

K&L GATES

OH, THE PLACES YOU'LL CLO!

WHERE TO GO WITH CLOS...IN 2018 AND BEYOND

K&L Gates Webinar March 26, 2018

CLO Investor Forum: Balancing Risk, Returns and Conflicting Interests

Anthony R.G. Nolan, Partner, New York

Kenneth Holston, Partner, Boston

Adam J. Tejeda, Partner, New York

Robert L. Sichel, Partner, New York

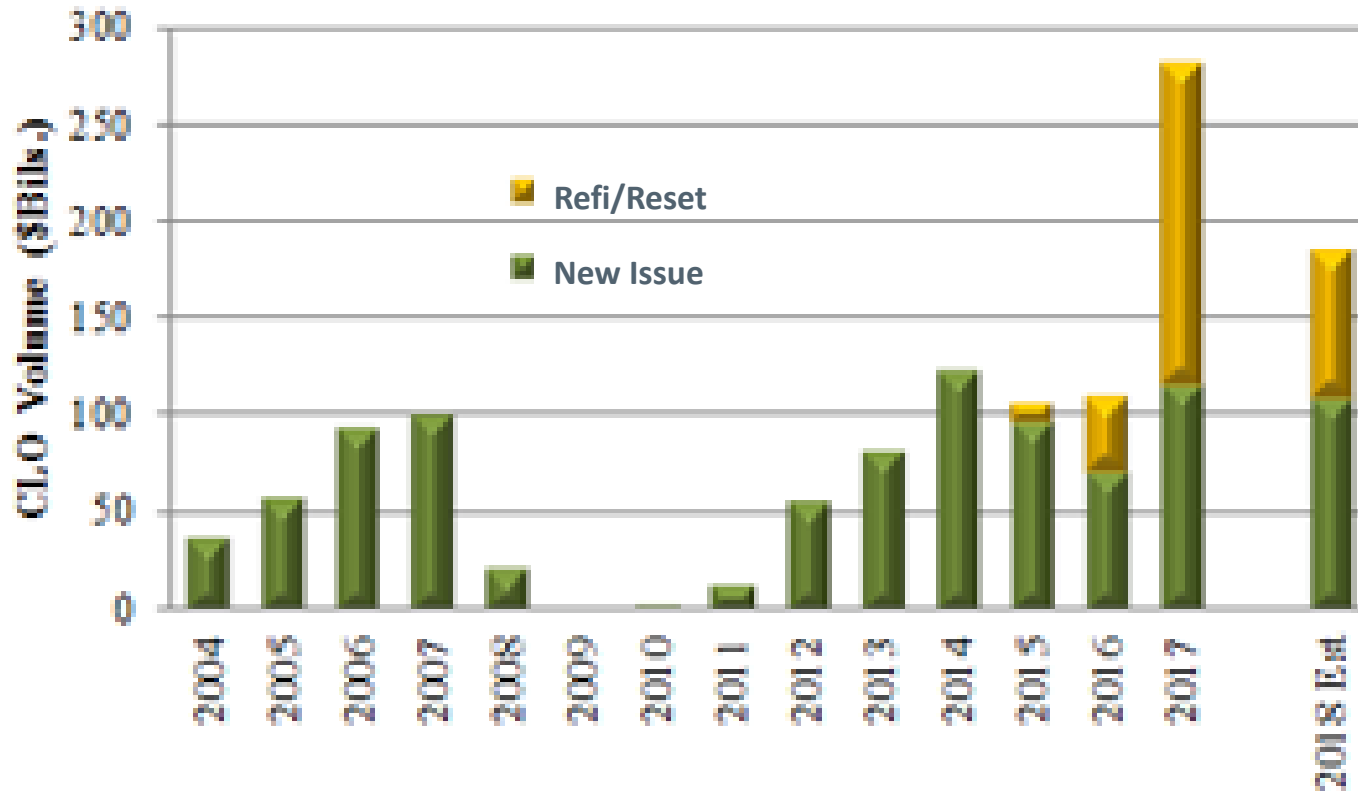
Agenda

- Overview and Structure
- Tax and ERISA Issues for CLO Investors
- Regulation Affecting CLO Investors
- Risk Retention

OVERVIEW AND STRUCTURE

CLOs in the U.S Economy

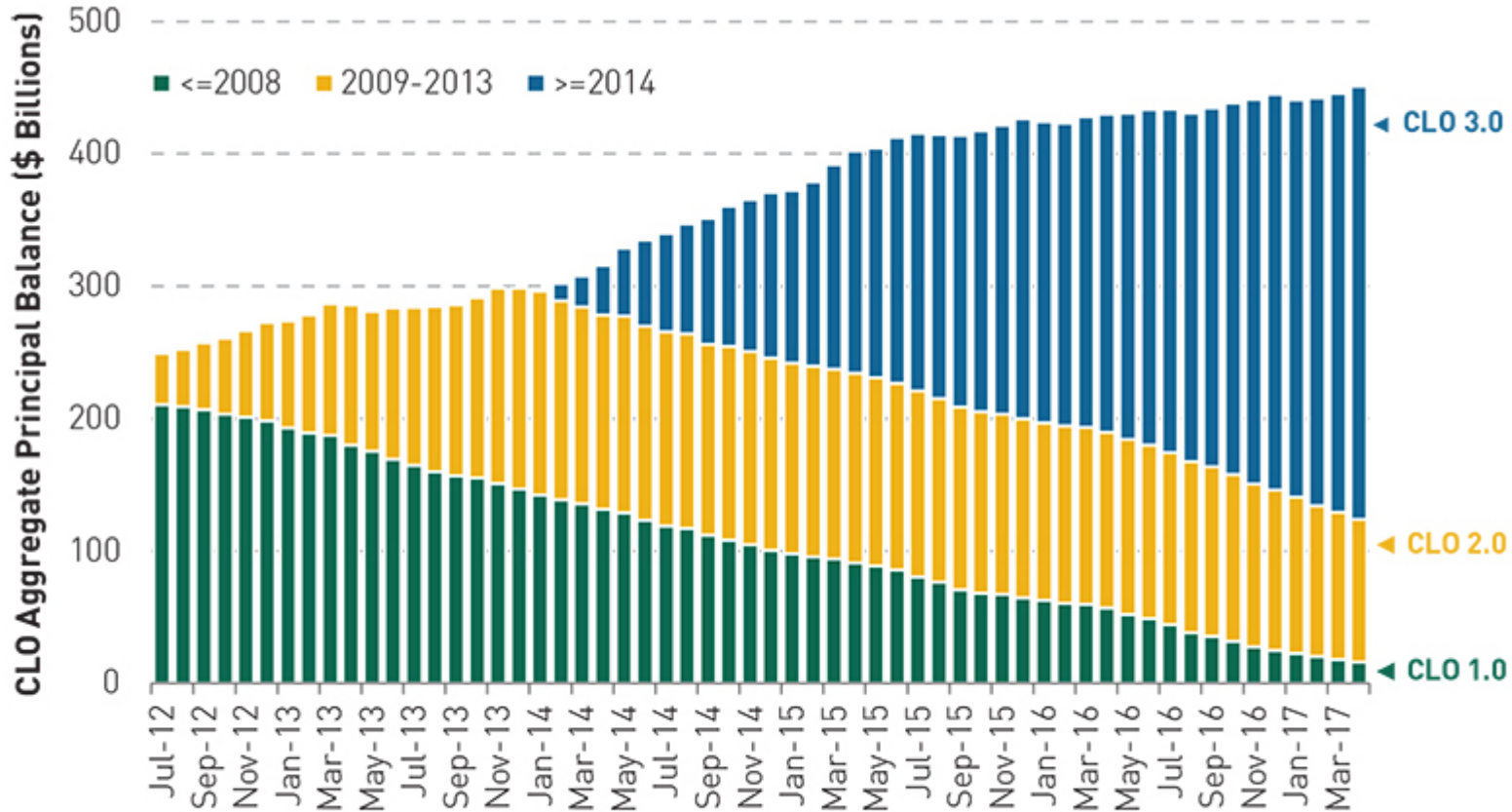
CLO Issuance 2004 – 2017



Source Loan Syndications and Trading Association

CLOs in the U.S Economy

US CLO Principal Balance by Vintage: 5 year snap

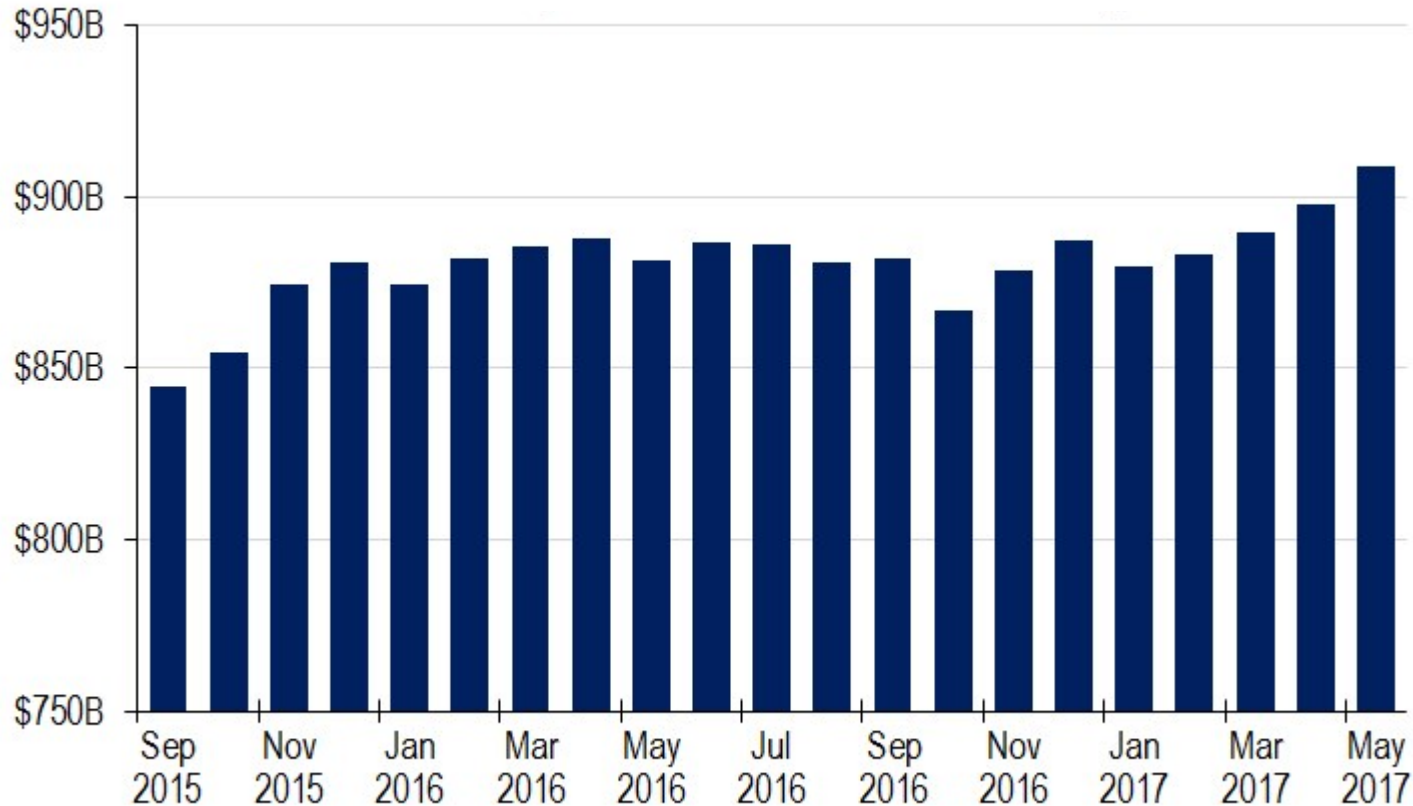


Based on year issued.

Source: Thompson Reuters LPC Collateral

CLOs in the U.S Economy

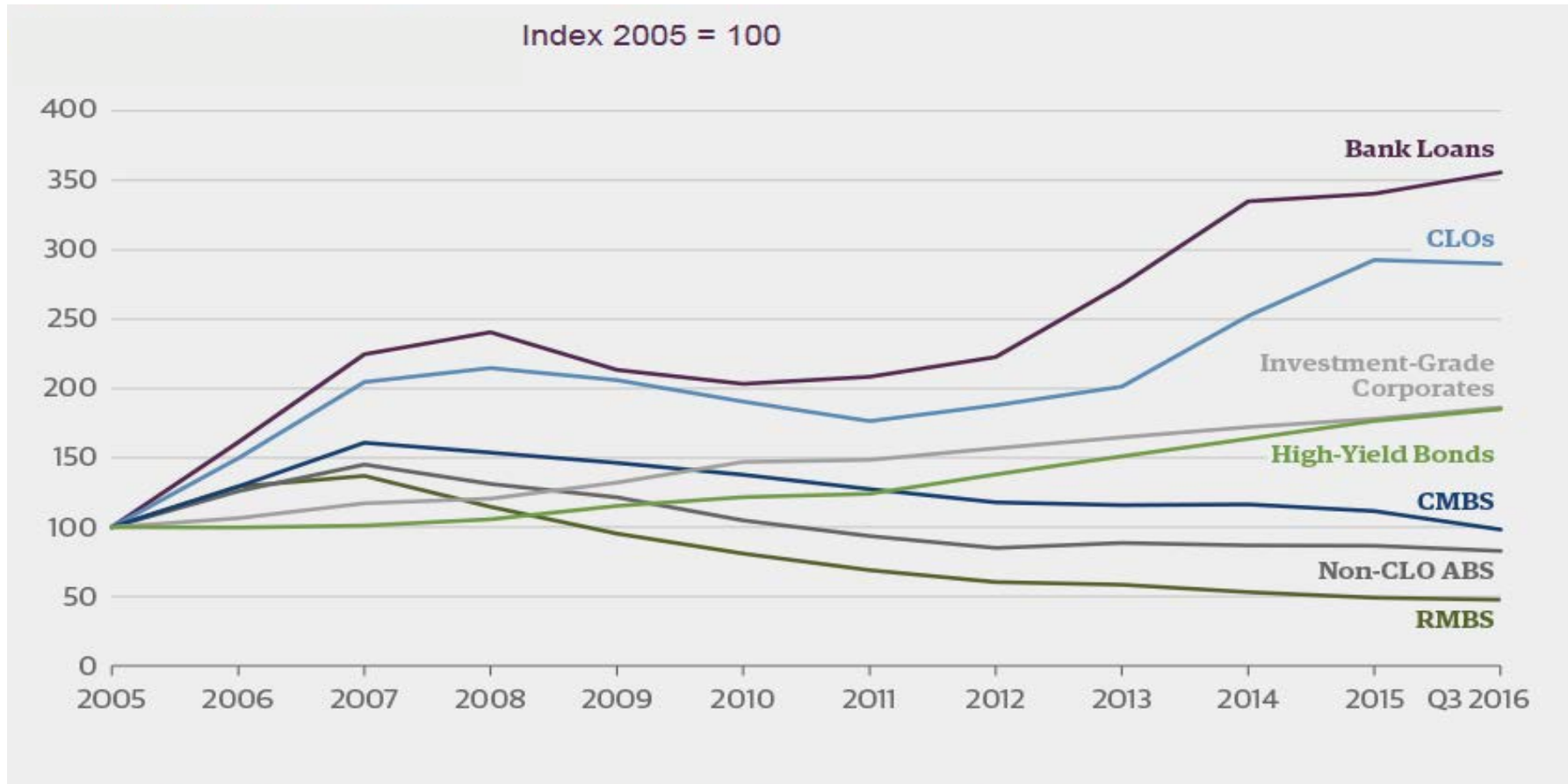
US Leveraged Loan Market Principal



Source: S&P/LSTA Leveraged Loan Index

CLOs in the U.S Economy

Fixed income market sectors, 2005-2016



Source: SIFMA, Wells Fargo, Credit Suisse, Guggenheim Investments. Data as of 9.30.2016.

CLO Structure and Documentation

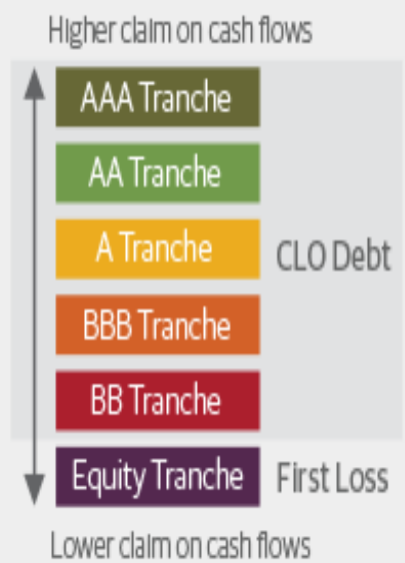
Overview



Selected for CLO collateral pool

- Diversified portfolio of senior secured loans
- Principal value of collateral exceeds value of CLO debt
- Typically 100 -225 issuers
- Actively managed

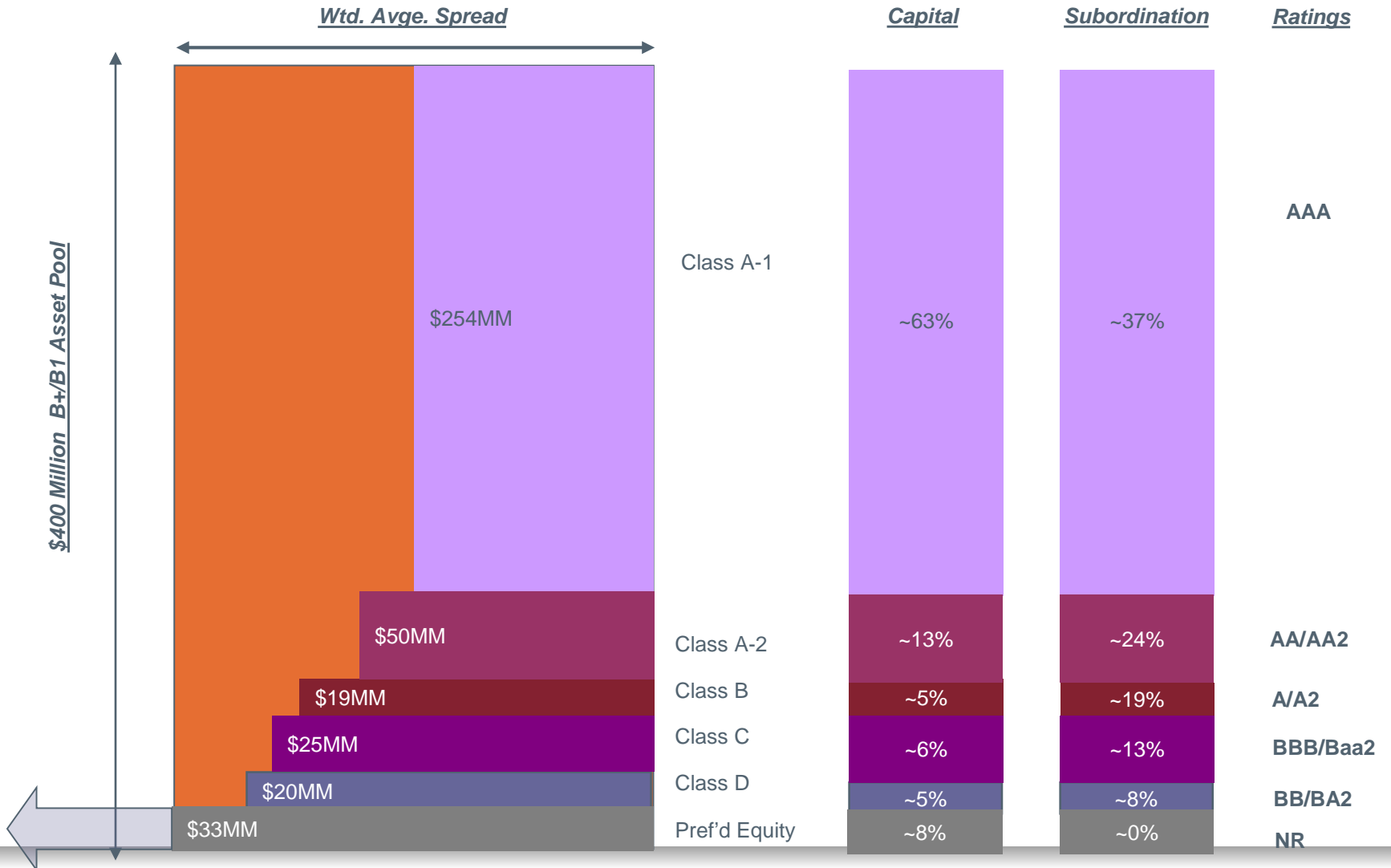
Cashflows Generated by Collateral



Source: Guggenheim Investments. Collateral pools for most CLOs also have a small allowance for second lien and unsecured debt.

CLO Structure and Documentation

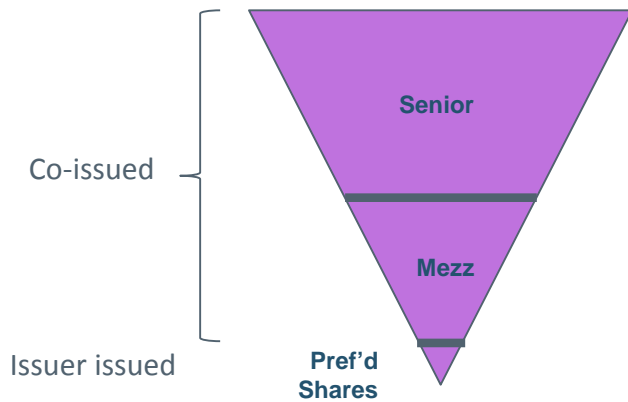
CLO Tranching



CLO Structure and Documentation

Parties to a CLO

Offered Securities



Investors

Initial Purchaser /
Placement Agent

Trustee,
Paying Agent,
Collateral Agent

Issuer
Cayman, Irish or Lux co.
*Owns / pledges assets;
co-issues debt;
issues equity*

Co-Issuer
Delaware SPE.
*Co-issues debt;
investor eligibility role*

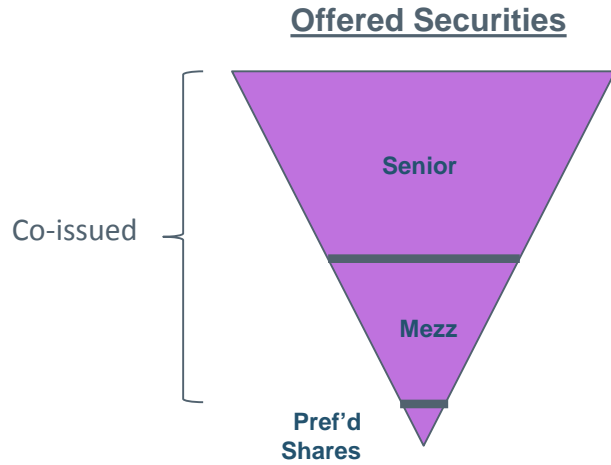
Hedge
Counterparty

Collateral Manager

Rating Agencies

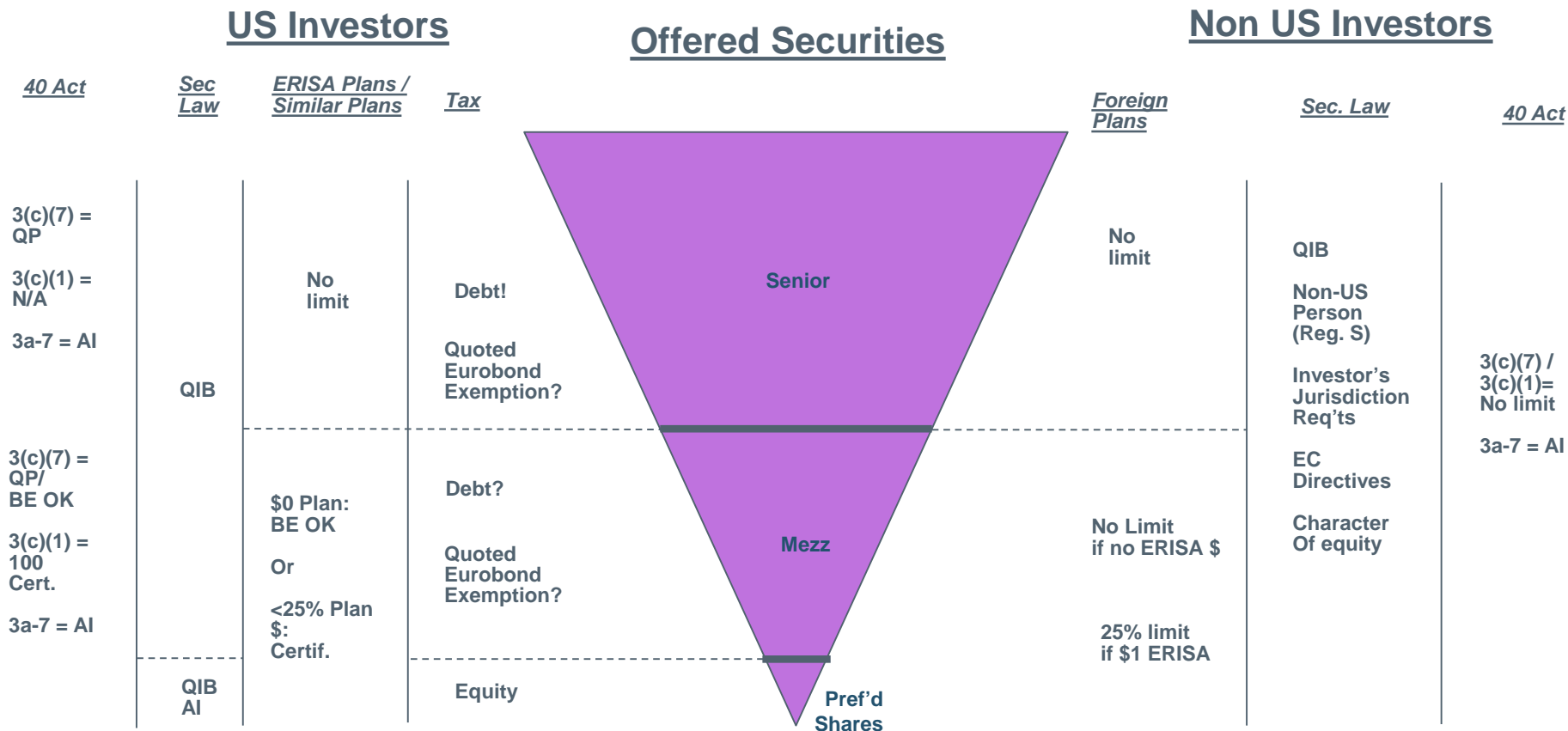
CLO Structure and Documentation

Investor considerations: rule of thumb



CLO Structure and Documentation

Investor considerations: rule of thumb



CLO Structure and Documentation

Lifecycle of a CLO

T minus 9 Months	T minus 2 months	T=Closing	T+2/6 months	T+2 years	T+3/4 years	T+5/7 years
<ul style="list-style-type: none"> • Basic Product Structure Determined • Manager Engagement Letter Signed* • Warehousing/ Ramp-Up Begins 	<ul style="list-style-type: none"> • Preliminary O/C Complete* • Pricing Soon After Preliminary O/C • Begin drafting Indenture, Management Agreement and Other Documents • Marketing Process Continues 	<ul style="list-style-type: none"> • Portfolio Risk Transferred to SPV • Settlement on Notes • Notes Begin Trading on Foreign Exchange 	<ul style="list-style-type: none"> • Ramp-up Period Ends; Effective Date Ratings Confirmation** 	<ul style="list-style-type: none"> • Non call period ends • Refinancing / repricing at election of subordinate investors 	<ul style="list-style-type: none"> • Reinvestment Period Ends; Portfolio Becomes Static 	<ul style="list-style-type: none"> • Notes are Amortized At Election of Noteholders

* The Preliminary Offering Circular contains a detailed summary of the deal terms; many key deal document provisions are, as a practical matter, drafted at this stage.

** For longer ramp-up period or if a significant percentage of assets will be acquired post-closing, interim ratings confirmations may also be required

CLO Structure and Documentation

Basic Documents

- Offering Circular
- Indenture
- Collateral Management Agreement

CLO Structure and Documentation

Basic Documents: Offering Circular

- Purpose; securities law disclosure and liability
- The red and the black; timing in relation to settlement
- Role of drafting OC in negotiating deal terms
- How to read the OC
- Indenture provisions of particular interest
 - Description of Waterfall
 - Description of portfolio management rules
 - ERISA Transfer restrictions for Equity and BB tranches
 - Voting control
- Collateral Management provisions of particular interest
 - Collateral management agreement description
 - Collateral Manager Description
 - Collateral Manager Conflicts Risk Factors
- What if there is a conflict between the agreements and the disclosure?

CLO Structure and Documentation

Basic Documents: Indenture

- Purpose; parties; structure
- Grant of security
 - Collateral
 - Secured Parties
- Accounts
- Waterfall
 - Priority of Payments
 - Interest v. Principal Collections
 - PIK Bonds
 - Coverage tests
 - Interest coverage; par value; sequential pay test
 - Market value haircuts from par for certain assets
 - Breach triggers deleverage of deal.
 - Redemption from interest v. principal waterfall
- Controlling Class
- Refinancing / Repricing

CLO Structure and Documentation

Basic Documents: Collateral Management Agreement

- Purpose; tie-in to other documents
- Who is the “customer”?
- Standard of care and liability provisions
- Compensation
 - Base, subordinate and incentive fees
 - Incentive management fee issues
 - Threshold IRR
 - Alternative Structures
- Termination and assignment provisions
 - Termination with cause
 - Percentage of holders required
 - Manager and affiliates may not vote for removal or replacement
 - Trustee right to exercise issuer’s rights under management agreement following certain events
- Indemnification provisions
- Advisers Act required provisions
 - Consent to assignment
 - Notification of change of membership of “partnership”

CLO Market and Product Evolution

CLOs Ten Years After the Start of the Global Financial Crisis

- Regulatory prescriptions after 2008:
 - Shoddy underwriting; misaligned incentives caused by “originate to distribute” model.
 - Insufficient disclosure.
 - Ineffective enforcement mechanisms for repurchase obligations.
 - Pernicious role of swaps.
 - Excessive reliance on ratings, problems with rating process.
 - Not enough investor due diligence.
 - Regulatory capital incentives.
- Dodd-Frank solutions:
 - “5% credit risk retention
 - Rating agency reform.
 - Promote simpler structures through Volcker Rule and other means.
 - Enhanced focus on regulation of intermediaries.
- Market response:
 - Simpler structures – less leverage. no synthetic deals. no securities buckets (US).
 - Issuance slows down as issuers grapple with regulatory changes.
 - Some signs of a move back to the future? *E.g.*, STACRS synthetic agency MBS deals.
- Current environment: Dodd-Frank rollback

CLO Market and Product Evolution

Balancing Risks and Rewards in the Current Market

- Types of CLOs
 - Open-market CLO
 - Middle-market CLO
 - CRE CLO
- Syndicated / Leveraged Lending Developments Affecting CLOs
 - Covenant lite loans
 - Sectoral displacement – bankruptcies in energy, retail, entertainment
 - Spread tightening
 - Settlement delays persist
- CRE CLO developments
 - Elimination of discretionary trading
 - OC test fine tuning in order to avoid gaming
 - More credit enhancement / less complex indentures
 - Focus on multi-family
- Effect of low interest rates, narrowing spreads
 - Bond market, loan market
 - Refinancing / Repricing
- LIBOR Replacement

CLO Market and Product Evolution

Managing Conflicts of Interest

- Collateral Manager conflicts
 - Standard of care and fiduciary duties; who is the client?
 - Acquisition of material non-public information arising from other investment activity
 - Allocation of investment opportunities among funds / accounts (incl. other CLOs)
 - Investments in assets that create adverse interests to those of the CLO investors
 - Collateral manager may be required to offer certain investments to funds or accounts that they manage or advise before or without offering those investments to the Issuer
 - Principal trades and client cross transactions
 - Pricing
- Initial Purchaser / Placement Agent conflicts
 - Provision of investment banking and other services to underlying issuers
 - Warehousing arrangements where issuer acquires at other than FMV
 - Securities lending
- Conflicts inherent in tranching investing
 - “Where you stand depends on where you sit.”
 - Controlling class determinations, *e.g.*
 - Refinancing and repricing
 - Collateral liquidations
 - “Tranche warfare” litigation from some pre-crisis CDOs still persists.

TAX AND ERISA ISSUES FOR CLO INVESTORS

TAX

General Tax Considerations for CLO Investors

- Foreign Corporate Issuer (Most Common)
 - Is Your Security Debt or Equity for US Tax Purposes?
 - Debt: character and timing of interest, OID, market discount, premium
 - Equity
 - Controlled Foreign Corporations (CFCs)
 - Passive Foreign Investment Companies (PFICs)
 - Phantom Income Concerns
- Foreign Pass-Through Issuer (Less Common)
 - DRE or Partnership
 - 10% withholding tax / “Non-Foreign Affidavit”
 - Income from Loans v. Dividends
 - Publicly Traded Partnerships
 - Section 199A Deduction: limited to ECI (see next slides)
- Issuer is US Corporation or Pass-Through

TAX

Tax Reform and CLOs

- Section 451(b): accrual method taxpayers must take items of income in account for federal tax purposes no later than the time income included on audited financial statements or annual report
 - Could accelerate income (but not loss or deduction), particularly with OID or market discount, if accrual method note holder prepares “applicable financial statements” and lists those items on statements
 - Potential for phantom income to equity taxpayers
- New CFC Testing:
 - now 10% vote *or* value
 - Downward attribution from non-US shareholder to US corporation
 - Even if US investor, could give rise to additional Form 5471 filing obligation if now investing into a CFC
- Section 199A Deduction: applies to ECI

TAX

General Tax Considerations for CLO Investors

- Choice of Entity Can Reduce Issuer Level Tax Leakage
 - Gross Basis Withholding on Payments to CLO Issuer
 - Net Income Tax on CLO Issuer
 - CLO Issuer Gross-up Payments to Investors
- Specific Tax Issues
 - US Trade or Business Issues
 - Relevant for corporate and pass-through issuers
 - ECI: income effectively connected to US trade or business
 - Securities Trading Safe Harbors
 - No Loan Origination / Revolvers / LOC
 - Receiving equity securities in default / Potential Attribution / Blocker
 - Portfolio Interest Exemption
 - Commitment Fees, etc.
 - Commercial Real Estate (CRE) CLOs
 - Avoiding “Taxable Mortgage Pools”

TAX

FATCA and US Filing Requirements

- FATCA Withholding and Compliance
- Potential US Filing Requirements for CLO Investors
 - Form 926: invest \$100k+ or own 10%+ of non-US corp stock
 - Form 8938: non-US assets exceed threshold
 - Form 8621: PFIC
 - Form 5471: CFC
 - Form 8865: non-US partnership
 - Form 8858: non-US DRE

ERISA

Plan Asset Rules

- U.S. corporate pensions are an important component of the investor base
- Is the tranche ERISA eligible? (“ERISA restricted securities”)
- Considerations:
 - Offering document prohibition
 - Debt vs. equity
 - 25% test
 - Exclude “controlling person” investments from the denominator
 - “Benefit plans”
 - Defining ERISA “equity”

ERISA

Overlay of the DOL's New Fiduciary Rule

- The DOL Fiduciary Rule is currently effective
- Its ultimate fate is uncertain
- Issuers may require representations and warranties from investors to address concerns

SELECTED REGULATORY ISSUES AFFECTING CLO INVESTORS

Regulatory Overview

US Treasury Recommendations: October / November 2017

- Broad Exemptions for Qualifying Asset Classes and CLOs
 - Rather than an across-the-board repeal, rulemaking agencies should create a set of loan-specific requirements which, if met, would allow managers to seek relief from the risk retention rule
- Retention Period
 - Regulators should review mandatory five-year holding period for third-party purchasers and sponsors subject to the requirement
- Streamlining Regulatory Oversight
 - Congress should designate a lead agency to be responsible for future actions related to the rulemaking, resulting in streamlined issuance of interpretive guidance and exemptive relief
- Regulation AB II
 - Clarify that Rule 144A offerings are not subject to Regulation AB II disclosure requirements

Regulatory Overview

Investment Advisers Act Issues in CLOs

- Rule 206(4)-2 and the DVP issue
 - SEC exam and guidance and no-action letter issued in February 2017
 - As “pooled investment vehicles”, CLOs are not required to comply with the most burdensome of the custody rule requirements
- Principal transactions
 - Potential Section 206(3) prohibited transactions in certain risk retention structures
- Consent to assignment of CMA

Regulatory Overview

Securities Law Considerations in CLOs

- Types of Offerings:
 - Private Placements (Section 4(a)(2), 4(a)(7), Reg. D).
 - Rule 144A Offerings to QIBs.
 - Offshore Offerings under Regulation S.
- Regulation AB II does not currently apply to CLOs
- Other SEC disclosure rules affect “Exchange Act ABS”:
 - Term covers public and private issuances.
 - Form ABS-15G
 - Rule 15Ga-1 – reports of due diligence requests
 - Rule 15Ga-2 – due diligence reports
 - Rule 17g-5 – rating agency process: communications and conflicts of interest
 - Among other things information available to one rating agency to rate a CLO must be made available to other rating agencies

Regulatory Overview

1940 Act and Volcker Rule Considerations in CLOs

- The Volcker Rule prohibits bank investments in “covered funds”
 - Definition Includes companies that rely only on §3(c)(7) or 3(c)(1)
 - This is a problem for managed CLOs because they rely on §3(c)(7)
 - Volcker has an exception from the covered fund definition for “loan securitizations”
- CLOs investing in US assets rely on the loan securitization exemption, meaning they cannot have a bond bucket or use derivatives to transform cash flows
- CLOs investing in European assets cannot do without a bond bucket and rely on 3a-7. This limits the scope for active trading
- Some European CLOs have also relied on the SOTUS exemption by limiting US investors to below 10%
- Recent SEC no-action letter makes it easier for REIT-sponsored CRE CLOs to rely on 3(c)(5)(C)
 - *Great Ajax Funding LLC* (February 12, 2018)

Regulatory Overview

The Limited Role of Swaps in CLOs

Dodd-Frank swaps reform affects securitizations that use derivatives for hedging and credit enhancement. Three issues in particular stand out.

- Commodity pool issues:
 - CLOs that use swaps for hedging purposes in standard ways are not commodity pools.
 - CLOs that use swaps more than a de minimis amount may be commodity pools.
- Variation margin on uncleared swaps:
 - CFTC has not exempted SPVs from the uncleared swap margin requirements.
 - This requires complicated structural features.
 - In absence of structural fix in a CLO investors may have to consider hedging individually.
- Mandatory clearing
 - CFTC has informally said SPV swaps need not be cleared if derivative clearing organizations (“DCO”) won’t accept standard provisions.
 - Swaps used in CLOs are effectively not required to be cleared because DCOs don’t clear swaps with limited recourse provisions and non-petition covenants.

Regulatory Overview

Selected EU issues affecting CLOs

- AIFMD
 - Risk retention requirements set via an indirect approach whereby the onus rests on investors to check whether the originator, sponsor or original lender has retained risk
 - Similarly, investor has due diligence requirement – before investing in CLO must demonstrate a thorough understanding of the risks in the position
- Securitization Regulation
 - Applicable to securitizations from January 1, 2019
 - Due diligence
 - Institutional investors must verify certain aspects of the transaction
 - Risk Retention
 - Originator, sponsor or original lender must retain material interest
 - Transparency
 - Originator, sponsor and issuer must provide investors with sufficient information on regular basis
 - Make this information available via a securitization repository
- Market dynamics

WHAT'S LEFT?

RISK RETENTION

Risk Retention: What's Left?

Overview of US and EU rules and approaches

- US and EU both require 5% credit risk retention by persons involved in securitization
- Both approaches have general similarities but differ in detail
- EU Approach:
 - Article 405 of the Capital Requirements Regulation, Article 51-53 of AIFMD and Article 254 of Solvency II
 - The EU requirements directly affect certain types of investors by removing favorable regulatory capital treatment for non-compliant exposures
 - Securitization sponsors and aggregators are indirectly affected and investors seek contractual undertakings from them to retain the requisite credit risk
- US Approach:
 - Section 941 of Dodd Frank Act; Section 15G of Securities Exchange Act; Rule 15G promulgated by the SEC, the federal banking regulators and the federal housing regulators
 - The US risk retention rules create a direct legal duty on securitizers
 - Investors benefit indirectly through disclosure and enforcement
 - Securitizer includes the depositor (or the issuing entity) and the sponsor, which is the person that organizes and initiates a securitization and transfers assets to the issuing entity.
 - Certain types of transactions are exempted

Risk Retention: What's Left?

EU CLO Risk Retention

- Article 405 of the Capital Requirements Regulation, Article 51-53 of AIFMD and Article 254 of Solvency II
 - EU credit institution or investment firm may invest in a securitization only if an originator, sponsor or original lender has disclosed a 5% a material net economic interest retention.
 - AIFMs and insurance / reinsurance undertakings may invest in a securitization only if the originator has disclosed a 5% risk retention
- Sponsor includes credit institutions and investment firms authorized under AIFMD
- Originators include aggregators, but can't be formed for sole purpose of securitization
- Five forms of risk retention:
 - Vertical slice
 - *Pari passu* interest
 - On balance sheet (cash collateralized if unfunded)
 - First loss (horizontal)
 - First loss exposure to each securitized exposure

Risk Retention: What's Left?

US: CLO Risk Retention Before the LSTA Decision

- CLO Manager considered to be the “sponsor”
- Open Market CLO exemption
 - Underlying loan arrangers retain 5% of face amount of each loan tranche
 - <50% of CLO assets are loans syndicated or originated by affiliates of the manager or CLO
 - Generally considered to be impracticable
- Refinancing / repricing exemptions by SEC no-action letter
 - *Crescent Capital Group* (July 17, 2015) – Refinancing / repricing
 - *Sancus Capital Management* (September 1, 2016) – Dutch auction repricing
- Three forms of risk retention
 - horizontal slice – 5% of par
 - or vertical slice – 5% of FMV; requires calculation and disclosure of FMV
 - L-shaped slice combining both of the above
- Consequence of risk retention:
 - Further consolidation of CLO managers
 - New investment opportunities in risk retention vehicles

Risk Retention: What's Left?

US: Impact of the LSTA Decision

- *LSTA vs. SEC and Bd. Of Governors of the Federal Reserve*
- Procedural History
- Decision of the Court:
 - The joint regulators lack authority to apply the credit risk retention rules to managers of open market CLOs
 - “Retain” ≠ “obtain”
- Post-judgment process
- US credit risk retention going forward
 - Open-market CLOs
 - Middle market CLOs
 - CRE CLOs
 - Other aggregator securitizations with open market features
 - Non-CLO true sale securitizations
- “We’ll always have Paris”
- Impact on collateral manager competition, style and support

Risk Retention: What's Left?

US: Risk Retention Investing

- Risk Retention Holding Entities
 - Sponsor
 - Separately capitalized manager
 - Majority Owned Affiliate
 - The legal determination
 - The accounting determination
- Restrictions on hedging and transferring risk retention
- Restrictions on financing risk retention
 - Recourse requirement
 - Foreclosure restrictions

QUESTIONS?

K&L GATES