KRAMER LEVIN
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Securitization
ALERT

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Collateralized Loan Obligations 2012 Update

After years of being lumped together with CDO transactions collateralized by sub-prime RMBS and other poorly performing ABS, the CLO market appears to have differentiated itself and rebounded strongly. In 2011, 28 new CLO transactions totaling $12.5 billion closed, more than three times the total in 2010. Thousands of vintage CLO classes previously downgraded were upgraded by the rating agencies in 2011. In the first quarter of 2012, the market saw new CLOs totaling over $5 billion by American Money Management Corp., Credit Suisse Asset Management, The Carlyle Group, ING Alternative Asset Management, Onex Credit Partners, Octagon Credit Investors, Invesco Senior Secured Management, Apollo Credit Management, LCM Asset Management, Ares Management, Babson Capital Management, Symphony Asset Management and others. Market participants believe that 2012 could see up to $20 billion in primary broadly syndicated CLO transactions as well as substantial growth in private bespoke CLO transactions. Below are some key issues for the CLO market in 2012.

Risk Retention. In March 2011, federal agencies jointly issued proposed risk retention rules that could impact the CLO market. The proposed rules include a footnote that identifies the collateral manager of a CLO as the sponsor required to retain a 5% credit risk in the securitized assets. Characterizing the collateral manager as a sponsor will likely have an adverse impact on the viability of the CLO market, particularly more broadly syndicated CLOs, as few collateral managers have the resources or the inclination to hold such a level of non-hedged credit risk. Market participants argue that (i) the footnote is inconsistent with a plain reading of the proposed rules' definition of "sponsor"; (ii) requiring CLOs and collateral managers to observe risk retention requirements is outside the scope of the Dodd-Frank Act's mandate; (iii) "skin in the game" was directed at parties engaged in an "originate to distribute" model that is not applicable to collateral managers; (iv) through subordinate and/or incentive fee structures, collateral managers already have "skin in the game"; and (v) CLOs have performed well and structures have held up throughout the crisis and imposing risk retention requirements in CLOs would damage a vibrant market for no credible policy reason. Industry comment letters are asking for clarity that CLOs are not subject to the risk retention rules or, alternatively, safe harbor provisions for CLOs and/or an expansion of the definition of a "qualifying commercial loan" exempt from risk retention. Given the vast dissatisfaction with the proposed rules, it is expected that the agencies will re-propose rules some time during 2012 with final rules in 2013. For CLOs, if applicable, the risk retention rules will be effective two years after the final rules are published.

In addition, Article 122a of the European Union Capital Requirements Directive requires credit institutions regulated in the European Economic Area investing in securitization transactions (including CLOs) to ensure that the originator, sponsor or original lender retain a 5% economic interest in the securitized assets. Article 122a appears to have limited the marketability of CLOs to European institutional investors.

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Volcker Rule. In October 2011, federal agencies jointly issued proposed rules to implement the Volcker Rule which prohibits and restricts banking entities from engaging in proprietary trading and having certain interests in hedge funds and private equity funds. Hedge Funds and private equity funds are covered under the proposed rules by reference to Sections 3(c)(1) and (7) of the Investment Company Act. While it is true that most hedge funds or private equity funds utilize these exemptions, so do many other securitization vehicles, including CLO issuers. If prohibitions on banking entity sponsorship and ownership contained in the Volcker NPR were to apply to CLOs, CLOs would be prohibited from engaging in tasks central to their existence, such as holding cash received from the sale or repayment of loans, investing in short-term debt instruments, or containing investment baskets for other types of debt securities like high-yield bonds. Further, most balance sheet CLOs would not be permissible and traditional warehousing arrangements may not be possible. This result appears to be in conflict with the stated rule of construction that there be no limit or restriction on the ability of banking entities to sell or securitize loans. Market participants are hopeful that the final Volcker Rule will (i) exempt all securitization vehicles and (ii) expand and clarify the definition of which "loan securitizations" are exempt from the Volcker Rule. The Volcker Rule will become effective on July 21, 2012, whether or not any rules are approved; however, banks will be given until July 21, 2014, to comply with the Volcker Rule and the FRB has additional discretion to extend the implementation period.

Third Party Due Diligence. In June 2011, the SEC issued proposed Rule 15Ga-2 and amendments to Form ABS-15G, which would require the issuer or underwriter of a rated asset-based security (whether registered or not) to disclose, in the new Form ABS-15G, the identity of the securitizer and the findings and conclusions of any third-party performing "due diligence services" and the resulting "due diligence report." The SEC also proposed a new Rule 17g-10 and Form ABS Due Diligence-15E which requires third party "due diligence providers" to provide rating agencies with a written certification that includes a summary of the findings and conclusions of such due diligence. As many of the activities of a collateral manager could be considered "due diligence services," depending on the final rules, a collateral manager could be treated as a third party "due diligence provider." Final rules are expected during 2012.

Re-Proposal of Regulation AB II. In July 2011, the SEC re-proposed disclosure rules to address public comments and resolve a number of the discrepancies between the Dodd-Frank Act and prior proposed rules. A key open issue is the highly controversial proposal requiring public-style disclosure in private offerings that rely on exemptions from the registration requirements of the Securities Act of 1933 (such as Rule 144A and Regulation D). Under such proposal, an issuer would be required to provide to any investor, upon request, the same information that would be made available to investors in a registered public ABS offering, including ongoing reports, updated asset by asset data and periodic reports. The failure to provide such information to investors could bring about an enforcement action by the SEC.

FATCA. The Foreign Account Tax Compliance Act ("FATCA") was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. The IRS recently published proposed regulations on FATCA which are expected to be finalized before the end of 2012. FATCA requires foreign financial institutions ("FFIs") to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. If an FFI does not enter into an agreement with the IRS to report such information (an "FFI Agreement"), the FFI will be a deemed a non-Participating FFI ("non-PFFI"). U.S. persons making payments to a non-PFFI generally will be required to deduct and withhold 30% of the payments and remit such amount to the IRS. Unless a grandfathering provision applies (generally, for obligations (other than equity) issued or entered into before January 1, 2013), beginning on January 1, 2014, U.S. persons making payments to a CLO issuer generally will be required to withhold unless such CLO issuer has an FFI Agreement in place with the IRS which qualifies it as a Participating FFI ("PFFI") or the CLO issuer is otherwise deemed to be compliant with FATCA. An FFI Agreement (a form of

agreement has not yet been introduced by the IRS) will generally require the CLO issuer to (i) obtain information regarding its debt and equity holders and perform diligence to determine which accounts are U.S. accounts (ii) annually report to the IRS information regarding its U.S. accounts; (iii) beginning in 2017, deduct and withhold 30% of "pass-through payments" made to non-PFFIs and investors who fail to comply with reasonable requests for necessary information; (iv) comply with requests by the IRS for additional information regarding any of its U.S. accounts; (v) obtain a waiver of any privacy protections under foreign law regarding any of its U.S. accounts or close such account; and (vi) adopt written policies and procedures governing its FATCA compliance, conduct periodic internal compliance reviews and periodically certify to the IRS it is in compliance with FATCA. It is anticipated that CLO issuers will be able to begin applying to the IRS for PFFI status as of January 1, 2013. A CLO issuer must enter into an FFI Agreement with the IRS by June 30, 2013 to ensure that it will be identified as a PFFI by the IRS in sufficient time to allow U.S. withholding agents to verify the CLO issuer's PFFI status and refrain from FATCA withholding which begins on January 1, 2014. A CLO issuer that enters into an FFI Agreement after June 30, 2013 might not be identified as a PFFI by the IRS in time to prevent FATCA withholding by U.S. payors beginning on January 1, 2014.

IRC Section 457A. As part of the Emergency Economic Stabilization Act, Section 457A was added to the Internal Revenue Code in 2008. That section generally requires fund managers who receive deferred compensation from offshore entities to include such compensation in taxable income when such compensation is no longer subject to a "substantial risk of forfeiture." Compensation under Section 457A is subject to "substantial risk of forfeiture" only if it is conditioned upon the future performance of substantial services. If the amount of compensation is not determinable when no longer subject to a risk of forfeiture, then the manager is subject to an interest charge on the income when it is determinable, plus a penalty equal to 20% of the compensation. Subordinate management fees and incentive management fees are generally not determinable until they are paid in accordance with the priority of payments and also arguably are not subject to "substantial risk of forfeiture." As a result, collateral managers could find that such subordinate management fees and incentive fees may be subject to an interest charge and a 20% penalty. Collateral managers should consider this possible tax when structuring their fee arrangements.

Investment Adviser Registration and Reporting. Effective July 2011, the Dodd-Frank Act repealed the commonly used "private adviser exemption." Subject to certain exemptions that few collateral managers will be in a position to utilize, non-registered collateral managers must be registered with the SEC by March 30, 2012 (initial applications for registration on Form ADV should have been filed with the SEC by February 14, 2012). Registered investment advisers must adopt a written compliance program and are subject to specific regulatory restrictions in key operational areas, including advertising and marketing, custody of client assets, books and records, cross trades and principal trades, and client solicitations.

Most registered investment advisers to private funds will also be required to file Form PF, which reports detailed information about the assets advisers manage. Form PF filings will be due in August 2012 for the largest advisers, and in 2013 for most smaller advisers.

While for purposes of Form ADV, CDOs and CLOs are considered "private funds" and all their assets must be included in calculating "regulatory assets under management," Form PF separates private funds into seven categories of which "securitized asset fund" would appear to include CDOs and CLOs. This allows CDOs and CLOs to comply with the lower reporting threshold of annual, aggregated reporting standard in contrast to managers of large hedge funds who must report quarterly and include more detailed portfolio-level information on a fund by fund basis. Form PF is filed electronically, and is not publicly available, although it may be shared by regulators and will be provided to the FSOC

Structure and Document Changes. Compared to older transactions, new CLOs appear to be less complex and less levered, have better defined and more investor directed eligibility criteria and shorter reinvestment periods. In addition, as the financial crisis unfolded, it became apparent that CLO transaction documents were not always flexible enough or did not contemplate some of the situations that arose. Expect to see changes in documents to affirmatively deal with, among other things, (i) the *Concord Real Estate CDO* scenario where junior notes were submitted for cancellation to cure OC tests, (ii) the *Black Diamond CLO* issues relating to trade settlements and reinvestment periods, (iii) the *Zing VII CDO* issues related to bankruptcy remoteness, non-petition clauses and rights to object to involuntary bankruptcy, (iv) how "amend to extend" transactions should be treated in the context of reinvestment criteria and reinvestment periods, (v) timing of rating agency confirmations, (vi) informational requirements under FATCA and (vii) tax issues arising in connection with exchange workouts of loans.

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