CLOs, Warehouse Facilities and Risk Retention Vehicles

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Jennifer advises hedge funds, private equity funds (including mezzanine and distressed funds), hybrid funds, funds of funds and investment advisers in connection with their structuring, formation and ongoing operational needs, general securities laws matters and regulatory and compliance issues. Her experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure and sale of their investment management businesses and the structure of their compensation arrangements and representing investment managers in connection with managed accounts and single investor funds.

Most recently, Jennifer was named among the world's "50 Leading Women in Hedge Funds" by *The Hedge Fund Journal*. A member of the board of directors of 100 Women in Finance, Jennifer is recognized by *The Legal 500 US, Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and has been named an *IFLR1000 "Rising Star"* (Investment Funds). She co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and recently presented at conferences on topics including attracting and retaining capital, operational due diligence, compliance issues, hedge funds and management company structures and considerations for emerging hedge fund managers.

Jennifer earned her J.D. from Columbia University Law School, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from the University of Pennsylvania.

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Dan concentrates on tax planning for complex transactions, including mergers and acquisitions, private equity, bankruptcy, workouts, corporate restructuring and distressed asset investing, structured finance and real estate. Some of Dan's more significant engagements and transactions, throughout a professional career spanning more than 25 years, include his recent representations of: Orchard Brands Corporation in its $410-million acquisition by Bluestem Group Inc., Cerberus Capital Management LP in the acquisition of a controlling interest in Chrysler LLC (and, later, the sale of Chrysler and its debtor subsidiaries' assets in their Chapter 11 reorganization), a group of senior secured lenders in their acquisition and recapitalization of Chapter 11 debtor Lenox Inc., an institutional real estate investor in a $3-billion leveraged recapitalization of a real estate joint venture, and a major investment bank in connection with the formation of Argentine and Brazilian real estate private equity funds. In addition, Dan served as tax counsel to Lionel LLC in its successful Chapter 11 reorganization and to a major European bank in its acquisitions of controlling interests in fund-of-funds managers with over $4 billion in assets under management. Over the years, he has served as tax counsel to debtors' and creditors' committees in numerous Chapter 11 cases, including TWA, Drexel Burnham Lambert, Phar-Mor Drugstores, Resorts International, Bibb Companies, the New York Daily News, Seaman's/Levitz Furniture, Ranger Industries and Mayflower Group.

Dan is a frequent speaker at Tax Executives Institute (TEI) programs and other tax seminars throughout the country and has been recognized by *The Best Lawyers in America* and *The Legal 500 US* as a leading tax attorney.

Dan received his J.D., *magna cum laude*, from Tulane University Law School, where he was Order of the Coif and managing editor of the *Tulane Law Review*, his LL.M. in taxation from New York University School of Law and his B.A., *cum laude*, from Tulane University.

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Dan represents hedge funds, private equity funds, asset managers, specialty finance companies and investment banks in a wide range of financing transactions. He has particular expertise in liquidity facilities, such as CLOs, warehouse lines, leveraged finance vehicles, capital call facilities and fund-of-fund loans. Dan's practice also encompasses a variety of other secured and unsecured finance transactions, both on the borrower and lender side, including cash-flow and asset-based loans, acquisition financing, Term B loans, unitranche loans, workout and restructuring transactions, cross-border transactions and other complex credit arrangements.

Recognized as leader in his field by *The Legal 500 US* and *New York Super Lawyers*, he co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and he has spoken on topics that include investing in corporate credit and leverage for investment funds.

Dan received his B.A., *magna cum laude*, from Yeshiva University and his J.D. from New York University School of Law.

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Craig is co-head of the Structured Finance & Derivatives Group. His practice focuses on swaps and other derivative products, including prime brokerage, clearing and customer trading agreements and structured finance and asset-backed transactions, primarily focusing on collateralized loan obligations (CLOs). He represents issuers, underwriters, collateral managers and portfolio purchasers in private structured finance transactions.

Craig is recognized as a leading lawyer by *Chambers USA*, *Chambers Global*, *The Legal 500 US* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Structured Finance and Securitization). He is a member of the Loan Syndications and Trading Association, the International Swaps and Derivatives Association and the Structured Finance Industry Group. He is a much sought-after speaker for hedge fund industry conferences and webinars and the author of numerous articles on advanced financial products. He recently authored "U.S. CLOs: Past and Present" in *The Journal of Structured Finance* and co-authored "Current Issues in the CLO Market: As of February 2017" for *The International Comparative Legal Guide to: Securitisation 2017.*

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CLOs, Warehouse Facilities and Risk Retention Vehicles

I. Overview of U.S. Risk Retention[1]

A. "Securitizers" of asset-backed securities are required to retain 5 percent of the credit risk of the collateral.

1. Standard forms of retention interests include "eligible horizontal residual interests" and "eligible vertical interests."

   (a) Eligible horizontal residual interests must have the most subordinate claim to payments.

   (b) Eligible vertical interests must include each class of interests in an ABS transaction.

2. Sponsors may retain a combination of eligible horizontal residual interests and eligible vertical interests that combine to equal at least 5 percent.

B. Pledging or transferring any risk retention interest is generally prohibited.

1. Exception for majority-owned affiliates of the sponsor.

   (a) Majority-owned affiliates must be directly or indirectly majority controlled or under common majority control with the sponsor.

   (b) For risk retention purposes, majority control is ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

2. The sponsor or permitted affiliate may also pledge the retained interest as collateral for an obligation that is full recourse to the sponsor or affiliate.

II. Overview of EU Risk Retention[2]

Institutional investors in the European Economic Area may not be exposed to the credit risk of any "securitization" unless any of the sponsor, originator or original lender retains at least 5 percent of the securitized exposures.

A. The securitizer can use alternative methods to comply with EU risk retention depending on whether the retention holder is contemplated as the "sponsor" or "originator" of the transaction.

B. An entity must have the appropriate permissions under MiFID and "establish" and "manage" a securitization in order to be treated as a "sponsor" under EU risk retention rules.

C. If a securitization has multiple "sponsors," the retention interest may either be held in part by each sponsor in proportion to the number of sponsors or in full by one sponsor whose economic interest is most aligned with that of investors (as determined by the sponsors using objective factors like fee structures and credit risk exposure).

D. Under EU risk retention rules, an entity is an "originator" if it either:

1. Originates obligations in the primary market; or

2. Acquires obligations in the secondary market for its own account and securitizes them.

   (a) An "originator" must acquire loans "for its own account," for instance by entering into purchase contracts directly with brokers or sellers in the secondary market.

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[1] Credit Risk Retention, 17 C.F.R. § 246 (2014).

[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

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(b) If a CLO has multiple originators, the retention requirement may be fulfilled by an originator who established the CLO and either contributed more than 50 percent of the total exposure or is managing the CLO.

3. Non-compliant transactions cannot be sold to EU institutional investors, but may be sold to other investors not addressed by the EU risk retention rules.

   Question of how detrimental the loss of liquidity and marketability would be.

4. Many structures have developed to allow securitizations to comply with EU risk retention, particularly the C-MOA structure discussed below.

III. Risk Retention Rules Differ as Between the United States and the European Union

A. U.S. rules apply to sponsors or securitizers, whereas EU rules apply to investors.

B. The term "sponsor" has a different meaning in U.S. rules as compared to EU rules.

   The term "sponsor" in U.S. rules has a meaning akin to the meaning of the term "originator" in EU rules.

C. U.S. rules apply to "securitization transactions," whereas EU rules apply to "securitizations," the definition of which differs substantially.

   The presence of tranches and/or subordination is an element in the EU rules definition, but not in the U.S. rules definition.

D. EU rules allow for a retention interest consisting of a random sample of the securitized exposures, whereas there is no equivalent allowance in the U.S. rules.

E. U.S. rules allow for a sunset mechanism to terminate the restrictions on hedging and transfer of the retention interests in certain cases, whereas the EU rules do not.

IV. Initial Effects of Risk Retention

A. Increased capital requirements for each transaction have increased the capital requirements for the CLO industry at large.

1. Many CLO managers have attempted to raise risk retention capital from outside investors.

2. Certain banks and financial institutions have begun lending money to CLO managers to purchase retention interests.

B. Uncertain whether new rules have improved the asset quality of collateral in ABS transactions.

V. Risk Retention Rules Update

A. Future implementation of U.S. risk retention regulation is uncertain.

1. The LSTA lawsuit to invalidate the risk retention regulation for CLOs is pending a decision in the D.C. Circuit of the U.S. Court of Appeals.[3]

   (a) Question of statutory authority to impose risk retention rules on CLO managers if they are not considered "securitizers" for risk retention purposes.

   (b) Question of whether requiring 5 percent of the fair market value of a CLO rather than 5 percent of the credit risk is a misapplication of the statute.

2. The U.S. Treasury Report proposes to maintain the risk retention requirement for CLOs, but also said that there should be an exemption for CLOs that meet certain asset quality requirements.[4]

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[3] Loan Syndications & Trading Association v. Securities and Exchange Commission, 223 F. Supp. 3d 37 (2016).

[4] *See* U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities: Capital Markets, Oct. 6, 2017, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

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Recommendation to "right-size" risk retention rules rather than eliminate completely.

B. Conclusions from first year of implementation of the U.S. risk retention regulation.

1. CLO managers have created new structures that enable them to raise the capital needed to comply with U.S. risk retention.

   (a) CMV and CMV feeder funds

      (i) Creating a new management company

      (ii) Registered investment adviser

      (iii) Sole employees that are compensated by CMV

      (iv) EU origination – 5-10 percent or target par at closing

      (v) Shared services and employment agreement

   (b) MOA fund

      (i) Passive investment vehicle

      (ii) Difficult to comply with EU RR

         (1) Must satisfy "sole purpose" and "substance" tests

         (2) Originate 50 percent over life of CLO

   (c) C-MOA

      (i) Relying adviser (issue if manager manages '40 Act funds)

      (ii) Dual employees

      (iii) EU Origination – 5-10 percent of target par at closing

      (iv) Shared services and employment agreement

   (d) Tax issues

      (i) ECI/trade or business

      (ii) UBTI

   (e) Other legal issues

      EU origination – cross transactions

2. Third-party financing has become available for risk retention.

   (a) Credit facilities and repo facilities.

   (b) Credit facilities often are rated by a rating agency and typically provided by insurance companies.

   (c) Resecuritization programs of risk retention investments.

   (d) So far, only to finance the vertical risk retention.

   (e) Borrower is often a C-MOA, or sometimes an MOA.

3. Third parties have created investment funds and other capital pools to invest in risk retention for unaffiliated managers.

4. Market has become comfortable that U.S. risk retention requirements do not apply to standard warehousing structures.

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(a) Revolving credit warehouse loans and swap-based warehouse facilities are not securitizations to which U.S. risk retention requirements are applicable.

(b) Senior loan/subordinated loan warehouse structure also not viewed as a securitization to which U.S. risk retention is applicable.

5. EU Risk Retention Rules

(a) U.S. managers using "origination" method to comply

(b) Dealer issues for EU origination

VI. CLO Warehousing[5]

A. Most common structures are either:

1. Revolving credit from a senior lender to the CLO with first-loss equity either from the CLO manager or a third-party equity source; or

2. Credit default swap or total return swap between the senior lender and either the CLO or an SPV to which the CLO manager has contributed "first-loss" equity, with the hedging loans held in a separate SPV that will be merged into the CLO at the closing.

B. Latest Structural Trends

1. Rated warehouses (typically credit facilities).

2. Warehouses that provide for "multiple exits" and have a longer term.

3. New sources of first-loss equity, i.e., unaffiliated investment funds, CMVs, C-MOAs and MOAs.

4. Senior loan and mezzanine loan as well as first-loss equity.

5. Increase in non-marked to market warehouses, but which still have an LTV trigger to stop the ramp up.

C. Tax Issues – Trade or Business

Although a trade or business opinion is usually only required at the CLO level, managers must ensure that tax guidelines are also followed during the warehouse phase.

D. Current Issues in CLO Warehouse Facilities

1. Conflicts can arise in the administration of the warehouse between the CLO manager, on the one hand, and the senior lender, on the other hand, if:

(a) The senior lender refuses to approve the purchase of a loan; or

(b) The senior lender refuses to approve an amendment to a loan document that the collateral manager wishes to approve.

2. Conflicts can arise between the first-loss equity provider and the arranger over whether to proceed with the pricing on terms that the first-loss equity provider does not like.

3. Main conflict occurs if an event of default or other "Liquidation Trigger" occurs. First-loss equity is concerned that the sale of a loan portfolio may cause it to lose its investment, and the CLO manager is concerned that the sale of a portfolio will prevent the completion of the CLO and damage the manager's reputation.

(a) CLO manager and the first-loss equity typically have the right to buy the portfolio at a price which repays all debt to the senior lender.

[5] *See* "Current Issues in the CLO Market: As of February 2017," *The International Comparative Legal Guide to: Securitisation 2017* (Global Legal Group).

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(b) CLO manager and the first-loss equity typically have the right to bid on the portfolio in the U.C.C. foreclosure auction.

4. Ineligible loans

   (a) Ineligible loans will be excluded from the borrowing base, so that they must be funded solely with equity.

   (b) Sometimes the senior lender has the right to direct the collateral manager to sell an ineligible loan.

   (c) In any event, all ineligible loans must be sold prior to the CLO closing date.

5. Almost all warehouses provide that if there is an increase in the LTV above a specified level, the ramp up will be suspended and sometimes terminated.

6. Warehouse agreements typically provide that the senior lender has discretion to reject any loan that the CLO manager proposes to buy. The warehouse agreement typically will not impose a legal obligation on the senior lender to disclose the reason for its rejection. If there is a preapproved model portfolio, the senior lender typically has the right to remove a loan from that portfolio, so long as they give sufficient advance notice to the CLO manager.

7. M-T-M warehouses require posting of additional collateral or additional capital contributions if LTV is above a certain threshold. Failure to post or contribute capital will result in the lender's right to liquidate.

VII. CLOs – Latest Trends

A. Refinancing and Resets

1. Emergence of provisions allowing second refinancings upon the occurrence of certain changes to risk retention rules.

2. Some cases where CLO managers have issued more equity as part of a reset.

3. Exploration of AMR mechanisms in CLOs.

B. New Issues

1. European CLO volume is at an all-time post-crisis high after November 2017.

2. Question of whether loan volume will be sufficient to support further growth in the CLO market.

C. Longer Non-call Periods and Reinvestment Periods

Initial surge of non-call and reinvestment period extensions in 2015 as CLO managers began to anticipate implementation of risk retention rules.

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