The CLO Manager's Handbook

A Practical Guide to Legal Issues in Managing CLOs

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CHAPTER ONE

Launching a New CLO

What You Need to Know When Setting Up a New CLO Manager

Due to the continuing changes in the regulatory landscape, establishing a new investment management firm with a focus on collateralized loan obligations ("CLOs") requires careful planning and efficient execution. In addition to regulatory issues, the founding members are likely to have tax and other considerations that should be carefully analyzed so that the overall structure can be customized to meet the needs of the relevant parties.

This article summarizes some of the more common legal issues that a new CLO manager should consider in launching a new firm.

SUMMARY

- When organizing a new firm, the founding members and the sponsor should consider corporate governance issues, such as control, transfer of ownership interest, dispute resolution and wind-up mechanisms.
- The entity structure for a new firm should be designed so that the related management activities and associated fees are handled in a tax-efficient manner.
- One of the key regulatory issues to be addressed by nearly all new CLO managers is registration with the Securities and Exchange Commission (the "SEC") as the registered investment adviser.

Entity Types

The entity type (pass through versus corporation) is typically determined based on tax considerations. A closely held management firm may be organized as a limited liability company ("LLC"), a limited liability partnership ("LLP") or a limited partnership ("LP"). LLCs are more common as they do not require the additional layer of having a general partner and can have a single member.

If the firm will have a widely held ownership structure (i.e., if it plans to make a public offerings of its shares), the founders may choose to organize the entity as a corporation. In the near term, however, tax considerations are often the prevailing consideration, with a pass-through entity (LLC, LLP, LP) generally favored in order to avoid an additional level of taxation that would exist with a corporate structure. Initial organizational decisions will not foreclose later changes should circumstances dictate.

Establishing a Control Framework

A new firm, controlled by one person, can be organized with straight-forward structures and legal documentation. When two or more individuals will be involved in the management, ownership and profits of the new firm, careful consideration must be given to issues that may later lead to potential disputes and disagreements, including:

- Determining on-going distributions
- Winding up of the firm
- Resolving disputes

For example, the firm's corporate governing document should address what happens when one principal leaves the firm (by choice, for cause or as a result of death or incapacity). The questions that should be answered, in advance, include whether such exit by a principal would result in the firm's wind up or whether the remaining principals would have a right or obligation to acquire the interests of the departing principal and, if so, how those interests would be valued.

The valuation method of the principals' ownership interests and other related questions should be discussed and agreed upon by the founding members (and the sponsors) at inception in order to adequately provide for any subsequent "change in control" transactions.

For managers with multiple principals, investing the time to address areas of potential friction will give all parties a clear expectation of how issues will be handled in accordance with agreed procedures. While the formation documents cannot address every conceivable issue, the agreements should establish a basic framework for areas of potential concern and provide a basis on which the principals can explore potentially divisive issues.

SEC Registration and Reporting

An investment management firm that has assets under management exceed $150 million will generally be required to register with the SEC. Because virtually all CLOs exceed the $150 million threshold, every CLO manager would be expected to be registered with the SEC. Among other things, registered investment advisers are subject to periodic reporting requirements under Form PF and reviews by SEC staff. Firms that are not required or eligible to register with the SEC must generally register with state regulatory authorities in the state where the manager maintains its principal business office, subject to any minimum requirements for registration in that state.

Investment firms in New York State are subject to somewhat different rules. Because New York does not periodically audit or inspect the operation of state registered investment advisors, firms in New York may register with the SEC if assets under management exceed $25 million.

The SEC and most states require registration to be accomplished through the filing of a Form ADV. The Form ADV requires detailed information about the operations and personnel of the manager. In addition, the Form ADV requires a brochure explaining various aspects of its fee arrangements and types of advisory services provided. The brochure must be made available to clients and is publicly available through the SEC's website.

New York Tax Considerations

Investment advisers to hedge funds located in The City of New York sometimes elect to receive management fees and incentive fees in separate entities in order to minimize the impact of the unincorporated business taxable income. This structure is not common among CLO managers, but relatively common among hedge fund managers. As many CLO managers also manage credit hedge funds, separate subsidiaries and affiliated entities may be used in different business endeavors in order to achieve maximum tax benefit.

The specific terminology used in each CLO may vary from that used here. It is also likely that, as the market continues to grow and evolve that other variations and terms may become more prevalent. As always, you should seek guidance from experienced counsel in negotiating all of the relevant terms of your CLOs.

Manager's Discretionary Roles under the CLO Indenture

While the primary duties of a manager in a CLO transaction are enshrined in the collateral manager agreement, the indenture also has numerous provisions that require the manager's direction or discretion. Managers must understand these responsibilities and the impact that they have on its day-to-day operations and other material periodic events, such as an early redemption of notes issued in the CLO transaction.

This article summarizes the most important roles and responsibilities set out in the indenture, although managers should be aware that there are many more provisions to be considered before launching a new CLO.

SUMMARY

- A CLO manager should have a clear understanding of each and every responsibility it has under the indenture.
- The manager (or its counsel) should carefully review the indenture provisions to ensure that each assignment of responsibility to the manager is clear.
- The manager should understand the standard of care applied to each activity it agrees to perform.

Activities Related to Assets and Accounts

This category of activities encompasses the daily management of the assets in the CLO portfolio. This includes:

- Determining whether an asset is a credit improved or a credit risk obligation.
- Selecting various collateral quality test levels related to spread, recovery and other portfolio characteristics.
- Determining the characteristics of discount obligations.
- Assigning the market value of certain assets that do not have readily available market prices.
- Directing sale and purchase of the assets (for more discussion on reinvestment activities, please see "Par-for-Par Reinvestment Provisions" article).

In negotiating indenture provisions that impose discretion on it, a manager should seek to achieve an appropriate balance between flexibility and potential liability. Discretion may help the manager address issues arising in different market environments. There may also be certain actions and decisions requiring a degree of flexibility that cannot be performed efficiently by other parties. At the same time, discretionary powers may subject the manager to potential liability for matters that it has limited or no control over. For example, the manager should not agree to asset transactions on pre-established terms within a pre-determined period unless such activity is qualified by a clear standard, such as on a reasonable or "best efforts" basis. And the manager should avoid agreeing to broad, generic duties to use its discretion (e.g., "subject to the manager's discretion") in favor of clear, discrete obligations in taking action in the interest of the deal.

The indenture provides for the creation of numerous accounts and related accounting and reporting obligations. The manager's roles regarding the accounts are typically mechanical in nature, but the manager should carefully review the scope and the timing of duties in respect thereof (e.g., the instructions to be delivered to various agents responsible for the accounts). And the manager should consider how these responsibilities under the indenture coordinate with its internal operational platform. For example, the manager should have clear internal procedures dealing with any transfer of funds during the period between payment dates and that these procedures align with the permitted actions under the indenture. These intraperiod payments may be related to the funding of revolving assets, hedge payments or administrative expense payments.

Activities Related to CLO Capital Structure

A majority of recent CLOs allow the CLO manager to change the CLO's capital structure as long as certain conditions are met. In that context, the collateral manager's decisions are often needed in connection with:

- Refinancing or issuance of additional notes
- Re-pricing of notes
- Optional redemption of notes

In most CLO 2.0 transactions (a general reference to more recent (post-crisis) deals), the mechanics of the refinancing or the re-pricing have become fairly standardized. The important issues that should be addressed, however, are who has the right to initiate these changes to the capital structure and who, if anyone, has veto power. For example, the manager should consider the possibility that the economic interests of the manager and the equity investors may diverge over time or as the composition of the equity investors changes.

The manager should also consider the operational implications of these activities in order to create flexibility in order to enhance the ability to fulfill its obligations in varying market environments. For example, in connection with an optional redemption in full of the secured notes, there may be a very small window between the latest date on which the redemption notice can be delivered and the date by which the manager must deliver a certification to the effect that the expected sale proceeds (adjusted by advance rates) would exceed the amount to pay the secured notes and the expenses. Depending on prevailing market conditions, the manager may need a longer time period to fulfill its obligations.

Other Activities

As an agent of the issuer, the manager may have the right to remove and/or replace, or participate in the removal and replacement of the trustee, the calculation agent and the paying agent. The manager should review these provisions to ensure that its authority in these decisions do not impose conditions that may be practically impossible to satisfy.

The manager should consider whether it would prefer an explicit provision that gives it the interpretive powers of the document provisions. In certain instances, the trustee (and other agents and transaction parties) may look to the manager to make decisions and interpretations (particularly with respect to collateral assets) when ambiguity exists or multiple methods could be used in making necessary calculations. As a general matter, it may be useful to have explicit interpretive power vested in the manager. The corollary to this provision is that other transaction parties (e.g., the trustee) will generally have an "out," protecting those parties relying on, and leaving the manager as the only party to make, those interpretations.

In addition, the manager should have the power to act to maintain the tax and securities law status of the issuers. These typically include the ability to force non-qualifying noteholders (e.g, holders that are not qualified institutional buyers or qualified purchasers) to sell their notes or to cause the issuer to comply with any future tax and other regulations.

Historically, the manager of a CLO transaction often arranged a credit facility with a bank (most likely the underwriter for the intended new-issue CLO) in order to provide short-term financing for the acquisition (or "warehousing") of corporate loans before the launch of the CLO. Securing a warehouse facility remains a popular means for the manager to ramp up the portfolio prior to launching a CLO transaction and affords the manager more options in the timing and speed of the ramp-up process. Managers should be acquainted with the warehousing options potentially available and the sources of such financing.

SUMMARY

- While not as common in the current market, traditional warehouse facilities offer managers tools to aggregate CLO eligible loans over a set period of time.
- Alternative financing methods and sources continue to evolve, including those that mitigate potential market value risk through par-based structures.

General Framework

A warehouse facility is a relatively straightforward credit facility. Recent facilities typically have had certain characteristics including:

- The warehouse facility may have several classes of loans with differing seniority levels, with the subordinated or "equity" class typically funded by the manager.
- The borrower is often the special purpose entity that will later issue securities in the CLO transaction.
- The borrower pledges the corporate loans purchased as security for the benefit of the warehouse lenders.

The warehouse credit agreement typically has loan eligibility criteria that are similar to those that are expected to be included in the indenture. Ineligible loans cannot be financed using the warehouse line, and the warehouse agreement will have liquidation provisions permitting the warehouse lender to direct the sale of any loans that were or become ineligible.

Market value risk

One of the most significant risks to a manager in its role as the holder of the subordinated class of a warehouse facility, is the market value fluctuation of the loans acquired. In order to mitigate this risk, a typical warehouse lender often requires that the manager (as the subordinate noteholder) maintain a certain level of loan-to-value ratio. As a result, if the market value of loans decreases, the manager may need to provide additional funding to maintain the warehouse lender's loan-to-value ratio.

Margin maintenance requirements continue to create potential for losses to CLO managers financing the ramp-up through a traditional warehouse facility. During the credit crisis, these requirements caused significant negative impacts on many market participants. In addition to forcing the manager to increase its investment in the subordinate class, the manager may otherwise adjust the portfolio in ways that may not be optimal to the timely completion of the CLO transaction. For example, the manager may elect to make changes to the portfolio (such as selling assets or seeking to acquire additional assets in order to achieve a more favorable loan-to-value ratio), which may extend the time necessary to reach an appropriate portfolio to launch the CLO transaction.

Innovation Continues

Recently, some CLO managers have successfully launched new-issue CLOs without relying on a warehouse facility. These transactions demonstrate that a warehouse facility is not a "must have" to launch a new CLO. The utility of having a well-structured warehouse facility, however, continues to be relevant for managers that seek more options to manage the ramp-up process and provide a hedge against challenging market conditions. A warehouse facility may afford the manager more time to select loans for the portfolio, will spread some of the risk during the ramp-up period to other parties and may permit the more rapid acquisition of assets based on ready availability of capital. The cost of a warehouse facility will reduce the overall economics of the CLO transaction as it adds an incremental interest cost during the ramp-up. Managers should carefully consider the trade offs in cost and how to best mitigate exposure to market volatility in determining whether to seek warehouse financing.

Some banks have begun to innovate how warehouse facilities are structured, creating new types of facilities that may reduce the market value exposure born by the manager. Using cash flow techniques similar to those embedded in CLO transactions, such as overcollateralization ratio tests, new "par based" warehousing structures may offer managers a financing tool better aligned with their overall capitalization and business structures. Features of these evolving structures include:

- Interest and principal proceeds are distributed in accordance with separate priorities of payment.
- The manager may sell assets out of the warehouse subject to set limits.
- Overcollateralization ratio tests are used to maintain the aggregate par amount of the warehouse portfolio, rather than a market value based test.
- Liquidation of the warehoused assets is permitted in certain limited instances.
- Delayed draw or variable funding notes may be used to help mitigate the negative carry created by upfront funding of a warehouse facility.

Managers should be aware of these emerging financing alternatives and consider the optimum financing approach to the ramp up phase of new issue CLO transactions.

Selected CLO 2.0 Features

As the market for new-issue CLOs continues its resurgence, the documentation for CLO 2.0 transactions continues to evolve. Managers should be aware of the structural features that have become more common over the last several years in CLO 2.0 transactions.

SUMMARY

- Senior noteholder input has become more prevalent, particularly in transactions that have an anchor investor in the senior class.
- Given the increased spread levels on senior notes compared to pre-crisis levels, refinancing and re-pricing mechanisms that allow CLO issuers to adjust the spreads post-closing have become popular.
- Additional features include limitations on specific activities of the issuer relating to reinvestment and amendment of underlying loans.

Features Affecting CLO Capital Structures

Refinancing

In many CLO 2.0 transactions, the noteholders agree to a mechanism to change the notes' spread during the life of the deal. The refinancing provisions allow the CLO issuer to lower the spread on the outstanding CLO notes as long as a number of conditions are satisfied. The refinancing is accomplished by redeeming outstanding notes and issuing new replacements.

The conditions for refinancing include:

- On the refinancing date, the sum of the refinancing proceeds and the CLO's cash balance (in its accounts and other proceeds) will be sufficient to pay the sum of the refinancing price plus any expenses related to the refinancing.
- The new notes' principal amount is equal to the principal amount of the notes being redeemed.
- The new weighted average spread over LIBOR is less than or equal to the existing weighted average spread over LIBOR.
- The stated maturity of the new obligations is no earlier than the stated maturity of the existing notes.
- The refinancing agreements contain limited recourse and non petition provisions
- A notice will be delivered to the rating agencies.
- The refinancing expenses are paid or adequately provided for by the issuer.

Re-pricing

While the refinancing mechanism offers a reasonably cost-effective way to lower the overall cost of funding for the CLO issuer, many CLOs incorporate a re-pricing mechanism, by which the CLO issuer can re-price the outstanding notes rather than going through the process of issuing new notes with lower spreads.

Typically, noteholders will have a 45 day notice period prior to the re-pricing. Notes held by any noteholders that do not consent to such re-pricing (the "non-consenting holders") are offered for sale in secondary market transactions.

Typical conditions for re-pricings include:

- Execution of a supplemental indenture dated as of the re-pricing date to modify the spread over LIBOR applicable to the class of notes being re-priced (the "Re-Priced Class");
- Confirmation by the issuer in writing that all notes of the Re-Priced Class held by non-consenting holders have been sold and transferred;
- Delivery of notice of the re-pricing to all rating agencies; and
- Payment or provision for all expenses incurred in connection with the re-pricing.

Some deals may also include "make whole" provisions so that the senior noteholders are protected against and compensated for the early redemption or refinancing of their notes.

Limits on Note Cancellation

Unlike in pre-crisis CLO transactions, many indentures in CLO 2.0 transactions contain provisions that limit the impact of the cancellation of notes before their expected maturities. This is likely in response to certain legacy CLO transactions that experienced deal changes that were not originally intended.

These provisions focus mainly on the calculation of the coverage tests, which are based on the outstanding notional amount of the notes. To avoid any potential for improving the coverage test through the redemption or cancellation of junior notes (presumably acquired at a discount), the coverage tests are calculated without giving effect to such redemptions or cancellations. Another variety of this provision is to allow cancellations or redemptions to be reflected in the calculations only to the extent that the principal balances would have been reduced in accordance with the priority of payments for the relevant class of notes.

Alternatively, some CLO 2.0 transactions simply contain an explicit prohibition on the issuer's purchase and cancellation of its own notes.

Features Affecting Manager Activities

Along with the eligibility guidelines and the collateral obligation definitions, CLO 2.0 indentures contain provisions specifically limiting manager activities relating to reinvestment and amendment of the underlying loans.

Shorter Reinvestment Periods

Generally, reinvestment periods now range from three to five years, compared to five to seven years in older, pre-crisis transactions.

In addition, some CLO 2.0 indentures contain provisions that explicitly allow reinvestments on a "trade date" basis immediately before the end of the reinvestment date. These provisions allow for asset purchases near the end of the reinvestment period that settle after the reinvestment period ends. Disputes arose in several earlier deals as to whether the issuer had authority to enter trades at or near the end of the reinvestment period.

Limits on Maturity Extension

In order to mitigate the potential for lengthening the amortization (i.e., post-reinvestment) period of a CLO, some noteholders have negotiated for a specific prohibition on the manager's ability to agree to maturity extensions on the underlying loans. A typical provision would require that the collateral manager may affirmatively vote in favor of a waiver, modification or amendment of the underlying loan only if (i) the extended maturity is no later than the stated maturity of the notes and (ii) the weighted average life test is satisfied.

Extension of maturities also has the effect of minimizing the aggregate size of any loans that would qualify in the "long-dated" basket (i.e., loans that mature after the stated maturity of the notes). These long-dated loans may expose the transaction to market value risk because it is likely that these loans will need to be sold at the maturity of the notes.

CHAPTER TWO

Managing On-Going Issues

The manager of a CLO transaction must give careful consideration to provisions in the indenture governing the reinvestment of principal when making reinvestment decisions. While many indenture provisions have become relatively standardized over the years, managers and investors continue to negotiate reinvestment terms in an effort to strike a reasonable balance between the manager's need for flexibility in addressing various market environments and the investors' desire for mitigating potential losses related to reinvestments.

In particular, a manager should carefully negotiate indenture provisions relating to the par amount of assets being sold and purchased. These provisions (found in Article 12 of the indenture) could have an unintended impact on the asset selection process depending on the prevailing asset prices at the time of the reinvestments. Over the years, these "par-for-par" provisions have evolved into multiple variations that are currently accepted in the market.

SUMMARY

- Variations in indenture provisions have emerged governing the reinvestment of par amounts.
- Trading plans, consisting of multiple separate asset trades aggregated into one plan, are a common feature, particularly where reinvestments tests requiring par-for-par trades cannot be satisfied on a single asset basis.
- Different standards may apply to the reinvestments of credit risk and defaulted assets.

"Par-for-Par" Requirements

CLO transactions allow managers to reinvest principal proceeds received during the reinvestment period, which typically includes the first three to five years of the transaction. During the reinvestment period, the manager will typically reinvest principal proceeds to purchase new collateral, provided that the reinvestments satisfy the conditions in the indenture. After the end of the reinvestment period, most indentures allow the manager to reinvest the principal proceeds received from the sale of certain types of assets or from unscheduled principal proceeds.

Many indentures incorporate three variations of the "par-for-par" framework with the objective of maintaining the overall par amount of the portfolio. The first alternative is an asset-by-asset comparison of the respective par amounts. If an asset with a par amount of $10 million is sold, assets with an aggregate par amount of $10 million must be purchased as a replacement. This test, while simple in concept, can have some practical limitations that can be resolved by allowing trading plans, which are discussed below.

In the second variation, the manager compares the sum of the par amounts of all the new assets with the sum of the par amounts of one or more "old" assets that generated the proceeds. The reinvestment condition is met if the aggregate par amount of the new assets maintains or increases the par amount of the "old" assets. In certain transactions, the par amounts being compared are adjusted ("haircut") to reflect different carrying values of certain assets (e.g., excess "CCC" assets). This additional comparison is commonly referred to as the "O/C to O/C" comparison as it focuses on maintenance of the overcollateralization ("O/C") ratio.

The third approach compares the total principal balance of all assets with the reinvestment target par balance. This overall threshold is linked to a pre-determined par amount, which is typically the targeted amount of assets the manager is required to purchase by a transaction's effective date. The target par amount must usually be achieved by a date certain. Under this approach, the reinvestment condition is met if the total asset par amount equals or exceeds the target par amount. In some transactions, the target amount decreases as CLO liabilities are paid down.

In some transactions, the manager has the option among all three variations in any "par-for-par" trades. Par-for-par trading requirements are applicable to any principal proceeds received during the reinvestment period, except for sale proceeds from credit risk obligations and defaulted obligations, which are discussed below.

Trading Plans

Most recent CLO transactions allow the manager to aggregate a number of purchases and sales into a single trading plan in determining satisfaction of the investment guidelines and par maintenance requirements. This limited flexibility allows reinvestment in situations where the proceeds and the new assets do not necessarily have closely aligned characteristics, such as position size, asset type and other factors.

A typical indenture contains conditions regarding trading plans such that:

- Only one trading plan may be in place (or open) at any time.
- Each trading plan may not account for more than a set percentage of the total collateral pool (typically, this ranges from 3% to 5% of the total portfolio collateral amount).
- Each trading plan can only be open for a set number of days (typically, seven to twenty days).
- Each trading plan may not extend beyond the next reporting date for the notes (typically, quarterly).
- The transaction documents will prohibit the manager from entering into future trading plans if any previous trading plan resulted in a deterioration of the issuer's compliance with any of the investment guidelines.

Credit Risk Obligations and Defaulted Obligations

In connection with the reinvestment of proceeds from the sale of credit risk obligations or defaulted obligations, the indenture typical includes a condition that would be satisfied if the new asset par amount was the same or greater than the sale proceeds, rather than the par amount, of the old asset as the proceeds from the disposition of a distressed asset may be less than its par amount, making par-for-par reinvestment difficult to achieve. As an alternative to this condition, many recent transactions also allow reinvestment related to these assets as long as the total principal balance of all assets is equal to or greater than the defined reinvestment target par balance.

Some indentures also require that the reinvestment of proceeds of defaulted obligations must result in satisfaction of the O/C tests. Other types of reinvestments generally require only that the level of compliance be maintained or improved (so that the trade can be completed even if the deal is out of compliance before and after the trade).

While indentures may require that deals dispose of distressed assets within certain time limits, the limitations on replacing those distressed assets help to ensure that the net effect of the trade either does not cause further deterioration to the portfolio or improves its overall compliance with the relevant tests and guidelines.

Control Issues—Manager Removal and Replacement

The performance history and the reputation of the manager of a new issue CLO transaction are among the most important marketing aspects in launching a new CLO. From the manager's perspective, it is critical to understand and negotiate appropriate terms in the collateral management agreement governing removal of the manager, assignment of the management contract and the standard of care to which the manager is held in the ongoing operation of the CLO. While many of these provisions appear to address common issues in a consistent way, there are numerous nuanced, yet potentially material, variations among transactions and managers.

Managers should be well acquainted with and give careful consideration to the contractual issues related to removal or resignation and replacement of the manager.

SUMMARY

- The manager can generally be removed at the direction of specified investors upon a "cause" event.
- The determination of "cause" generally allows immediate removal for certain willful breaches of agreements or bankruptcy of the manager as well as upon breach following notice and opportunity to cure.
- The details of what constitutes "cause" may vary from deal to deal; many deals also provide for non-cause removal.
- Because the removal provisions may become relevant far in the future and under circumstances materially changed from those expected at closing of the CLO, care should be taken in crafting the removal and replacement provisions.

Definition of "Cause"

The manager can typically be removed for "cause" including the following:

- Willful violation or willful breach of any material provision of the management agreement or indenture
- Breach of any material provision of the management agreement or the indenture (excluding coverage tests) that would reasonably be expected to have a material adverse effect on investors and, if capable of being cured, is not cured within the permitted grace period after knowledge or notice
- Breach of representation, warranty, certification or statement of the manager that could reasonably have a material adverse effect on investors and is not cured within the permitted grace period
- Dissolution, winding up, bankruptcy, insolvency, etc., of the manager
- Event of Default under the indenture resulting from breach by the manager of duties under the management agreement or the indenture that is not cured within any applicable cure period

- Fraud or criminal activity by the manager or its affiliates in the performance of obligations under the management agreement, conviction of any officer or director of the manager of a criminal offense materially related to the primary business of the manager or the indictment of the manager or its executive officers primarily responsible for administration of the collateral
- The occurrence of a "key manager event"

With respect to these "cause" events, the parties may negotiate varying gradations, such as whether fraud or criminal activity is merely alleged or definitively established by final determination of a court of competent jurisdiction. As the definition of "cause" may later become important to both investors and the manager, great care should be taken to ensure that the agreed definition sets the proper balance in protecting the rights and interests of the negotiating parties.

Removal without Cause

The manager may generally resign upon requisite notice or immediately if a material change in law renders performance a violation of law. In addition, the manager may be immediately removed if the appointment of the manager requires the issuer or the collateral pool to be registered as an investment company, causes the issuer to be engaged in a U.S. trade or business or otherwise causes material adverse tax consequences to the issuer.

Because there is lack of clarity as a matter of law regarding the rights of certain parties to remove the manager without cause, some management agreements reserve all rights necessary to permit removal of the manager to the extent required to permit compliance with the Investment Advisers Act of 1940, as amended.

Control of Removal and Appointment of Replacement

The removal and replacement determinations are held by one or more classes of investors in the CLO. Removal provisions can require as little as the majority vote of the economic equity of the CLO or can be as constraining as to require a supermajority of each class of outstanding securities voting as a separate class.

Nomination of a replacement manager may be within the authority of the issuer or the relevant class of investors above certain thresholds (likely to be the equity or the most senior class of notes). The vote to appoint the proposed replacement manager can vary, but typically requires the consent of a majority of the most senior class of notes and often includes the vote of the equity. Other CLOs may require the consent of a majority of all outstanding securities, voting separately or as a single class.

CLO securities held by the manager are generally not included in determining the requisite vote necessary for removal of the manager, but may be included for purposes of voting for any replacement manager. Some collateral management agreements will exclude manager-held securities from voting for a replacement manager if the incumbent manager has been removed for "cause."

Control Issues—Assignment of Management Agreements

Some managers of CLO transactions have strategically increased assets under management by seeking to acquire contracts from other managers or through merger and acquisition transactions. Managers who may consider acquiring existing transactions or managers should be aware of the potential challenges as well as the relevant contractual provisions in their own new-issue CLOs in order to better understand the potential ramifications of the assignment or transfer of the collateral management agreement (the "CMA"). In particular, the manager should carefully consider the rights of other constituents (including senior noteholders and equity investors) typically provided for in the transfer restrictions in the CMA.

Managers should understand the terms and requirements involved in the assignment of management agreements from both the perspective of assignments of their contracts as well as potential acquisition of contracts from other managers.

SUMMARY

- The CMA can generally be assigned only with the consent of the requisite percentage of the controlling class of notes, equity investors or all classes of securities.
- Assignment may require satisfaction of the rating agency condition.
- Amendment of the CMA may be subject to different consent thresholds depending upon the types of changes sought.
- In originating new CLOs, managers should consider the benefits and burdens of adopting terms that inhibit or complicate assignment of the CMA.

Limits on Assignment

Both the indenture and management agreement will have provisions relating to the assignment of the management agreement. Many of the typical assignment provisions are drafted to comply with the related requirements of the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act").

The assignment of the CMA typically requires the consent of the holders of the controlling class (i.e., the most senior class of notes) and the equity. Alternatively, some transactions require the consent of only the equity or each class of CLO securities voting separately. The threshold is typically a majority of each relevant class, but some CLOs require a supermajority (usually two-thirds of each relevant class).

There is often greater flexibility in assigning the CMA to an affiliate or another entity that employs the same principal personnel managing the collateral pool as prior to the assignment. The fundamental issue is whether the same individuals continue to make the investment decisions, regardless of whether they are employed by or otherwise affiliated with a different organization.

In any permitted CMA assignment, any CLO securities held by the manager may be excluded in determining the relevant thresholds. This exclusion varies from CLO to CLO.

The assignment provisions will generally not interfere with the ability of the manager to delegate or appoint agents and other parties to act on behalf of the manager where the manager remains primarily liable for the performance of its obligations under the management agreement.

In analyzing or establishing consent requirements for assignment of CMAs, consideration should be given to the following:

- Affirmative consent of controlling class and/or equity (or of all classes of outstanding CLO securities)
- Exclusion of securities held by manager in satisfying consent thresholds
- Satisfaction of rating agency requirements
- In order to satisfy requirements of the Investment Advisers Act, consent of the issuer (or directors of the issuer independent of the manager) or some other independent party acting on behalf of the issuer may be required
- Deemed consent after giving written notice and opportunity to object
- Assignments in which "key personnel" continue to manage the collateral portfolio (e.g., assignments resulting from a corporate reorganization or merger transaction)
- Requirements of Investment Advisers Act in conjunction with "assignment" as defined in and interpreted pursuant to such act
- Whether the proposed assignment also includes amendment of the management agreement

Investment Advisers Act

Many managers are now subject to registration as investment advisers under the Investment Advisers Act of 1940. Because the Investment Advisers Act imposes requirements for assignment of advisory contracts, managers should be aware of the relevant requirements. Generally, the Investment Advisers Act provides that an advisory contract cannot be assigned by the adviser without the consent of the other party to the contract. An assignment of the investment advisory agreement without consent results in automatic termination of the agreement. Accordingly, it is important for all parties to consider and reach conservative conclusions regarding the possible implications of the Investment Advisers Act on any potential acquisition or merger arrangement regardless of the other terms of the CMA.

Amendment of Management Agreement

Often in conjunction with the assignment of a CMA, the new manager will seek to amend certain terms of the CMA being taken over. The indenture will typically include requirements with respect to the CMA requiring consent for amendments that are consistent with a similar type of amendment involving the indenture. Accordingly, any amendment will require satisfaction of the rating agency condition (or at least notice to the rating agencies) and possibly the consent of one or more classes of securities issued by the CLO issuer. These requirements may impose a higher threshold than the assignment of the CMA without any substantive changes. Whether to accept the existing terms or to seek amendment as part of the assignment process is a strategic decision that should be made in contemplation of known information regarding the requirements of the indenture and CMA, the perspectives of relevant investors and the likelihood that the proposed assignments may disrupt timely completion of the assignment.

Balancing Interests in Crafting Assignment Provisions

The thresholds for assigning CMAs may give reasonable power to various investors or may be onerous to the point of making an elective assignment virtually impossible. While more restrictive assignment provisions may appear to be more protective of the incumbent manager and investors, those provisions may ultimately inhibit transfer where all parties could be better served by allowing transfer to a new manager.

CHAPTER THREE
Regulatory Perspectives

What CLO Managers Should Know About U.S. Credit Risk Retention Rules

Six federal agencies (the "Agencies") requested public comments on a re-proposed rule (the "Re-Proposed Rule") to implement the credit risk retention requirements under the Dodd-Frank Act. We summarized some of the relevant new elements of the Re-Proposed Rule in an earlier alert, titled "U.S. Regulatory Update – Credit Risk Retention for CLOs" originally published on September 10, 2013.

Managers should also be aware of the Re-Proposed Rule's proposed changes that may affect the management activities of CLO transactions.

SUMMARY

- If adopted in their current form, the Re-Proposed Rules may have a material impact on how a manager would launch and manage a new CLO transaction. In particular, a newly proposed limitation on equity distributions may fundamentally change—or worse—stifle the new issue CLO market.
- A newly proposed "open market CLO" option appears unlikely to provide a meaningful alternative.
- In order to satisfy the risk retention rule under the horizontal option, additional disclosure requirements must be met.

General Framework

The manager of a CLO is a "securitizer."

A manager is deemed to be a "securitizer" because the Agencies believe that it is "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." In the Re-Proposed Rules, the Agencies have explicitly set out their rationale for declining to accept numerous comments arguing for the inapplicability of the term "securitizer" to managers.

The manager must hold, at minimum, a 5% risk retention piece of each CLO it manages.

A manager may satisfy the risk retention requirement by owning[1] any combination of vertical and horizontal interests of a CLO it manages, as long as the total interests retained are at least five percent of the "fair value" of all ABS interests. Referred to as the "combined risk retention option" in the Re-Proposed Rules, this option would permit a manager to satisfy the requirement by retaining an "eligible vertical interest," an "eligible horizontal residual interest," or any combination thereof, in a total amount equal to no less than five percent of the fair value of all ABS interests in the CLO issuer.

[1]The Re-Proposed Rule makes clear that the sponsor may hold interests through majority-owned affiliates.

What does the manager retain? – The numerator.

To satisfy the five percent threshold, a manager would hold the aggregate amount of any combination of the vertical and horizontal interests, which would count towards the numerator for this calculation. While any "combination" would satisfy the rules, the manager must hold the requisite percentage in every CLO tranche if a vertical interest is used in the combination.

What is included in "ABS interest"? – The denominator.

In the Re-Proposed Rules, the Agencies declined to make substantial changes to the original definition of the term "ABS interest."[2] The Agencies, however, added one more eligible component, calling it the "servicing assets."[3] Essentially the cash equivalents, the servicing assets are similar to "eligible assets" in Rule 3a-7 under the Investment Company Act of 1940, as amended (the "Investment Company Act").

Newly proposed "open market CLO" option is unlikely to be available.

Another option specifically proposed for "open market CLOs" is not likely to be a realistic option for managers because it relies on market developments beyond the control of the manager. To become useful, this option would require the underlying U.S. corporate loan market to adopt a set of new practices to create "CLO eligible loans." Most market participants and other observers have stated that it would be difficult to implement such a framework. For more details of the open market CLO option, see the additional discussion in "U.S. Regulatory Update—Credit Risk Retention for CLOs" article.

What's Fair in the 5% Retention Option?

A manager must also adhere to additional requirements in order to satisfy the horizontal risk retention option, including:

The manager must disclose fair value determinations.

A manager relying on the horizontal risk retention option must disclose the reference data set or other historical information which would meaningfully inform third parties of the reasonableness of the key cash flow assumptions underlying the measure of fair value (such as default, prepayment, and recovery).

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[2]It refers to "all types of interests or obligations issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest or residual interest, the payments on which are primarily dependent on the cash flows on the collateral held by the issuing entity. The term, however, does not include common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests in an issuing entity that are issued primarily to evidence ownership of the issuing entity, and the payments, if any, on which are not primarily dependent on the cash flows of the collateral held by the issuing entity."

[3]It refers to "any rights or other assets designed to assure the servicing, timely payment, or timely distribution of proceeds to security holders, or assets related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets. These may include cash and cash equivalents, contract rights, derivative agreements of the issuing entity used to hedge interest rate and foreign currency risks, or the collateral underlying the securitized assets."

The Agencies proposed a list of disclosure items to be provided to potential investors a reasonable time prior to the sale of CLO notes. See Appendix for a list of the disclosure items.

There are limits on distributions to the horizontal risk retention piece.

In their efforts to "establish economically meaningful horizontal risk retention that better aligns the sponsor's incentives with those of investors," the Agencies proposed to impose limits on payments to the holder of the eligible horizontal residual interests[4] (the "EHRIs").

The Re-Proposed Rules would "prohibit the sponsor from structuring a deal where it receives such amounts at a faster rate than the rate at which principal is paid to investors in all ABS interests in the securitization, measured for each future payment date." This approach would be inconsistent with the typical CLO priority of payments. In fact, it is not clear if one can structure a CLO with this type of prohibition on equity distribution. The implementation of this restriction could substantially dampen market demand for CLO equity, effectively closing the CLO market to many managers.

If adopted as proposed, this requirement may cause significant, negative impact on the CLO market.

What to Expect In the Near Future

The comment period expired on October 30, 2013 and substantial comments were submitted by the community involved in CLO transactions prior to the end of the comment period. The final rule is expected to become effective two years after adoption. While it is not clear when the risk retention rules will be finalized, many market observers believe that the Agencies are under substantial pressure to finalize and implement the rules as soon as practicable. Managers should remain alert to developments related to the Re-Proposed Rules as the final rules could be announced at any time.

[Originally published October 2013]

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[4] An interest qualifies as an ''eligible horizontal residual interest'' under the proposed rules only if it is an ABS interest that is allocated all losses on the securitized assets until the par value of the class is reduced to zero and has the most subordinated claim to payments of both principal and interest by the issuing entity.

Appendix—List of Disclosure Items

- The fair value (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the eligible horizontal residual interest that will be retained (or was retained) by the sponsor at closing, and the fair value (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the eligible horizontal residual interest required to be retained by the sponsor in connection with the securitization transaction;
- A description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;
- A description of the methodology used to calculate the fair value of all classes of ABS interests;
- The key inputs and assumptions used in measuring the total fair value of all classes of ABS interests and the fair value of the eligible horizontal residual interest retained by the sponsor (including the range of information considered in arriving at such key inputs and assumptions and an indication of the weight ascribed thereto) and the sponsor's technique(s) to derive the key inputs;
- For sponsors that elect to utilize the horizontal risk retention option, the reference data set or other historical information that would enable investors and other stakeholders to assess the reasonableness of the key cash flow assumptions underlying the fair value of the eligible horizontal residual interest. Examples of key cash flow assumptions may include default, prepayment, and recovery;
- Whether any retained vertical interest is retained as a single vertical security or as separate proportional interests;
- Each class of ABS interests in the issuing entity underlying the single vertical security at the closing of the securitization transaction and the percentage of each class of ABS interests in the issuing entity that the sponsor would have been required to retain if the sponsor held the eligible vertical interest as a separate proportional interest in each class of ABS interest in the issuing entity; and
- The fair value (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of any single vertical security or separate proportional interests that will be retained (or was retained) by the sponsor at closing, and the fair value (expressed as a percentage of the fair value of all ABS interests issued in the securitization transaction and dollar amount (or corresponding amount in the foreign currency in which the ABS are issued, as applicable)) of the single vertical security or separate proportional interests required to be retained by the sponsor in connection with the securitization transaction.

On August 28, 2013, six federal agencies, including the Board of Governors of the Federal Reserve System, the U.S. Securities and Exchange Commission and the Federal Deposit Insurance Corporation (collectively, the "Agencies"), issued a re-proposed rule (the "Proposed Rule") to implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934, as added by Section 941 of the Dodd-Frank Act.

Managers should be aware of the key points of the Proposed Rule that may are anticipated to affect CLO market practice.

SUMMARY

- Two risk retention options would be available: (a) retention of horizontal or vertical interests or a combination of the two; or (b) in connection with an "open market CLO," a new option that requires the lead underwriter of corporate loans to hold 5% of the face amount of the term loan tranche purchased by the CLO.
- Additional disclosure and certification requirements are proposed with respect to "open market CLOs."
- The risk retention requirements for CLOs would become effective two years after final adoption of the Proposed Rules (i.e., not earlier than the fourth quarter of 2015).
- Comments to the Proposed Rules must be submitted not later than October 30, 2013.

Combined Vertical and Horizontal Risk Retention Option

The Proposed Rule brings more flexibility in satisfying the requirements by allowing a sponsor to retain any combination of vertical and horizontal interests as long as its total interests retained is at least 5% of the "fair value" of all ABS interests (rather than the prior 50%-50% split).[5] The Proposed Rule also makes clear that the sponsor may hold interests through majority-owned affiliates.

This standard risk retention option is replete with various additional requirements, including the disclosure requirements for the fair value methodology used, the certification requirements relating to eligible horizontal residual interest ("EHRI")recovery percentages, and certain limits on payments that exceed the expected percentage of the EHRI's fair value (compared to all ABS interests).

[5]The Proposed Rule would provide for a combined standard risk retention option that would permit a sponsor to satisfy its risk retention obligation by retaining an "eligible vertical interest," an "eligible horizontal residual interest," or any combination thereof, in a total amount equal to no less than 5% of the fair value of all ABS interests in the issuing entity that are issued as part of the securitization transaction.

Lead Arranger Risk Retention for "Open Market CLOs"

The Proposed Rule allows a new option available for "open market CLOs."[6] An "open market CLO" must acquire more than 50% of its assets from non-affiliate syndicates. Accordingly, the proposed "open market CLO" option is intended to exclude "balance sheet" CLOs.

In addition to the definitional scope of an open market CLO, the proposed new option (the "Open Market CLO Option") has the following requirements:

- The lead arranger[7] for each loan purchased by the CLO must retain at the origination of the syndicated loan at least 5% of the face amount of the term loan tranche purchased by the CLO.
- The lead arranger would be required to retain this portion of the loan tranche until the repayment, maturity, involuntary and unscheduled acceleration, payment default, or bankruptcy default of the loan.
- This requirement would apply regardless of whether the loan tranche was purchased on the primary or secondary market, or was held at any particular time by an open market CLO issuing entity.

The Agencies anticipate that this would effectively create a new type of "CLO-eligible loan tranches" in the market.

In addition, the sponsor of an open market CLO transaction could avail itself of this option only if the following conditions are satisfied:

- The CLO issuer does not hold or acquire any assets other than CLO-eligible loan tranches and servicing assets.
- The CLO issuer does not invest in ABS interests or credit derivatives (other than permitted hedges of interest rate or currency risk).
- All purchases of assets by the CLO issuer (directly or through a warehouse facility used to accumulate the loans prior to the issuance of the liabilities by the CLO issuer) are made in open market transactions.

The sponsor under the Open Market Option would be required to disclose a complete list of each asset held by the open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing).[8]

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[6] The Proposed Rule defines an "open market CLO" as "a CLO whose assets consist of senior, secured syndicated loans acquired by such CLO directly from sellers in open market transactions and [related] servicing assets, and that holds less than 50 percent of its assets by aggregate outstanding principal amount in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates."

[7] The lead arranger must have taken an initial allocation of at least 20% of the face amount of the broader syndicated facility, with no other member of the syndicate assuming a larger allocation or commitment.

[8] The disclosure would need to include the following information: (i) the full legal name and Standard Industrial Classification category code of the obligor of the loan or asset; (ii) the full name of the specific loan tranche held by the CLO; (iii) the face amount of the loan tranche held by the CLO; (iv) the price at which the loan tranche was acquired by the CLO; and (v) for each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions.

Considerations

It is too early to fully anticipate the practicality of the Open Market Option other than to note that for the Open Market CLO Option to become a meaningful alternative, the syndicated loan market would have to achieve some notable changes. Given current market practices, the following challenges and potential drawbacks may arise for any sponsor to utilize the Open Market CLO Option:

First, it is not clear what the long-term impact would be if the Proposed Rule creates a subset of leveraged loans by making them CLO-eligible. While the CLO-eligible tranche and the non-CLO-eligible tranche may share the same terms and conditions and would have the same credit risk associated with them, the CLO-eligibility may create different supply-demand dynamics that may affect the price and the liquidity of these loans. If the CLO-eligible loans were to receive special treatment in the syndicated loan market, it is likely that trading of those loans would be less frequent. This may result in CLOs, and by extention, CLO noteholders, paying more for the same loan issued by the same obligor.

Second, it is not clear what incentives corporate loan underwriters would have to create CLO-eligible loans. It is possible, under certain market conditions, that a successful syndication of certain corporate loans would be difficult without creating CLO-eligible loans. That consideration would need to be measured against the potential regulatory capital cost of owning the 5% retention piece.

In particular, these banks (which may have not other involvement in the securitization markets) may be further disincentivized in the context of one bank taking on an obligation to hold the 5% retention piece of a loan in one or more CLOs to be underwritten by a competitor bank.

Furthermore, the Proposed Rule would require that these banks hold (without hedging) the retention piece until the loans pay in full or default. This means additional credit risk would be borne by the originating banks that may or may not benefit from CLO business. The market will need to help determine whether there is a compatible economic solution to the proposed regulatory approach.

Continuing Discussion of CLO Risk Retention Rules

The Agencies requested comments on a long list of questions, and robust industry feedback is expected to develop throughout the comment period, which expired on October 30, 2013. For ease of reference, the Agencies' list of questions is reproduced in the appendix.

[Originally published September 10, 2013]

50(a). Does the proposed CLO risk retention option present a reasonable allocation of risk retention among the parties that originate, purchase, and sell assets in a CLO securitization?

50(b). Are there any changes that should be made in order to better align the interests of CLO sponsors and CLO investors?

51. Are there technical changes to the proposed CLO option that would be needed or desirable in order for lead arrangers to be able to retain the risk as proposed, and for CLO sponsors to be able to rely on this option?

52(a). Who should assume responsibility for ensuring that lead arrangers comply with requirement to retain an interest in CLO-eligible tranches?

52(b). Would some sort of ongoing reporting or periodic certification by the lead arranger to holders of the CLO-eligible tranche be feasible?

52(c). Why or why not?

53(a). The agencies would welcome suggestions for alternate or additional criteria for identifying lead arrangers.

53(b). Do loan syndications typically have more than one lead arranger who has significant influence over the underwriting and documentation of the loan?

53(c). If so, should the risk retention requirement be permitted to be shared among more than one lead arranger?

53(d). What practical difficulties would this present, including for the monitoring of compliance with the retention requirement?

53(e). How could the rule assure that each lead arranger's retained interest is significant enough to influence its underwriting of the loan?

54(a). Is the requirement for the lead arranger to take an initial allocation of 20 percent of the broader syndicated credit facility sufficiently large to ensure that the lead arranger can exert a meaningful level of influence on loan underwriting terms?

54(b). Could a smaller required allocation accomplish the same purpose?

55(a). The proposal permits lead arrangers to sell or hedge their retained interest in a CLO-eligible loan tranche if those loans experience a payment or bankruptcy default or are accelerated. Would the knowledge that it could sell or hedge a defaulted loan in those circumstances unduly diminish the lead arranger's incentive to underwrite and structure the loan prudently at origination?

55(b). Should the agencies restrict the ability of lead arrangers to sell or hedge their retained interest under these circumstances?

55(c). Why or why not?

56(a). Should the lead arranger role for CLO-eligible loan tranches be limited to federally supervised lending institutions, which are subject to regulatory guidance on leveraged lending?

56(b). Why or why not?

57(a). Should additional qualitative criteria be placed on CLO-eligible loan tranches to ensure that they have lower credit risk relative to the broader leveraged loan market?
57(b). What such criteria would be appropriate?

58(a). Should managers of open market CLOs be required to invest principal in some minimal percentage of the CLO's first loss piece in addition to meeting other requirements for open market CLOs proposed herein?

58(b). Why or why not?

59(a). Is the requirement that all assets (other than servicing assets) consist of CLO-eligible loan tranches appropriate?

59(b). To what extent could this requirement impede the ability of a CLO sponsor to diversify its assets or its ability to rely on this option?

59(c). Does this requirement present any practical difficulties with reliance on this option, particularly the ability of CLO sponsors to accumulate a sufficient number of assets from CLO-eligible loan tranches to meet this requirement?

59(d). If so, what are they?

59(e). Would it be appropriate for the agencies to provide a transition period (for example, two years) after the effective date of the rule to allow some investment in corporate or other obligations other than CLO-eligible loan tranches or servicing assets while the market adjusts to the new standards?

59(f). What transition would be appropriate?

59(g). Would allowing a relatively high percentage of investment in such other assets in the early years following the effective date (such as 10 percent), followed by a gradual reduction, facilitate the ability of the market to utilize the proposed option?

59(h). Why or why not?

59(i). What other transition arrangements might be appropriate?

60(a). Should an open market CLO be allowed permanently to hold some de minimis percentage of its collateral assets in corporate obligations other than CLO-eligible loan tranches under the option?

60(b). If so, how much?

61(a). Is the requirement that permitted hedging transactions be limited to interest rate and currency risks appropriate?

61(b). Are there other derivative transactions that CLO issuing entities engage in to hedge particular risks arising from the loans they hold and not as means of gaining synthetic exposures?

62(a). Is the requirement that the holders of a CLO-eligible loan tranche have consent rights with respect to any material waivers and amendments of the underlying legal documents affecting their tranche appropriate?

62(b). How should waivers and amendments that affect all tranches (such as waivers of defaults or amendments to covenants) be treated for this purpose?

62(c). Should holders of CLO-eligible loan tranches be required to receive special rights with respect those matters, or are their interests sufficiently aligned with other lenders?

63. How would the proposed option facilitate (or not facilitate) the continuance of open market CLO issuances?

64(a). What percentage of currently outstanding CLOs, if any, have securitized assets that consist entirely of syndicated loans?

64(b). What percentage of securitized assets of currently outstanding CLOs consist of syndicated loans?

65(a). Should unfunded portions of revolving credit facilities be allowed in open market CLO collateral portfolios, subject to some limit, as is current market practice?

65(b). If yes, what form should risk retention take?

65(c). Would the retention of 5 percent of an unfunded revolving commitment to lend (plus 5 percent of any outstanding funded amounts) provide the originator with incentives similar to those provided by retention of 5 percent of a funded term loan?

65(d). Why or why not?

66(a). Would a requirement for the CLO manager to retain risk in the form of unfunded notes and equity securities, as proposed by an industry commenter, be a reasonable alternative for the above proposal?

66(b). How would this meet the requirements and purposes of section 15G of the Exchange Act?

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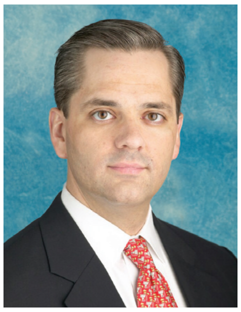

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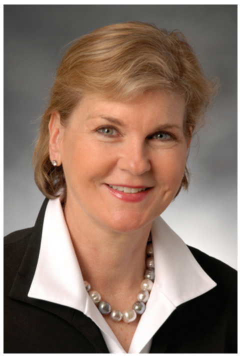

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