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Dodd-Frank Credit Risk Retention Rules: House Financial Services Committee Passes Bill to Reduce Compliance Burden for Collateral Managers of Qualified CLOs

Attorneys
Patricia C. Lynch
Chris McGarry

On March 2, 2016, the House Financial Services Committee approved a bill, H.R. 4166, sponsored by Representatives Andy Barr (KY) and Dave Scott (GA), that would significantly reduce the credit risk retention obligations imposed on the collateral managers of collateralized loan obligations ("CLOs") under regulations recently adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Overview

The Dodd-Frank credit risk retention rules will apply to CLOs that close (or in certain cases are materially amended) on or after December 24, 2016. As currently drafted, the rules specify that for each such CLO, the relevant collateral manager must purchase and hold, unhedged, directly or through a majority-owned affiliate, either (i) 5% of each tranche of the CLO's securities, (ii) an amount of the CLO's equity equal to 5% of the aggregate fair value of all of the CLO's securities or (iii) a combination of the two. The required risk must be retained until the latest of (x) the date that the CLO has paid down its securities to 33% of their original principal amount, (y) the date that the CLO has sold down its assets to 33% of their original principal amount and (z) the date that is two years after closing.

If passed by both the full House of Representatives and the Senate, and signed into law by the President (a process that admittedly involves considerable hurdles, particularly in an election year), H.R. 4166 would reduce the amount of CLO securities required to be held by the collateral manager of a "qualified collateralized loan obligation" (or "QCLO") to an amount equal to 5% of the CLO's equity securities. Since CLO equity typically represents less than 10% of the aggregate value of the securities issued by a given CLO, this change would translate into more than a 90% reduction in the amount of securities that a manager of a QCLO would need to purchase in order to comply with the risk retention rules.

Criteria for Qualified CLOs

The criteria for a QCLO are set out in the bill and were developed in consultation with industry participants to track, or be less restrictive than, the terms of most CLOs of broadly syndicated loans that have recently been offered in the U.S. A QCLO must comply with the following criteria:

1. **Asset quality protections**

    - At the time that the CLO purchases any asset, it must either be in compliance with the following criteria or, if it is not in compliance, maintain or improve its level of compliance after giving effect to the purchase:

        - 90%1[1] of the CLO's assets must be senior secured loans and cash equivalents.

[1] The Foster amendment (referred to below) increased this percentage to 100%. It is as yet unclear how this change will affect the portion of the bill that currently permits QCLOs to invest in a limited amount of other assets, such as loan participations and certain hedging arrangements. Presumably, however, the sponsors of the bill will work to harmonize it with the "loan

- No more than 60% of the CLO's asset may be covenant lite loans.
- All of the loans held by the CLO must be issued by companies that issue financial statements that are audited annually by an independent, accredited accounting firm.2[2]
- At the time of its purchase, each loan must have at least three other investors or lenders that are unaffiliated with the CLO's collateral manager.
- The CLO may not hold any asset-backed securities or derivatives, with the exception of loan participations, letters of credit, or derivative transactions entered into for the purpose of hedging interest rate or currency mismatches.
- The CLO may not purchase assets in default, margin stock or securities convertible into equity.

2. Asset portfolio protections

- At the time that the CLO purchases any asset, it must either be in compliance with the following criteria or, if it is not in compliance, maintain or improve its level of compliance after giving effect to the purchase:
  - No more than 3.5% of the assets of the CLO may relate to a single obligor.
  - No more than 15% of the assets of the CLO may relate to a single industry.

3. Structural protections

- The CLO's equity tranche must be at least 8% of the value of its assets.
- The CLO's transaction documents must contain over-collateralization and interest coverage tests, the breach of which will cause interest collections (and, if necessary, available principal collections) to be applied to pay down the CLO's debt in order of seniority until compliance with the applicable test is restored.

4. Alignment of manager and investor interests

- The CLO must be an open market CLO (defined in the bill as a managed CLO whose assets consist predominantly of senior secured syndicated loans acquired in open market transactions).
- The CLO's equity investors, excluding risk retention equity, must have the right to remove the collateral manager for cause.
- A majority of the manager's fees (including any incentive fee) must be subordinated to payments then due on the CLO's debt.
- Discretionary sales by the manager of the CLO's assets (excluding sales of defaulted, credit deteriorated, credit risk and credit improved loans) must be capped at 30% of the aggregate principal amount of the CLO's assets annually.
- All holders of the CLO's securities that are U.S. persons (as defined in Regulation S promulgated under the Securities Act of 1933, as amended) must be qualified investors, defined in the case of CLO debt to

securitization" exemption of the Volcker Rule, which permits CLOs to hold loan participations and hedges subject to certain conditions and which is broadly relied upon in the U.S. CLO markets in order to permit bank investments in CLOs.

[2] The Foster amendment added a requirement that these audited financial statements be delivered within 90 days of the end of the obligor's fiscal year, and that the obligor deliver unaudited financial statements within 45 days after the end of each fiscal quarter.

mean qualified purchasers (as defined in Section 2(a)(51) of the Investment Company Act of 1940, as amended (the "Investment Company Act")) and in the case of most issuances of CLO equity to mean qualified purchasers and knowledgeable employees (within the meaning of Rule 3c-5 promulgated under the Investment Company Act).

5. **Regulatory oversight**

    - The CLO's collateral manager must be an SEC-registered investment adviser.
    - All purchases and sales of the CLO's assets must be conducted on an arm's-length basis and in compliance with the Investment Advisers Act of 1940, as amended.

6. **Transparency and Disclosure**

    - The CLO must deliver a monthly report to its debt investors that includes the following information:
        - A list of the CLO's assets, detailing for each asset the name of its obligor, its CUSIP or security identifier (if applicable), its interest rate and maturity date, the type of asset and its market price (where available).
        - The aggregate principal balance and aggregate adjusted collateral principal amount (as defined in the CLO's transaction documents) of the CLO's portfolio, and the percentage of the aggregate adjusted collateral principal amount represented by each asset.
        - The level of compliance with each of the CLO's over-collateralization and interest coverage tests.
        - All purchases, repayments and sales of assets.
        - The identity of each defaulted asset (as defined in the CLO's transaction documents).

Form of Retained Risk

H.R. 4166 originally proposed that a collateral manager of a QCLO be able to meet its reduced risk retention obligation by holding 5% of such CLO's equity securities. The House Financial Services Committee, however, approved an amendment to the bill proposed by Representative Bill Foster (IL) (the "Foster amendment"), under which the manager's retained risk must be held through a combination of CLO debt and equity in an aggregate amount equal to the value of 5% of the CLO equity, with the equity securities representing at least 3.5%. These securities may be held either directly by the collateral manager, by a majority-owned affiliate of the manager (as defined in the existing risk retention rules) or by the manager's employees.

For more information about the bill or about the U.S. and E.U. credit risk retention rules more generally, please feel free to contact Patricia Lynch or Chris McGarry.