the partial refinancing date could satisfy the risk-retention requirements if held in a sufficient amount without regard to when such securities were issued or when the CLO manager purchased them. Similarly, the CLO manager could satisfy the retention requirement through ownership of a combination of the Refinanced Notes and subordinated notes.

The foregoing analysis would apply whether the CLO transaction was subject to the Rule on the original closing date or the transaction became subject to the Rule as a result of the refinancing. If the CLO manager held notes that satisfied the risk-retention requirements prior to the refinancing (or that would have satisfied such requirements if they had been in effect), it is likely that the risk-retention requirements would be satisfied after the refinancing. In the case of an eligible horizontal interest, prior to the refinancing, the required interest would have been 5% of the fair value of all securities issued by the CLO issuer, which is unlikely to be less than 5% of the fair value of the Refinanced Notes at the time of the refinancing. If, however, there were a shortfall, the CLO manager could purchase either additional subordinated notes in an amount required for its total holdings to qualify as an eligible horizontal interest or a portion of the Refinanced Notes in an amount qualifying as an eligible vertical interest (or a combination of an eligible horizontal interest and eligible vertical interest) in order to satisfy the risk-retention requirements of the Rule.

FINANCING THE RISK-RETENTION INTEREST

Many CLO managers consider it essential that they obtain financing for all or a portion of the retention

¹³ The analysis that follows was discussed with SEC staff members. In response to a question as to whether the SEC would provide written guidance on the question, staff indicated that the analysis was "sufficiently unambiguous as to not need guidance." A former staff member of the SEC, who participated in the consideration of the matter prior to his departure, has subsequently made similar reports as a panelist at CLO conferences.

¹⁴ Rule §_2 (definition of securitization transaction).

¹⁵ Rule Release 77614. Language was added to the Rule "clarifying that the requisite percentage of eligible vertical interest, eligible horizontal residual interest, or combination thereof retained by the sponsor must be determined as of the closing date of the securitization transaction.

¹⁶ "Eligible vertical interest means, with respect to any securitization transaction, a single vertical security or an interest in each class of *ABS interests in the issuing entity issued as part of the securitization transaction* that constitutes the same proportion of each such class." Rule §_2 (definition of eligible vertical interest, emphasis added).

¹⁷ "Eligible horizontal residual interest means, with respect to any securitization transaction, an ABS interest in the issuing entity: (1) That is *an interest in a single class or multiple classes in the issuing entity*, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition; (2) With respect to which, on any payment date or allocation

footnote continued from previous column...

date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts payable to the eligible horizontal residual interest prior to any reduction in the amounts payable to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) That, with the exception of any non-economic REMIC residual interest, has the most subordinated claim to payments of both principal and interest by the issuing entity." Rule §_2 (definition of eligible horizontal interest, emphasis added).

interest. The Rule does allow the retention interest to be pledged in a financing, but only if such financing is with full recourse to the CLO manager (or majority-owned affiliate holding the interest).

In recent transactions, financing for a portion of vertical interests has been provided by anchor equity investors, banks, insurance companies, and other financial institutions. Uncertainly regarding rights of foreclosure on the retention interest in the case of a default has caused some lenders to be reluctant to provide such financing. A number of lenders took the view initially that a right of the borrower to pledge the interest inherently included a right of the lender to foreclose, and that the resulting transfer of the retention interest to the lender would be an involuntary transfer by the CLO manager and therefore, absent fraud or an intent to evade the rule, should be permissible under the Rule. However, the SEC staff indicated informally that certain of the Agencies would consider the transfer of the retained interest in a foreclosure to be a transfer of the retained interest in violation of the Rule. As a result of this informal feedback, many CLO managers have been unwilling to sign on to a financing that includes a right of foreclosure. This presumed lack of foreclosure rights has led to a more limited number of lenders and higher finance charges. In some financing transactions, the CLO managers have agreed to foreclosure after a specified standstill period during which the CLO manager presumably would seek refinancing. In others, the CLO managers have refused to allow foreclosure under any circumstance. In some cases, lenders have attempted to mitigate these restrictions through shorter maturities on the financing and/or early amortization through application of management fees to the principal balance of the financing based on certain financial covenants. As CLO managers consider the economic benefits of continuing to participate in the CLO market, the availability and cost of financing will certainly be an important consideration.

STRUCTURING THE RISK-RETENTION INTEREST

A typical balance sheet securitization is generally not affected by the performance (or existence) of the sponsor of the transaction (considered separately from any capacity as servicer), other than to the extent of any repurchase obligations of the sponsor, or in revolving structures where the securitization may continue to obtain assets from the sponsor. In contrast, because CLOs are actively managed, the performance of the ABS issued by the CLO is affected by the continued performance of the CLO manager. As a result, CLO investors, particularly equity investors but also investors in the debt classes, are typically concerned about the

future viability of the manager of a CLO and the manager's continued participation in new CLO transactions as indicators that the manager will have resources and expertise to manage the portfolio of loans throughout the life of the CLO. Therefore, risk retention, and CLO managers' plans for complying with the risk-retention requirements of the Rule in post-Compliance Date transactions, have been a key component of many investors' review of current transactions, and the importance of such provisions will increase as the Compliance Date approaches.

An analysis of the various structures being developed and implemented is beyond the scope of this article, but suffice it to say this continues to be a topic of great interest and import to CLO managers. Determining how to raise and employ third-party capital in a retention structure without running afoul of the Rule's hedging restrictions or restrictions on limited recourse financing, and in a manner that ultimately provides sufficient economic benefits to CLO managers for them to continue participating in the CLO market, has created a number of challenges. The most one can say with confidence at this point in the development of these structures is that there is not any one structure that will work for all CLO managers and that it is inevitable that some CLO managers will leave the market, including not only smaller CLO managers whose options may be greatly limited by their size but also some large managers who determine compliance with the risk-retention requirements is not the best use of their capital.

U.S. AND EU RISK-RETENTION REQUIREMENTS

Options for U.S. CLO managers to actively participate in the European CLO market have been limited. Under the European Union risk-retention regime, the risk-retention requirements must be satisfied by a "sponsor" or an "originator." Because of EU restrictions that require CLO managers to be subject to EU regulation in order to act as a "sponsor," unless the U.S. CLO manager has an EU affiliate that is able (and willing) to act as sub-advisor to the CLO, this option is not available.¹⁸ Accordingly, the primary approach for U.S. CLO managers has been through the use of an originator structure. Simply put, in this structure an "originator" assembles and sells to the CLO issuer a

¹⁸ There are a number of CLO managers with advisory affiliates in the EU that would qualify as a sponsor but which have chosen not to take this path, presumably, at least in part, due to tax and regulatory implications of such an arrangement.

portfolio of assets that constitutes all or a portion of the CLO issuer's initial portfolio and continues to provide at least a portion of the assets in which the CLO issuer reinvests. The portion of the CLO's assets that must come from the originator varies depending upon whether the originator also serves as the CLO manager. In theory at least, if an originator were the CLO manager or a majority-owned affiliate of a CLO manager, an originator structure could be designed to satisfy both U.S. and EU requirements. A few U.S. CLO transactions have been structured with this objective and many more are being considered.

Policy constraints on the use of third-party funding to satisfy risk-retention requirements have led to

uncertainty regarding the structuring and operation of originators almost since their first appearance on the EU risk-retention scene. Because of this uncertainty, many EU investors (who, through capital regulations, bear the burden of compliance of the transaction with the EU risk-retention requirements) have shied away from investing in CLOs that rely on originator structures. As U.S. CLO managers move closer to finalizing their initial structures for achieving compliance with the Rule before the Compliance Date and as such structures are refined after the Compliance Date for greater efficiency in satisfying both U.S. and EU risk retention requirements, it is likely that there will be continued pressure on the EU regulators for more clarity on acceptable originator structures. ■

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