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On the CLO Horizon—Regulations Expected to Impact CLOs

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In July 2010 the U.S. Congress passed, and President Obama signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in order to address, among other things, perceived abuses in the securitisation markets occurring during the years preceding the financial crisis of 2008.

Three months earlier, the U.S. Securities and Exchange Commission ("SEC") issued its Asset-Backed Securities Release (Securities Act Release No. 9117; Exchange Act Release No. 61858; referred to as the "ABS Reform Release") proposing significant revisions to its Regulation AB and other rules governing asset-backed securities ("ABS").

Although as of the date of this writing most of the regulations required by the Dodd-Frank Act relating to ABS and the regulations proposed in the ABS Reform Release have not been issued as final rules, the Dodd-Frank Act and the ABS Reform Release will have a significant effect on offerings of collateralised loan obligations ("CLOs") in the U.S.

Other changes in U.S. laws will also affect CLOs. The U.S. Emergency Economic Stabilization Act of 2008 added Section 457A to the U.S. Internal Revenue Code (the "IRC"). Section 457A significantly affects the fees which may be charged by CLO managers (that are subject to U.S. tax) to non-U.S. corporations, including non-U.S. CLO issuers (such non-U.S. corporate CLOs are referred to as "CLOs" in the tax discussion below). In addition, the so-called "FATCA" provisions of the U.S. Hiring Incentives to Restore Employment Act (the "HIRE Act"), which was signed into law by President Obama in March 2010, impose significant withholding, documentation and reporting requirements on certain payments made to non-U.S. entities, including most CLOs.

Finally, although perhaps not as obvious to participants in the U.S. CLO market, regulatory changes adopted by international organisations, such as the European Banking Authority (formerly the Committee of European Banking Supervisors), also significantly affect the CLO landscape.

Dodd-Frank Wall Street Reform and Consumer Protection Act

Subtitle D of Title IX of the Dodd-Frank Act requires changes to the ABS securitisation process. The legislation defines an "asset-backed security" in a way that includes CLO securities.

Definition of Asset-Backed Security

Prior to the Dodd-Frank Act, the term "asset-backed security" was defined in Regulation AB ("Reg AB"), promulgated by the SEC under the U.S. Securities Act of 1933 (the "Securities Act"), as a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period ("Reg AB ABS"). [See Endnote 1.] The definition also includes several conditions, including that the activities of the issuing entity for the ABS are limited to passively owning or holding the pool of assets, issuing the ABS and incidental activities. CLO securities typically have not satisfied the requirements of the definition of Reg AB ABS; this has not been a problem because CLO securities have been marketed as private placements and currently Reg AB is applicable only to public offerings of ABS registered with the SEC.

However, the Dodd-Frank Act adopted a broader definition of "asset-backed security" ("Exchange Act ABS") in its amendments to the U.S. Securities Exchange Act of 1934 (the "Exchange Act"). [See Endnote 2.] A CLO security falls within the Dodd-Frank Act's definition of asset-backed security, which specifically includes any collateralised debt obligation and generally includes securities collateralised by self-liquidating financial assets (such as loans) that allow holders of the securities to receive payments that depend primarily on the cash flow from those assets. As a result, many of the changes imposed by the Dodd-Frank Act on offerings of Exchange Act ABS will apply to CLO issuers.

Credit Risk Retention

The Dodd-Frank Act amended the Exchange Act to add a new Section 15G, which required the SEC and Federal banking agencies (the "Agencies") jointly to adopt regulations requiring any securitiser to retain an unhedged economic interest in at least 5% of the credit risk of any assets that the securitiser, through the issuance of an ABS, transfers to a third party. A securitiser is the issuer of the ABS or an entity that organised and initiated the ABS transaction by transferring assets, directly or indirectly, to the issuer. Section 15G also directed the Agencies to allocate risk retention obligations between a securitiser and an originator in the case of a securitiser that purchases assets from an originator. An originator is the person who, through the extension of credit or otherwise, creates a financial asset that collateralises an ABS and sells an asset directly or indirectly to a securitiser. In March 2011, the Agencies issued their jointly proposed rules (the "CRR Proposal") to implement the credit risk retention requirement.

The CRR Proposal provides that a "sponsor" of an ABS transaction (which is the entity that organises and initiates a securitisation transaction by selling or transferring assets to the issuing entity) is the securitiser which must satisfy the risk retention requirement.

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[See Endnote 3.] The Agencies believed this to be appropriate in light of the active role of a sponsor in arranging a securitisation transaction and selecting the assets to be securitised. In the context of CLO transactions, the Agencies identified the CLO manager as the sponsor, and accordingly as the entity which must satisfy the risk retention requirement, because "the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure". [See Endnote 4.]

The Agencies proposed various options for satisfying the credit risk retention requirement. These options include: (i) vertical risk retention, which a sponsor may satisfy by retaining at least 5% of each class of ABS interests issued as part of the securitisation transaction; (ii) horizontal risk retention, which the sponsor may satisfy by retaining an eligible residual interest (i.e., a first loss position) equal to at least 5% of all ABS interests issued or, alternatively, by funding a cash reserve account in the same amount to bear the first loss on securitised assets; (iii) L-shaped risk retention, which the sponsor may satisfy by retaining a combination of vertical and horizontal exposure to the credit risk of the securitised assets (which a sponsor may satisfy by retaining an exposure of 2.5% of each tranche, plus an additional exposure to the residual interest equal to 2.564% of all ABS interests issued in the securitisation transaction net of those retained by the sponsor); and (iv) representative sample risk retention, which the sponsor may satisfy by retaining a randomly selected sample of assets equivalent to the assets which are securitised in an amount equal to at least 5% of the unpaid principal balance of the pool of assets. The Agencies also authorised other risk retention options specific to securitizations using revolving master trusts, asset-backed commercial paper, commercial mortgages, U.S. government sponsored enterprises and excess spread. The CRR Proposal also requires disclosure to investors prior to the sale of the ABS, and to the applicable Agencies upon request, regarding credit risk retention by the sponsor.

The CRR Proposal permits a sponsor that used the vertical risk retention or horizontal risk retention options to allocate a portion of its risk retention obligations to any originator that contributed at least 20% of the assets in the securitisation. The Agencies concluded that only the original creditor under a loan is the originator for these purposes.

In addition, the CRR Proposal: (i) prohibits the sponsor from transferring any of the retained credit risk except to an affiliate whose financial statements are consolidated with those of the sponsor; and (ii) prohibits a sponsor and its affiliate from purchasing or selling a financial instrument, or entering into an agreement, derivative or other position if (A) payments are materially related to the retained credit risk, and (B) it in any way reduces or limits the financial exposure of the sponsor or its affiliate to the retained credit risk. The CRR Proposal also prohibits a sponsor or its affiliate from pledging as collateral for any of its obligations any interest that the sponsor is required to retain, unless the lender has full recourse to the sponsor or its affiliate.

The Agencies proposed that there would be no risk retention requirement for ABS collateralised exclusively by one of the asset classes specified in the proposed rules if the assets satisfy new underwriting standards. Commercial loans are one of the asset classes where the sponsor is not required to retain any risk if the loans satisfy the new underwriting standards. In order for a CLO to qualify for zero risk retention, the CLO must be collateralised solely by commercial loans and may not invest in any other asset class. A CLO which qualifies for zero risk retention may only invest in a commercial loan which satisfies the underwriting standards proposed by the Agencies, which require the originator to have determined, among other things, that during the two most recently completed fiscal years and the two-year period after the closing of the commercial loan, the borrower had, or is expected to have: (i) a total liabilities ratio of 50% or less; (ii) a leverage ratio of 3.0 or less; and (iii) a debt service coverage ratio of 1.5 or greater. In addition, the loan documents for each commercial loan acquired by the CLO must satisfy minimum standards, including standards for repayment terms, maturity, security interests (if the loans are secured), and affirmative and negative covenants. Only a CLO which has no reinvestment period can qualify for this exemption from the risk retention requirement. [See Endnote 5.] Finally, the "depositor" [see Endnote 6] of the assets is required to make certifications regarding its process for ensuring that the securitised commercial loans satisfy the applicable requirements, which the sponsor is required to deliver to investors (and to the applicable Agencies upon demand). If a sponsor that relies on this exemption from the risk retention requirement learns after the closing of the securitisation transaction that a loan does not satisfy the underwriting requirements, the sponsor will not lose the exemption if it repurchases the loan, it promptly provides notice of the repurchase to the investors and the depositor has complied with the initial certification requirement.

Securitisations conducted outside the United States which do not have a significant effect on underwriting standards and risk management practices in the U.S. or the interests of U.S. investors will not be subject to this proposed risk retention requirement. To this end, the Agencies provided a safe harbour exemption that would make the risk retention requirement inapplicable to the sponsor of a non-U.S. securitisation transaction. In order to qualify for this exemption, the securitisation transaction must meet several requirements, including: (i) the securitisation transaction is not required to be registered with the SEC under the Securities Act; (ii) no more than 10% of the dollar value by proceeds of all classes of ABS interests sold in the transaction are sold to, or for the account or benefit of, U.S. persons; (iii) neither the sponsor nor the issuing entity is (A) organised under the laws of the U.S. or a U.S. state or territory or (B) the unincorporated branch or office located in the U.S. of an entity not organised under the laws of the U.S. or a U.S. state or territory (collectively, a "U.S.-located entity"); and (iv) no more than 25% of the assets collateralising the ABS were acquired by the sponsor, directly or indirectly, from a consolidated affiliate of the sponsor or issuing entity that is a U.S.-located entity.

The Agencies requested that comments on the CRR Proposal be submitted by June 10, 2011. For CLOs the risk retention rules will not become effective until two years after the date on which the final rules are published in the U.S. Federal Register.

Third Party Due Diligence

The Dodd-Frank Act added a new Section 15E(s)(4)(A) to the Exchange Act, which requires an issuer or underwriter of any Exchange Act ABS to make publicly available the findings and conclusions of any third party due diligence report obtained by it. To implement Section 15E(s)(4)(A) for privately placed securities (including CLOs), the SEC proposed in October 2010 to adopt a new rule (Rule 15Ga-2) and a new form (Form ABS-15G).

Rule 15Ga-2 would require the issuer to file the new Form ABS-15G to disclose the findings and conclusions of any third party engaged to perform a review for private placements of ABS not registered with the SEC. Rule 15Ga-2 would also require underwriters (which the SEC interpreted to include placement agents and initial purchasers in private placements) to file Form ABS-15G with the same information for any such report obtained

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by an underwriter or placement agent for ABS. The SEC proposed that Form ABS-15G would be required to be filed five business days prior to the first sale of the ABS.

Whether the collateral manager hired by a CLO issuer would be considered a "third party engaged for the purposes of performing a review" was not specifically addressed by the SEC. Section 15E(s)(4) of the Exchange Act addresses "due diligence" services, which may be viewed as a subset of the services which a CLO manager provides to a CLO issuer. In its final release adopting Rule 193 under the Securities Act (which requires issuers to review assets underlying ABS offerings registered with the SEC), the SEC postponed its adoption of rules to implement Section 15E(s)(4)(A) of the Exchange Act until the SEC adopts rules to implement all of Section 15E(s)(4), which the SEC anticipates proposing later in 2011. Hopefully the SEC will provide more clarity on what does and does not constitute due diligence services and due diligence reports in the context of a CLO when it issues these proposed rules.

The Volcker Rule

Section 619 of the Dodd-Frank Act (commonly referred to as the "Volcker Rule") prohibits a "banking entity" [see Endnote 7] from acquiring or retaining an equity, partnership, or other ownership interest in, or sponsoring, any hedge fund or private equity fund. The terms "hedge fund" and "private equity fund" include any issuer that does not register with the SEC as an investment company under the U.S. Investment Company Act of 1940 (the "Investment Company Act") based on the exceptions in Section 3(c)(1) or Section 3(c)(7) thereof, and any "similar fund". Most (but not all) CLOs have been structured as either "3(c)(1)" or "3(c)(7)" vehicles, which limit investors (or, in the case of CLOs domiciled outside of the United States, U.S. investors) to 100 persons or to "qualified purchasers" (as defined in Section 2(51)(A) of the Investment Company Act). Therefore, many managed or "arbitrage" CLOs will fall under the purview of the Volcker Rule as currently drafted, despite the fact that CLOs are not regarded by market participants as hedge funds or private equity funds.

Many banks use what is commonly referred to as a "balance sheet" CLO for regulatory capital efficiency. In a "balance sheet" CLO a bank transfers loans (or the credit risk of the loans) from its balance sheet to the CLO and holds all or a substantial portion of the equity in the CLO. If a balance sheet CLO is structured as a Section 3(c)(1) or Section 3(c)(7) vehicle, the prohibitions on banking entity sponsorship and ownership contained in the Volcker Rule would apply. Interestingly, as discussed above under *Credit Risk Retention*, the bank, as the securitiser, would be required to retain 5% of the credit risk of its balance sheet CLO—a requirement which appears inconsistent with the Volcker Rule.

In addition, the Volcker Rule may restrict the warehouse arrangements used to accumulate loans for a CLO. Prior to the closing of a CLO, the placement agent often provides a warehouse facility to the CLO which enables the CLO to acquire most of its portfolio of loans prior to the issuance of the CLO securities. If the placement agent is a banking entity and it is regarded as a sponsor or adviser to the CLO, then this warehouse facility could constitute a prohibited covered transaction under Section 23A of the U.S. Federal Reserve Act. The Volcker Rule does provide some flexibility to a banking entity which organises and offers the CLO, in that it allows a banking entity to make and retain an investment in a hedge fund or private equity fund for purposes of establishing the fund and providing it with a sufficient initial equity investment to permit it to attract unaffiliated investors. However, the banking entity actively must reduce its investment such that, no later than one year (subject to extension by the Federal Reserve for two additional years) after the establishment of the fund (which in this case would be the CLO), the banking entity's investment has been reduced to less than 3% of the total ownership interests in the fund and is immaterial (to be defined by rule) to the banking entity; the investment of the banking entity in all such funds is not permitted to exceed, in the aggregate, 3% of the Tier 1 capital of the banking entity.

These problems can be avoided if the regulations implementing the Volcker Rule do not treat CLOs as "hedge funds" or "private equity funds". Alternatively, CLOs can escape the Volcker Rule if they are offered without relying on Section 3(c)(1) or Section 3(c)(7). Many balance sheet CLOs and some managed or arbitrage CLOs have been structured to qualify for the SEC's Rule 3a-7 exemption for issuers of ABS. However Rule 3a-7 imposes many restrictions and is best suited for static or very lightly managed CLOs (especially static balance sheet CLOs) that do not invest in credit default swaps.

Conflicts of Interest

The Dodd-Frank Act adds a new Section 27B to the Securities Act entitled "Conflicts of Interest Relating to Certain Securitizations". Section 27B(a) states that an underwriter, placement agent, initial purchaser or sponsor (or any affiliate thereof) of ABS (including synthetic ABS) shall not, for a period ending one year after the first closing of the sale of the ABS, engage in any transaction that would involve or result in any material conflict of interest with any investor in the ABS. This prohibition does not apply to hedging activities in connection with positions arising out of the underwriting, placement, initial purchase or sponsorship of ABS, purchases or sales of ABS made pursuant to commitments of the underwriter, placement agent, initial purchaser or sponsor (or any affiliate thereof) to provide liquidity for the ABS, or *bona fide* market-making in the ABS.

Section 27B resulted from hearings on the financial crisis held in April 2010 by the Senate Permanent Subcommittee on Investigations. One of the "most dramatic findings" of the subcommittee hearings was that some firms were "betting against financial instruments they are assembling and selling". [See Endnote 8.] The intent of Section 27B, according to its sponsors, Senators Jeffrey Merkley and Carl Levin, is to prohibit securitisation participants from intentionally designing ABS to default in order to profit from the default. [See Endnote 9.]

The Dodd-Frank Act requires the SEC to issue rules implementing Section 27B by April 15, 2011. As of the date of this writing, those rules have yet to be proposed. Some ABS market participants have encouraged the regulators to adopt a rule which applies only to the specific conflict of interest identified by the Senators; however, Section 27B refers more broadly to any material conflict of interest between certain securitisation participants and investors. Many conflicts of interest arise in the ordinary course of securitisation transactions. If the rule prohibits these types of conflicts of interest, then it may adversely affect the CLO market.

For example, placement agents of CLOs provide warehouse lines to finance a CLO's purchase of assets. Because the proceeds from the issuance of the CLO securities are used to repay this financing, it does create a potential conflict of interest for the placement agent and, as a result, a broad interpretation of Section 27B could restrict these warehouse lines. The risk retention requirement of the Dodd-Frank Act also could create potential conflicts of interest, because it may result in a sponsor holding classes of securities whose interests may or may not be aligned with those of other investors. A sponsor or its affiliate may provide credit enhancement to a CLO (such as a guarantee) which creates a potential conflict of interest with holders of CLO securities. Many of the financial institutions that

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participate in the CLO market are comprised of multiple affiliates, offices and business units, any one of which may, independently of the CLO desk, engage in activities that result in potential conflicts of interest with investors. Many investors receive financing from an underwriter or sponsor to purchase CLO securities, which also may create conflicts of interest.

If the rule applies Section 27B to the manager of a CLO (as a "sponsor"), additional potential conflicts of interest may arise from the activities of the manager. A collateral manager may acquire loans on behalf of other funds or accounts that it manages that would be appropriate investments for the CLO, so that the manager's other funds and accounts are competing with the CLO for investments. A collateral manager may engage in "agency cross" transactions in which the collateral manager or an affiliate acts as a broker for compensation for both the CLO and the other party to the transaction. The collateral manager may also engage in "client cross" transactions in which the collateral manager or an affiliate causes a transaction between a CLO and another fund or account of the collateral manager. A collateral manager may be entitled to receive an incentive fee and it (or an affiliated fund) may hold subordinated CLO securities, which may cause the manager to take greater risks to the detriment of investors in senior classes of CLO securities.

Depending on what conflicts of interest the final rule restricts, Section 27B may have an adverse impact on the CLO market and may change the way CLOs are structured and managed.

Synthetic CLOs–Loan Total Return Swaps and the Dodd-Frank Act

Loan total return swaps ("LTRS") are swaps that create economic exposure to a loan or a portfolio of loans on a leveraged basis without transferring ownership of the loans. At the end of the transaction, or at pre-determined time periods, the counterparty will make a payment to the swap dealer in an amount equal to the decline in value of the loans or the swap dealer will make a payment to the counterparty in an amount equal to the increase in value of the loans. During the life of the transaction, the counterparty will receive from the swap dealer cash flows received on the loans and, in exchange, the counterparty will make periodic payments to the swap dealer equal to the financing cost of an investment in the loans. Typically, the swap dealer will own the loans, but it is not required to own the loans. At the end of the transaction, the counterparty may have the option to purchase the loans from the swap dealer at the then prevailing market price.

Under the Dodd-Frank Act, a LTRS on a single loan is a "security-based swap" and a "security" and is now subject to the jurisdiction of the SEC and the anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act. In addition, LTRS on a single loan must be traded with a counterparty that is an "eligible contract participant" [see Endnote 10] unless there is an effective registration statement for the LTRS. A LTRS on a portfolio of loans is probably not a "security-based swap", but is a "swap" under the Dodd-Frank Act and, as a result of the Dodd-Frank Act's amendments to the Commodity Exchange Act ("CEA"), subject to the jurisdiction of the U.S. Commodity Futures Trading Commission ("CFTC") and the anti-manipulation provisions of the CEA.

The Dodd-Frank Act requires the SEC and the CFTC to designate the types of swaps that must be cleared through a derivatives clearing organisation ("DCO"). The Dodd-Frank Act requires the SEC and the CFTC to adopt rules prescribing how they will determine whether a swap should be cleared. The CFTC has proposed a rule to set out the process for DCOs to submit swaps to the CFTC and for the CFTC to review them before making such a determination. The Dodd-Frank Act also requires the SEC and the CFTC on an ongoing basis to review swaps that have not been accepted for clearing by a DCO to make a determination as to whether the swaps should be cleared. LTRS are not currently being cleared by any DCO and it may be unlikely given the customised nature of the product that LTRS will be cleared in the near future. However, uncleared swaps may be subject to higher capital and margin requirements than cleared swaps, which could increase the cost of entering into LTRS. In addition, a counterparty to an uncleared swap may request that the swap dealer segregate its initial margin with a third party custodian, which may also increase the cost of the LTRS.

Swap dealers will also need to comply with business conduct standards when they enter into any swap, including LTRS. These business conduct requirements include disclosing specific information to their counterparties, including the material risks and characteristics of the swap, material incentives or conflicts of interest, and the daily mark of the transaction. In addition swap dealers must communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith. There are additional requirements for swap dealers acting as advisors or transacting with counterparties that are "special entities" (such as pension funds and municipalities). These new duties may change the way that dealers transact in the LTRS market and result in higher transaction costs.

Other Dodd-Frank Act Amendments

Other provisions of the Dodd-Frank Act make major changes in the offering of ABS and the operations of ABS issuers, but are unlikely to affect CLO transactions because they relate only to ABS registered with the SEC and sold in public offerings, and CLO securities are typically offered and sold in private transactions. There are also provisions of the Dodd-Frank Act that address features of ABS transactions which are generally not present in CLO transactions.

Investment Adviser Registration

Prior to the enactment of the Dodd-Frank Act, a manager of a CLO was not required to register with the SEC as an "investment adviser" under the U.S. Investment Advisers Act of 1940 (the "Advisers Act") if, during the preceding 12-month period, the investment adviser had fewer than 15 clients and did not hold itself out to the public as an investment adviser, unless it acted as an investment adviser to an investment company registered with the SEC or to a business development company registered with the SEC. As a result, without registering as an investment adviser, a manager could advise up to 14 "private funds", which are funds that are not required to register with the SEC under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Most hedge funds and most (but not all) CLOs rely on Section 3(c)(7) (and less frequently, Section 3(c)(1)), and as a result many collateral managers of CLOs were not required to register with the SEC if they managed up to 14 CLOs and other private funds—even if there were more than 14 investors in those CLOs and private funds. However, effective July 21, 2011, this exception will no longer be available and collateral managers of CLOs, if they are not already registered with the SEC, will be required to register with the SEC. The Dodd-Frank Act does include exceptions to the requirement to register with the SEC as an investment adviser; however, given the size of most CLO transactions and the likelihood that a manager has more than one CLO (and possibly other funds) under management,

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it is unlikely that the exceptions will be available to collateral managers of CLOs. For CLO managers that do not maintain an office in the United States (and do not hold themselves out as investment advisers in the United States, or advise investment companies or business development companies registered with the SEC), there is an exception to this new requirement if the manager has fewer than 15 U.S. clients and investors in private funds and limits the investment by U.S. residents in CLOs and other funds and accounts advised by it to less than $25 million.

ABS Reform Release

If the proposals in the ABS Reform Release relating to the offering process for "structured finance products" are adopted by the SEC, the effect on CLO offerings in the U.S. will be significant.

Definition of Structured Finance Product

Currently Reg AB has little or no direct effect on CLOs because it applies only to public offerings of Reg AB ABS registered with the SEC, whereas CLO securities are privately placed with investors and, therefore, are not required to be registered with the SEC. (Most CLO securities also do not qualify as Reg AB ABS.) However, the ABS Reform Release imposes new requirements on a private placement of any "structured finance product", [see Endnote 11] including a CLO security, if the private placement is made pursuant to Rule 506 of the SEC's Regulation D or the SEC's Rule 144A.

Information Requirements

As part of the ABS Reform Release, the SEC proposed a new requirement that a structured finance product, such as a CLO, could not be privately placed in reliance upon the exemptions from registration of the securities with the SEC provided to resellers under Rule 144A or to issuers under Rule 506 of Regulation D, unless the indenture (or similar document) contains a covenant requiring the issuer to provide to any initial purchaser, any security holder and any prospective purchaser of its securities, upon request, the same information which would be made available to investors in a public offering of ABS registered with the SEC (including ongoing reports). CLO securities have typically been offered as private placements under the SEC's Rule 144A and would be subject to this new requirement. Therefore a CLO issuer would be required to prepare disclosure documents that include the information that would be required to be in a prospectus for a public offering registered with the SEC, and an asset data file and computerised waterfall programme. The ABS Reform Release and the guidelines in the existing Reg AB do not specify the type of disclosure which would be required by CLOs. However it is clear that CLO offering materials will be required to include much more information than in the past, including loan-level data. For example and by comparison, for Reg AB ABS backed by corporate debt securities, the ABS Reform Release would require disclosure to investors of general information regarding each asset (including identification number, origination date, original and current balance, original and current term to maturity, original and current interest rate, interest calculation method and delinquency status) and other data such as the obligation currency, payment frequency, and whether or not the obligation is callable.

In addition, the changes to Rule 144A and Rule 506 would require a CLO issuer to prepare annual reports meeting the requirements of Form 10-K, distribution reports meeting the requirements of Form 10-D, and current reports meeting the requirements of Form 8-K under the Exchange Act. This would likely require updates to the loan-level information included with the original offering documents. In a comment letter submitted to the SEC, the Loan Syndication and Trading Association suggested that, if the SEC determines that the content of ongoing reports should be prescribed by regulation, then the data points for corporate loans should be limited to the loan-level data which market participants in the CLO market have come to expect: (i) identity of the asset; (ii) identification number; (iii) borrower, guarantor or other obligor; (iv) principal balance; (v) interest rate (or spread over the applicable index); (vi) maturity date; (vii) country in which the issuer, borrower or selling institution is organised; (viii) public ratings; and (ix) market value for defaulted loans.

Finally, the SEC proposed a new rule (Rule 192) which would require any issuer of a privately-placed structured finance product that had covenanted to provide the information required by Rule 144A, Rule 506 or the SEC's Rule 144 [see Endnote 12] to provide such information, upon request. The SEC could bring an enforcement action under this rule if the issuer failed to comply with this requirement.

A CLO would not be subject to these requirements if it privately placed its securities under Section 4(2) of the Securities Act, which provides an exemption from registration for transactions by an issuer not involving any public offering, provided that it did not rely upon the Rule 506 safe harbour and did not permit resales of its securities to be made under the Rule 144A safe harbour. However, private placement of CLO securities under Section 4(2) presents many difficulties; for example, this would diminish the liquidity of the CLO's securities because it is more difficult for an institutional investor to resell a CLO security in the U.S. market if it cannot rely on Rule 144A.

Form 144A-SF and Form D

The SEC also proposed a new requirement that any issuer of a structured finance product offered under Rule 144A file a notice with the SEC. The notice, which would be filed on new Form 144A-SF, would be signed by the CLO issuer and filed (electronically via the SEC's electronic filer system known as "EDGAR") with the SEC no later than 15 calendar days after the first sale by the CLO of its securities.

Form 144A-SF would include information regarding: (i) the major participants in the securitisation; (ii) the date of the offering and initial sale; (iii) the type of securities being offered; (iv) the structure of the securitisation; (v) the loans in the underlying pool; and (vi) the principal amount of the securities offered. In the notice the CLO issuer would undertake to provide its offering materials to the SEC upon request.

The SEC also proposed to amend Form D, which is the notice filed with the SEC after a private placement of securities in reliance upon Regulation D, to require the issuer to file with the SEC the same information required in proposed Form 144A-SF.

Internal Revenue Code Section 457A

Under IRC Section 457A, compensation payable by a non-U.S. corporation (established in a tax haven jurisdiction where such non-U.S. corporation is not engaged in a U.S. trade or business) is generally includible in the gross income of a service provider that is subject to U.S. tax, such as a CLO manager, when there is no "substantial risk of forfeiture" of the right to such compensation. Generally, compensation is considered subject to a substantial risk

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of forfeiture under IRC Section 457A only if a person's right to such compensation is conditioned upon the future performance of substantial services. Typically, fees paid by a CLO to its collateral manager are subject to IRC Section 457A, because a CLO is generally organised in a tax haven jurisdiction, like the Cayman Islands, and it does not derive its income from business activities in the United States. [See Endnote 13.]

CLO managers are typically paid fees pursuant to "waterfall" provisions in the applicable indenture which specify the priority of distributions to investors and to service providers as cash from the underlying portfolio is received. Although the "senior fee" paid by a CLO to a manager usually is not contingent, CLO managers also generally charge "subordinated fees" and "incentive fees" which are typically at (or near) the bottom of the waterfall, and the payment of such fees is generally not subject to a "substantial risk of forfeiture" within the meaning of IRC Section 457A. There is a real risk that the amount of such fees would not be determinable and paid by the deadline under IRC Section 457A and, as a result, CLO managers that are subject to U.S. tax would be subject to an additional 20% tax and interest penalty charge when the amounts of such fees are finally determined and included by the CLO managers in their income.

CLO managers that are subject to U.S. tax need to consider structuring CLOs in a manner such that either IRC Section 457A would not apply or the compensation arrangement operates in compliance with IRC Section 457A.

Foreign Account Tax Compliance Act

The HIRE Act adopted IRC Sections 1471 through 1474 (referred to as the Foreign Account Tax Compliance Act or "FATCA") which mandate reporting by "foreign financial institutions" (including certain investment vehicles like CLOs) of their direct and indirect U.S. beneficial owners. Under IRC Section 1471(a), as a general rule, any "withholdable payment" made to a CLO would be subject to a 30% withholding tax, unless the CLO entered into an agreement with the U.S. Treasury Department (an "information sharing agreement") and complied with certain tax reporting requirements. Withholdable payments consist of (1) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States, and (2) any payment of U.S. source interest (including original issue discount and "portfolio interest"), dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, emoluments and other fixed or determinable annual or periodic gains, profits and income. It is expected that substantially all of a CLO's income and potentially all cash receipts or proceeds from U.S. obligors would be subject to FATCA withholding beginning in 2013 if the CLO fails to enter into the required information sharing agreement with the U.S. Treasury Department and fails to meet its regular tax reporting obligations.

The information sharing agreement will generally require a CLO to, among other things: (i) obtain information regarding each holder of each "account" maintained by the CLO as is necessary to determine which "accounts" are "United States accounts" (which include not only financial accounts held directly by U.S. persons but also financial accounts held by non-U.S. entities owned by U.S. persons) [see Endnote 14]; (ii) report to the U.S. Treasury Department detailed information regarding any United States accounts on an annual basis (including names, addresses, taxpayer identification numbers, account numbers, account balances or values, and gross receipts and payments from the accounts); (iii) deduct and withhold 30% of any "pass-through payments" made to an account holder who fails to comply with reasonable requests for necessary information; (iv) comply with requests by the U.S. Treasury Department for additional information regarding any of its United States accounts; and (v) obtain a waiver of foreign law confidentiality protection regarding any of its United States accounts or close such account. The term "financial account" is defined broadly to include any debt or equity interest in a CLO. As such, both equity and debt investors (as determined for tax purposes) in CLOs are affected by FATCA.

The FATCA reporting and withholding requirements apply to payments made after December 31, 2012, and in the case of obligations, only to payments made pursuant to obligations issued after March 18, 2012 (or gross proceeds from the disposition of such obligations). [See Endnote 15.]

CLO managers should start building systems to enable them to collect the information required from CLO investors, and CLO investors will need to understand that increased documentation and a waiver of confidentiality will be required of them to avoid the 30% FATCA tax.

Committee of European Banking Supervisors– Capital Requirements Directive

On December 31, 2010, the Committee of European Banking Supervisors ("CEBS") [see Endnote 16] published its guidelines (the "Article 122 Guidelines") to Article 122a of the Capital Requirements Directive ("Article 122a") which imposes requirements on European Union ("EU") credit institutions investing in securitisations. The Article 122a Guidelines, which were implemented together with the Capital Requirements Directive itself and effective December 31, 2010, provided guidance on, among other things, paragraph 1 of Article 122a which requires that EU credit institutions (other than when acting as an originator, sponsor or original lender) may be exposed to the credit risk of a securitisation position (for example, by purchasing a CLO security) only if the originator, sponsor or original lender has disclosed to the credit institution that it will retain, on an ongoing basis, an unhedged position equal to not less than a 5% net economic interest in the securitisation.

Although the Article 122a Guidelines apply to CLOs offered to EU credit institutions after December 31, 2010, the CEBS acknowledged that in a typical managed CLO there may be no entity that can adequately and efficiently fulfill the role of originator, sponsor or original lender. In these circumstances another entity that is not the originator, sponsor or original lender, but whose interests are aligned with those of investors, may instead satisfy the retention requirement. As one example, the Article 122a Guidelines cited the circumstance where the retained interest was held by an "originator SPV" which could be owned by either the asset manager of a CLO or an entity with responsibility in the structuring or asset selection for the CLO (e.g., a portfolio selection adviser). However, the commonly used structure in which an interest in CLO securities is retained by a fund whose adviser is also the collateral manager of the CLO would not satisfy these guidelines.

Article 122a also imposes due diligence requirements on investors in ABS that are EU credit institutions. EU credit institutions are required to be able to demonstrate for each of their securitisation positions, before making the investment (and as appropriate after the investment), that they have a comprehensive and thorough understanding of, and have formally implemented appropriate policies and procedures for analysing and recording: the information disclosed by the originator or sponsor regarding the retention of the net economic interest; the risk characteristics of the

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individual securitisation position and the exposures underlying the position; the reputation and loss experience in earlier securitisations by the originator or sponsor (in relevant exposure classes); the disclosure made by originators or sponsors about their due diligence on the underlying collateral; valuation methodologies; and other material structural features (such as waterfalls, triggers and reserve accounts). If, prior to investing, a credit institution determines that it does not have adequate information, it should not invest. EU credit institutions are also required to perform regular stress tests on the securitisation positions. The European Banking Authority published guidelines on stress testing ("CEBS Guidelines on Stress Testing (GL32)") in August 2010. Annex II of the guidelines includes specific principles in relation to securitisation exposures. The overall effect of the requirements is to impose a significant due diligence burden on an EU credit institution which purchases a CLO security, especially if it is a managed CLO where the underlying exposures may change from time to time.

European Commission–Alternative Investment Fund Managers Directive

Article 13 of the European Commission's ("EC") Alternative Investment Fund Managers Directive ("AIFMD") is comparable to Article 122a in that it requires, among other conditions, the originator, the sponsor or the original lender to retain a net economic interest of no less than 5% in a securitisation in order for any EU incorporated or managed alternative investment fund or non-EU alternative investment fund that is marketed in the EU to be exposed to a securitisation position. However, the final text of the AIFMD has not been published in the EU's Official Journal; it is generally anticipated that the text will be published in June 2011. Given that EU directives come into force two years after being published in the Official Journal, it would appear that, accordingly, it is unlikely to take effect prior to June 2013. Furthermore, the AIFMD is merely a framework directive onto which EU law-makers will add the detail of the relevant regulatory regime in subordinate legislation. None of the AIFMD subordinate legislation has been published yet, so the detail of the regime that will apply to offerings of CLO securities to alternative investment funds is currently unknown.

Conclusion

There is much uncertainty regarding how new regulations will affect CLO offerings; however, participants in the CLO market have been providing their views to regulators. Hopefully, the final regulations will adopt an approach which improves the offering process for CLO securities, without impairing the ability to complete CLO offerings and the important credit function which CLOs perform.

Endnotes

1. The Reg AB definition of "asset-backed security" also addresses the treatment of assets underlying leases included in a pool of financial assets, the quality of the pool of financial assets and other matters which are beyond the scope of this discussion.
2. As defined in the Dodd-Frank Act's amendment to Section 3(a) of the Exchange Act, the term "asset-backed security" (A) means a fixed income or other security collateralised by any type of self-liquidating financial asset (including a loan, a lease or mortgage or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including: (i) a collateralised mortgage obligation; (ii) a collateralised debt obligation ("CDO"); (iii) a collateralised bond obligation; (iv) a CDO of ABS; (v) a CDO of CDOs; and (vi) a security that the SEC, by rule, determines to be an asset-backed security for purposes of Section 3(a); and (B) does not include a security issued by a finance subsidiary held by the parent company or an affiliate of the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company. The Dodd-Frank Act's definition of asset-backed security includes securities that are typically sold in transactions pursuant to an exemption from registration under the Securities Act.
3. The proposed definition of the term "sponsor" in the CRR Proposal is a person who organises and initiates a securitisation transaction (defined as a transaction involving the offer and sale of ABS by an issuing entity) by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.
4. The Agencies included this statement in footnote number 42 of the CRR Proposal.
5. This was included in clause (a)(2) in the proposed rule for "Underwriting standards for qualifying commercial loans".
6. The term "depositor" is defined in the proposed rules as: (1) the person that receives or purchases and transfers or sells the securitised assets to the issuing entity; (2) the sponsor, in the case of a securitisation transaction where there is not an intermediate transfer of the assets from the sponsor to the issuing entity; or (3) the person that receives or purchases and transfers or sells the securitised assets to the issuing entity in the case of a securitisation transaction where the person transferring or selling the securitised assets directly to the issuing entity is itself a trust.
7. The term "banking entity" means any insured depository institution, any company that controls an insured depository institution, or that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.
8. 156 CONG. REC. S3470 (May 10, 2010) (statement of Sen. Levin).
9. *See id. See also* 156 CONG. REC. S5901 (July 15, 2010) (statement of Sen. Levin) (relating Subcommittee findings that showed some firms were creating and selling financial products, and betting against the same products); 156 CONG. REC. S4057 (May 20, 2010) (statement of Sen. Merkley) (stating that a fundamental conflict of interest arises when those who design securities take out insurance on the sold securities).
10. An eligible contract participant is generally an entity or person that has sufficient regulated status or a specified amount of assets and includes financial institutions, insurance companies, commodity pools and wealthy individuals.
11. The term "structured finance product" would capture more categories of securities than does Reg AB's current definition of "asset-backed security". The proposed definition of "structured finance product" would cover a synthetic ABS or a fixed income or other security collateralised by any pool of self-liquidating financial assets, such as loans, leases, mortgages, and secured or unsecured receivables, that entitles its holder to receive payments that depend on the cash flow from the assets, including: Reg AB ABS; a collateralised mortgage obligation; a CDO; a collateralised bond obligation; a CDO of ABS; a CDO of CDOs; or a security that at the time of the offering is commonly known as an ABS or a structured finance product.
12. The SEC also proposed to amend Rule 144 (which, among other things, provides a safe harbour for resales of restricted securities) to change the condition requiring the availability

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of adequate current public information, in the context of resales of structured finance products, by imposing the same requirements as those proposed for Rule 144A and Rule 506.

13. Section 457A also applies to any partnership (both U.S. and non-U.S.) unless "substantially all" of its income is allocated to persons other than non-U.S. persons not subject to "comprehensive foreign income tax" and tax-exempt U.S. persons.
14. The U.S. Internal Revenue Service's ("IRS") Notice 2010-60 sets forth the steps that foreign financial institutions will be required to follow to determine whether an account is a United States account, which differ depending on whether an account is an existing account or a new account.
15. The U.S. Treasury Department and the IRS intend to issue regulations providing that the term "obligation" means any legal agreement that produces or could produce a withholdable payment, but an obligation for this purpose does not include any instrument treated as equity for U.S. tax purposes, or any legal agreement that lacks a definite expiration or term.
16. The CEBS was renamed the European Banking Authority on January 1, 2011.

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