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CLOs and Rule 3a-7 – A Port in Uncertain Regulatory Seas?

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Key Takeaways:

- **CLOs that rely on Rule 3a-7 are exempt from several regulatory regimes that apply to traditional CLOs that rely on Section 3(c)(7)**
- **These CLOs are structured similarly to Section 3(c)(7) CLOs, but are subject to restrictions on trading for value, among other technical wrinkles**

Overview

In recent years, a number of regulations have been proposed or gone into effect that apply to investment vehicles relying on Section 3(c)(7) ("**Section 3(c)(7)**") of the Investment Company Act of 1940 (the "**'40 Act**"), which most collateralized loan obligation transactions ("**CLOs**") rely on for their exclusion from the definition of "Investment Company" under the '40 Act. These include the regulations commonly referred to as the Volcker Rule[1] and the Marketing Rule[2]; they also include the initial proposed version of the Securities and Exchange Commission's ("**SEC**") private funds rules,[3] and while the final version of those rules largely did not apply to CLOs, the uncertainty about how CLOs could structure themselves to comply with the proposed rules caused considerable consternation in the CLO market.[4]

By contrast, deals that are able to rely on Rule 3a-7 ("**Rule 3a-7**") for exclusion from the definition of "investment company" have largely been spared from the scope of these regulations. Significantly, this is not novel technology, as many middle-market CLOs in particular have been relying on Rule 3a-7 for a long time. And while there are aspects of Rule 3a-7 that have their own implications for how CLOs operate, managers may want to consider whether those implications are outweighed by the lighter regulatory touch that these deals have enjoyed.

In this OnPoint, we will summarize the key requirements of CLOs that rely on Rule 3a-7 ("**3a-7 CLOs**"), including their differences compared to CLOs relying on Section 3(c)(7) of the '40 Act ("**Section 3(c)(7)**", and "**3(c)(7) CLOs**").

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1 12 U.S.C. § 1851 *et seq.* (2018); 12 C.F.R. § 248 (2023). The implementing regulations define a "covered fund" to include "An issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act." 12 C.F.R. § 248.10(b)(1)(i) (2023) (*citations omitted*). The implementing regulations specifically exclude from the definition of "covered fund" any issuer "[t]hat may rely on an exclusion or exemption from the definition of "investment company" under the Investment Company Act of 1940 other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act." *Id*. at 248.10(c)(12)(ii) (*citations omitted*).

2 17 C.F.R. § 275.206(4)–1 (2023). The Marketing Rule covers, in relevant part, communications between an investment adviser and "prospective clients or investors in a private fund," *id.* at 275.206(4)–1(e)(1)(i), where a "private fund" "means an issuer that would be an investment company, . . . but for section 3(c)(1) or 3(c)(7) of [the '40] Act." 15 U.S.C. §80b-2(a)(29) (2010).

3 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 88 Fed. Reg. 63,206 (Sept. 14, 2023) (to be codified at 17 C.F.R. 275) (the "**Private Funds Rules**").

4 For a helpful summary of the Private Funds Rules, see *The SEC's Private Fund Adviser Rules: Exploring the Critical Questions*, Dechert LLP (October 12, 2023).

Requirements of Rule 3a-7

The Unfamiliar: Trading Restrictions and Trustee Independence

Rule 3a-7 sets out a number of requirements for issuers of asset-backed securities looking to rely on its exemption. Many of these requirements track how 3(c)(7) CLOs already operate, but there are a few key differences that managers need to be aware of:

Trading Requirements:

CLOs reliant on 3a-7 are subject to limits on when and why they can buy and sell assets. In particular:

- Assets must be acquired or disposed of in accordance with the terms of the indenture;
- The acquisition or disposition may not cause the rated notes to be downgraded; and
- Assets may not be acquired or disposed of "for the primary purpose of recognizing gains or decreasing losses resulting from market value changes."

These restrictions were intended to encompass the then-current practices of "virtually all structured financings, including those that require a significant degree of asset acquisitions and dispositions," when Rule 3a-7 was enacted, while preventing covered securitizations from engaging in trading activities like mutual funds.[5] In the indenture for a 3a-7 CLO, there will typically be specific requirements that these conditions be met in order to invest.

Practically speaking, the first two conditions should not materially impact trading activity, but the third likely does affect how CLO managers may trade, particularly BSL CLO managers, as anticipating and realizing market movements to achieve trading gains is how many managers seek to add value to a CLO. (By contrast, this limitation is frequently less of an issue for a balance sheet CLO where a manager is simply seeking greater leverage on assets coming from its origination platform.) Note that trading for other reasons, including for changes in credit profile or to achieve a desired portfolio mix, are permitted.

Trustee Substance and Independence:

Rule 3a-7 also imposes certain requirements on the entity acting as trustee of the CLO. These are far less onerous than the trading restrictions, but could still require careful consideration in selecting service providers. Specifically, the trustee must:

- meet the requirements of Section 26(a)(1) of the Investment Company Act (requiring the trustee to be a bank with a combined capital and surplus of at least $500,000), and
- not be affiliated with the issuer or any person involved in its organization or operation, and not provide credit support or credit enhancement to the issuer.

While most trustees will meet these criteria as a matter of course, certain non-bank service providers may not be eligible to act as trustees, and in certain cases a bank that acts as trustee may have another division within the same

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5 Exclusion From the Definition of Investment Company for Structured Financings, 57 Fed. Reg. 56,248 (Nov. 27, 1992) at 56,254 (the "**Adopting Release**").

bank that invests in the CLO securities, in which case a different bank affiliate (that also meets the requirements of Section 26(a)(1)) may need to be appointed to act as trustee instead.

The Familiar: Aspects of 3a-7 Consistent with Current Practice

As noted above, other than a couple of specific requirements where Rule 3a-7 differs from Section 3(c)(7), most of the requirements of Rule 3a-7 are roughly consistent with how CLOs already operate. Specifically, Rule 3a-7 requires:

- An issuer engaged in the business of acquiring and holding ***eligible assets***
  - "Eligible assets" are defined in Rule 3a-7 as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders." This is consistent with market-standard collateral obligation criteria consisting of fixed-maturity corporate loans and cash equivalents.
  - We note that a CLO may occasionally receive equity securities in connection with a workout or restructuring. The SEC commented at the time Rule 3a-7 was published that eligible assets include "ancillary or incidental assets which are necessary in the course of servicing the underlying assets or to assure the distribution of cash flow and/or proceeds to the security holders" and specifically that "issuers could hold common stock, for example, that was involuntarily obtained through a work-out because the common stock would be an ancillary or incidental asset."[6]
- Does not issue ***redeemable securities***
  - Redeemable securities under Rule 3a-7 are those that are redeemable at the option of the holder (i.e., a put), not the issuer (i.e., a call). CLO indentures give the Issuer the ability to redeem outstanding notes in a refinancing, repricing or redemption, but do not give the noteholders the right to redeem their own securities on demand.
- Issues ***fixed-income securities*** or ***other securities*** which entitle their holders to receive ***payments that depend primarily on the cash flow from eligible assets***
  - Rated CLO note and loan classes are fixed-income securities bearing interest at a stated rate, while subordinated notes are other securities. In either case, payments on the CLO securities depend primarily on the cash flow from eligible assets.
  - Note that typical CLO credit enhancements like an interest diversion test or par subordination of the senior notes would *not* cause a CLO to fail to qualify. Instead, this prohibits unusual features like parent guaranties, or payments that depend on the *market value* of the issuer's assets (such as a mandatory early redemption requiring notes to be repaid with realization proceeds).
- Securities are initially ***rated in one of the four highest categories*** by at least one nationally recognized statistical rating organization, except that (i) ***any fixed-income securities may be sold to accredited***

6 *Id.* at 56,250 n.18.

investors as defined in paragraphs (1), (2), (3), and (7) of Rule 501(a) under the Securities Act , and (ii) ***any securities may be sold to qualified institutional buyers*** as defined in Rule 144A under the Securities Act and to persons involved in the organization or operation of the issuer or an affiliate

  - Senior CLO securities are typically issued with an investment-grade rating – i.e., one of the four highest rating categories – but the rule also allows for fixed-income securities (like rated CLO notes) as long as they are sold to "institutional" accredited investors.[7]

  - CLO subordinated notes may only be sold to "QIBs" under Rule 144A or persons or entities involved in the issuer's organization, meaning third-party equity investors may only be allowed if they are QIBs, and not merely accredited investors.

  - Note that Rule 3a-7 does ***not*** rely on the "Qualified Purchaser" definition used in CLOs relying on Section 3(c)(7). And while senior CLO securities are typically sold pursuant to Rule 144A under the Securities Act, it is not unusual for subordinated notes to be available for purchase by Qualified Purchasers (or "knowledgeable employees") that are accredited investors. In a CLO relying on Rule 3a-7, this requirement is more limiting, in that subordinated notes can be sold to investors that are not QIBs only if those investors are involved in the organization or operation of the issuer or an affiliate of such a person.

- The issuer or underwriter exercises reasonable care to ensure that the above restrictions on sales and resales are followed

  - This can typically be shown based on the requirements in the indenture and the representations included in the note purchase agreement or placement agreement.

Takeaways

CLO managers concerned about the uncertain regulatory landscape applicable to vehicles relying on Section 3(c)(7) should consider whether the limitations imposed by Rule 3a-7 are an acceptable tradeoff for the greater regulatory certainty that 3a-7 CLOs have benefitted from. In particular, managers that do not anticipate trading to recognize changes in market value (for example, managers of static CLOs, CLOs intended to obtain better leverage for an existing portfolio, or CLOs concentrated in loans that do not trade widely) may find that the benefits of Rule 3a-7 outweigh its limitations.

7 The referenced clauses of the definition of "Accredited Investor," 17 CFR § 230.501(a), include banks, broker dealers, investment advisers, insurance companies, investment companies and other specific categories of entity investors; as well as corporations, trusts, partnerships, 501(c)(3) charitable organizations and LLCs not formed for the purpose of making the particular investment and with more than $5,000,000 of assets; but not certain categories of individuals, directors, officers, etc.

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