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ONPOINT / A legal update from Dechert

The Rise of the C-MOA

Authored by Mary Bear, Cynthia J. Williams, John M. Timperio, Sean Solis, James Waddington and Daniel J. Colaizzi

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The Rise of the C-MOA

Since the release of the final U.S. risk retention rule (the "Final Rule")[1] *in October 2014, CLO market participants have been grappling with its ramifications and working to devise solutions that permit collateral managers to raise the capital necessary to support the investments mandated by the Final Rule. In a Dechert OnPoint published shortly after the Final Rule was released, we proposed a number of potential solutions for CLO market participants.*[2] *In January, we discussed the capitalized manager vehicle option ("CMV") and answered many other frequently asked questions, including queries surrounding the permissibility of the majority-owned affiliate ("MOA") option.*[3] *More recently, we have seen increased interest in the use of a hybrid structure that participants are referring to as the capitalized majority-owned affiliate ("C-MOA"). In this OnPoint, we describe both the structure of a prototypical C-MOA and how a C-MOA may be structured to satisfy both EU and US risk retention requirements.*

I. Introduction

In October 2014, the Agencies[4] passed the Final Rule pursuant to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Final Rule requires the "sponsor" of a "securitization transaction" (or its majority-owned affiliate) to retain an economic interest in the credit risk of the securitized assets (the "U.S. Retention Interest"). The U.S. Retention Interest may be held vertically (as an interest equal to 5% of the face value of each tranche issued by the CLO), horizontally (as an interest in the first loss tranche equal to 5% of the fair value (determined in accordance with GAAP) of all tranches issued by the CLO), or in any combination of the two.

In the Final Rule, the Agencies confirmed their view that the "sponsor" of a CLO transaction is the collateral manager.[5] Thus, the basic tenets of the Final Rule require the collateral manager (or a majority-owned affiliate of the collateral manager) to retain the U.S. Retention Interest. The Final Rule also contains the "lead arranger" option for "open-market" CLOs (which has not gained any traction).

While the Agencies were completing the Final Rule in the United States, the European Commission published the final regulatory technical standards for European risk retention rules (the "RTS") on March 13, 2014[6], specifying the requirements for investors, sponsors, original lenders and originator institutions relating to exposures to transferred credit risk under Articles 404-410 of the Capital Requirements Regulation ("CRR", together with the RTS, the AIFMD[7]

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[1] Credit Risk Retention, 79 Fed. Reg. 77,602 (December 24, 2014).

[2] *Dechert OnPoint*, U.S. Risk Retention Final Rule: Playing it Forward for CLOs (October 2014).

[3] *Dechert OnPoint,* U.S. Risk Retention Final Rule: Capitalized Manager Vehicles, Majority Owned Affiliates and Other FAQs (January 2015).

[4] The FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Department of Housing and Urban Development, the Federal Housing Finance Agency and the Securities and Exchange Commission (together, the "Agencies").

[5] *Final Rule, supra* note 1, at 77,655.

[6] Commission Delegated Regulation (EU) No 625/2014, relating to Articles 404-410 of the Capital Requirements Regulation.

[7] "AIFMD" refers to the EU Directive 2011/61/EU on Alternative Investment Fund Managers, as amended from time to time and as implemented by Member States of the European Union.

and Solvency II[8], the "EU Rules").[9] The EU Rules prohibit investors subject to them from entering into a securitization transaction unless the "sponsor, originator or original lender" retains at least 5% of the nominal value of the securitized exposures (the "EU Retention Interest" and together with the U.S. Retention Interest, the "Retention Interest").[10]

In anticipation of the effective date of the Final Rule, on December 24, 2016, CLO collateral managers are currently working to develop and implement strategies and structures to facilitate the capital investment required by the Final Rule while also creating a structure that will simultaneously comply with the EU Rules. We have seen significant interest in three methods to accomplish this: the CMV, the MOA and, more recently, a hybrid option we refer to as the "C-MOA" (capitalized majority-owned affiliate).

II. The Goldilocks Option – The Capitalized Majority-Owned Affiliate

The C-MOA hybrid option essentially seeks to draw from both the CMV and MOA option and solve for some of the perceived challenges present in both. In particular, the C-MOA addresses the following considerations present in the CMV and MOA options, respectively (each of which are discussed in more detail herein):

- **CMV**: Many collateral managers are leery of committing the upfront time and resources associated with creating a new capitalized, self-managed asset management business for their CLOs on a going forward basis (including independent investment adviser registration, hiring portfolio managers and employees and setting up an independent board).

- **CMV**: Many collateral managers do not want to have to give up the control or economics required to create a standalone asset management business.

- **MOA**: Most collateral managers are not looking for a one-off deal solution.

- **MOA**: Most collateral managers want a risk retention solution that also complies with EU Rules and (if possible) enables them to avail the favorable treatment with respect to the percentage of loans that must be originated.

- **CMV**/**MOA**: All CLO market participants are concerned about the potential for regulatory static and ways of addressing the lack of clarity in the Final Rule. Not surprisingly, these participants are also all looking for a first mover to lead the way.

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[8] "Solvency II" refers to Article 135(2) of European Union Directive 2009/138/EC, as amended from time to time.

[9] Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

[10] Note that while the EU Retention Interest and the U.S. Retention Interest (required by the EU Rules and Final Rule, respectively) may overlap to a significant degree, diverging requirements and measurement criteria for each mean that they may not fully overlap. For example, the size of the EU Retention Interest is calculated based on the notional amount – i.e. the nominal value – of the issued asset-backed security ("ABS") interests, regardless of whether the interest is vertical or horizontal; conversely, while a vertical U.S. Retention Interest is also calculated using the nominal value of the issued ABS interests, a horizontal U.S. Retention Interest is calculated based on the fair value of the issued ABS interests. Additionally, unlike the Final Rule, the EU Rules do not allow for the use of combined vertical and horizontal retention interests (also known as an "L-shaped" interest).

By the way of background, the Final Rule contemplates that collateral managers (who do not already have it) will need to come up with the additional capital required to satisfy the new mandates, including by capitalizing existing or new management companies and/or through the use of majority-owned affiliates.[11] To date, market participants have focused on these as largely independent options – each of which (as noted above) had its own challenges. Like Goldilocks, however, many market participants are now increasingly focusing on the C-MOA option and finding it just right.

A. *Initial Step: Establishing a Majority-Owned Affiliate*

As a threshold matter, the C-MOA option requires the existing collateral manager or investment advisor, referred to in this context as the "Existing Manager," to create a majority-owned affiliate. The Final Rule defines an MOA as "an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person." For purposes of the definition, "majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP." [12]

Along these lines, in order for the C-MOA to be considered an MOA of the Existing Manager, the Existing Manager[13] must either (i) hold more than 50% of the equity in the C-MOA or (ii), to the extent relying on the "controlling financial interest" limb of the definition, meet the requirements therefore set forth under GAAP. Although the "controlling financial interest" analysis is ultimately subject to determination by the relevant accounting firm, generally, if the MOA is a variable interest entity under GAAP, the Existing Manager (or controlling party) must own equity in the C-MOA (most accounting firms would likely require between 10-20% as a minimum) and must possess the power to direct the activities that most significantly impact the C-MOA's economic performance.

B. *C-MOA: Applicability in Europe*

One of the main quandaries faced by CLO managers who seek to set up a majority-owned affiliate to hold the U.S. Retention Interest is how to simultaneously solve for the EU Rules. Since many contemplated MOAs are simply special-purpose vehicles whose sole purpose is to hold the Retention Interest in one or more CLOs, under the EU Rules, such MOAs would not be "entities of substance," nor would they be sufficiently capitalized to originate loans.[14] However, although MOAs can be SPVs, they do not have to be. Essentially, the C-MOA approach attempts to solve this by incorporating sufficient "substance" into the MOA entity such that it can be an "entity of substance" that can act as "originator" for purposes of the EU Rules[15] and, in some cases, also attempts to create a construct in which the C-MOA is an originator (for purposes of EU Rules) that acts as collateral manager of the CLO (thus permitting, for purposes of the EU Rules, a lower percentage of loans to be originated by the C-MOA or a related party or required

[11] As noted in the adopting release accompanying the *Final Rule*, "[i]f smaller CLO managers do not have sufficient available capital to hold 5% risk retention, then they will be unable to sponsor CLO transactions unless they are able to get funding from another source." *See Final Rule, supra* note 1, at 77,729.

[12] *Final Rule*, *supra* note 1, at 77,741 (Subpart A, §__.2).

[13] We note that the MOA need not be a subsidiary of the Existing Manager itself; given that the MOA definition requires that the entity "directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person," the MOA could be set up by a subsidiary or parent of the Existing Manager, for example.

[14] In January the EBA issued a report and opinion about how to improve the capital markets. In the report, the EBA suggested that the definition of "originator" be narrowed to prevent circumvention of the EU Rules. In April, the Bank of England and the European Central Bank issued a report that echoed the concerns of the EBA.

[15] See Diagram A on page 6.

to be acquired and seasoned on the books of the C-MOA)[16]. These two scenarios are discussed further in sub-part C below.

Unlike an MOA which is an SPV, a C-MOA would be capitalized beyond what is necessary to simply hold the Retention Interest so that it can originate loans itself or though a related party (the first limb of the definition of "originator under EU Rules) and/or select loans to acquire for its own account and then sell to the CLO (the second limb of "originator" definition).[17] The minimum required equity capitalization of the C-MOA must come from the Existing Manager[18] and additional debt and/or equity capital may come from third parties. The C-MOA should have sufficient capital to both "originate" loans for purposes of the EU Rules (by the C-MOA or an affiliate thereof originating them in the primary market or by the C-MOA purchasing them for its own account in the secondary market and then subsequently selling into the CLOs) and to acquire the required Retention Interests with respect to various CLO transactions. Additionally, for the C-MOA to be an "entity of substance," it should have its own business plan and purpose.

Furthermore, to have personnel available to act as an EU "originator", it may be desirable for the C-MOA to have some type of a staff and servicing arrangement or advisory agreement with the Existing Manager. However, unlike the CMV context,[19] in the context of a C-MOA, it is not necessary nor even possible to show "independence" between the Existing Manager and the C-MOA, since the C-MOA is a majority-owned affiliate of the Existing Manager and must be controlled by the Existing Manager.[20] This feature is appealing to those Existing Managers who are reluctant to surrender certain elements of control or submit certain key decisions to an independent board, which would be required in a CMV context.

C. Two Possible Scenarios for a C-MOA

In the C-MOA realm, the C-MOA can either be set up as an EU originator that only originates, but does not manage the CLOs (see Diagram A) or it can be set up as an EU originator that also serves as collateral manager of the CLOs (see Diagram B).

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[16] See Diagram B on page 7.

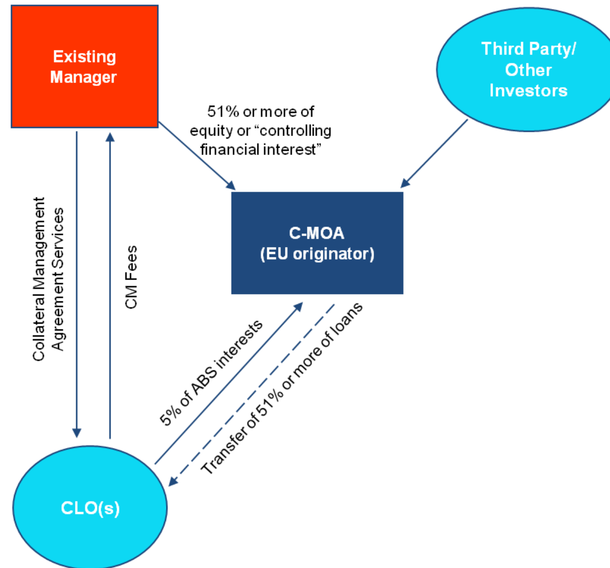
[17] Because of this "origination" activity, parties to the CLO will likely ask for a "true sale" opinion between the C-MOA and the CLO issuer. Although this "true sale" opinion should not be problematic in instances in which the C-MOA holds a vertical strip, instances in which the C-MOA holds a horizontal strip may present true sale issues. Although these issues are not necessarily insurmountable, they may require certain modifications to the structure, which should be discussed in more detail at the time of the transaction.

[18] If, however, the C-MOA is set up as a subsidiary of the parent of the Existing Manager (which is one possible scenario, *see supra* note 13), then the equity would come from that parent.

[19] In the context of a CMV in which the Existing Manager serves as staff and service provider , in order to mitigate the risk that the Existing Manager rather than the CMV is viewed as the sponsor, among other things, we recommend that the CMV have an independent board (which must approve and can terminate any staff and servicing arrangement with the Existing Manager), have personnel to perform critical investment advisory activities and independently register as an investment advisor (rather than acting as a relying advisor).

[20] Although it is preferable for an EU originator to be "independent" and self-managed, this is not explicitly required by the EU Rules, although market practice may continue to evolve on this point, particularly if there is further guidance from the regulating bodies on this matter.

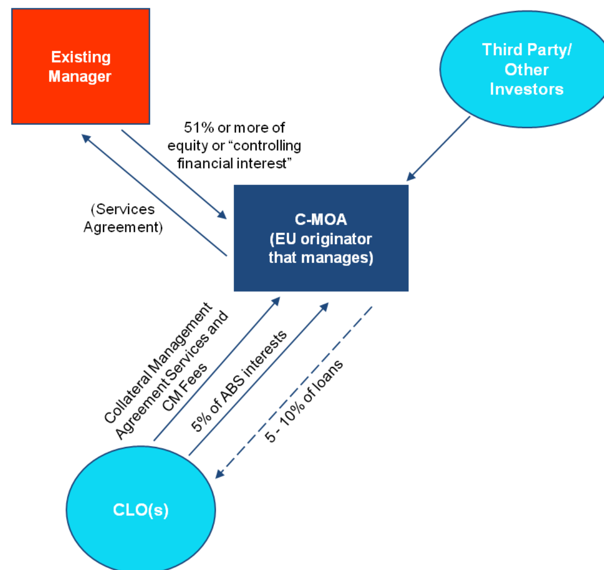
Diagram A



C-MOA as an Originator that does not Manage (Diagram A). In this scenario, the Existing Manager would form a majority-owned affiliate (the C-MOA) which functions solely as an "originator" for EU purposes and holds the Retention Interest. In this context, the C-MOA would have to "originate" more than 50% of the loans comprising each CLO. As noted above, the C-MOA can "originate" these loans by purchasing them for its own account in the secondary market and then subsequently selling into the CLOs; it is important, however, that the C-MOA is capitalized sufficiently to perform this origination function, which in most cases requires more capital than just what is necessary to purchase a Risk Retention Interest in a single CLO. Furthermore, although a separate C-MOA could be set up for each CLO, if the same C-MOA is used for multiple CLOs (with that C-MOA acquiring Retention Interests in multiple CLOs), it becomes easier it becomes to demonstrate that the C-MOA is an "entity of substance" with its own independent business purpose (e.g., to acquire loans for its own account and transfer them to CLOs which it in turn invests in).

The Existing Manager would structure and manage the relevant CLOs, serve as collateral manager to each CLO, and earn the management fees that the Existing Manager has traditionally expected. The C-MOA could also contract with the Existing Manager to provide it with advisory services or other support services it may require to fulfill its function as an "originator" under the EU Rules.

From a U.S. standpoint, the Diagram A scenario satisfies the Final Rule since the Existing Manager would be the "sponsor" and the C-MOA as a "majority-owned affiliate" of the sponsor would be holding the U.S. Retention Interest. From an EU standpoint, the Diagram A scenario satisfies the EU Rules since the C-MOA acts as "originator" of at least 50% of the assets comprising each CLO and holds the EU Retention Interest. The main advantage of the Diagram A approach over the Diagram B approach is that it creates little disruption in the existing management practices of the Existing Manager; in other words, it does not require double-staffing or sharing of employees and allows the Existing Manager to earn all of the collateral management fees it is accustomed to earning. The main drawback of the Diagram A approach is that it requires the C-MOA to originate a higher percentage of the loans than the Diagram B approach (discussed further below), which imposes an increased administrative burden and capital burden on the C-MOA.



C-MOA as an Originator that Manages (Diagram B). Many market participants have expressed interest in making the C-MOA the collateral manager of the CLOs in which it holds a Retention Interest since it would be viewed as the sole EU "originator" even if it has not originated a majority of the loans for the CLO. As a result, only a small percentage of loans (say 5%) need to be originated at or prior to closing, with no ongoing origination requirement.[21] Such a route would require establishing some managerial capacity at the C-MOA level, which means that the C-MOA would need some employees (which may be shared with the Existing Manager), including credit and investment professionals responsible for decision-making associated with both acting as an EU "originator" and collateral manager of the CLOs. Furthermore, the C-MOA should retain some of the collateral management fee revenue it receives from the CLOs to support the fact that it is in the asset management business. Although it may remit some portion of the fees to the Existing Manager (for its services as sub-advisor or staff and service provider) and may use a portion of the fees to pay its shared employees and other expenses, any attempt to allocate all of the collateral management fee revenue to the Existing Manager and other expenses may weaken the argument that the C-MOA is an actual asset management business. Instead, it may be seen by EU investors as simply an investment vehicle which is a "manager" to the CLOs in name only.

In these situations where the C-MOA is the collateral manager on the CLO, it is possible that either or both the C-MOA and the Existing Manager could be considered the "sponsor" for U.S. purposes: the C-MOA could be considered the sponsor since it is the party which serves as collateral manager under the CLO documents, or the Existing Manager because of its control over the C-MOA, combined with the staff and servicing or advisory support it provides to the C-MOA. In these scenarios, we would recommend appropriate disclosure to CLO investors describing these relationships and also detailing how the Final Rule is satisfied in the event either or both the C-MOA or Existing

[21] Contrast this requirement with that applicable to a CLO where the originator is not the manager in which case the originator must originate at least 50% of the assets owned by the CLO. For an originator that is the manager, although the 5-10% originator is not specifically required by the EU Rules, most market participants have imputed some level of origination that generally falls within this range. This percent, however, may fluctuate with different market interpretations.

Manager is considered the "sponsor."[22] Furthermore, the parties should spell out the precise relationship between the C-MOA and the Existing Manager and each CLO issuer via a tri-party advisory agreement. While it may be the case that both the C-MOA and Existing Manager could be considered "sponsors", the Final Rule and accompanying gloss has very little guidance on what situations arise to a "dual sponsorship" of a securitization. However, the appeal of the C-MOA approach, from a U.S. standpoint, is that the Final Rule would be satisfied regardless of whether the C-MOA or the Existing Manager (or both) are considered the "sponsor"; this is especially attractive given the static around what it means to "sponsor" a securitization under the Final Rule and the explicit rejection of using "third party money" to satisfy risk retention obligations.

III. Further Considerations

The C-MOA, like any other risk retention structure, has its drawbacks. In comparison to the plain vanilla MOA approach, to the extent a C-MOA is better capitalized than required for an MOA (i.e., it is capitalized beyond just what is needed to hold the Retention Interest for a particular CLO) in order to demonstrate that it is an entity of substance capable of "originating" assets for purposes of the EU Rules, the required capital of the Existing Manager necessary to establish a "controlling financial interest" correspondingly increases (i.e., the 10-20% minimum would apply to a higher capitalization level). Furthermore, for C-MOAs that want to be managers (Diagram B), there is a risk that EU investors may not accept the position that the C-MOA in fact does manage the CLOs (thus potentially giving rise to a more than 50% origination requirement), although this becomes less likely to the extent the C-MOA employs key credit and investment professionals and earns a profit from its management activities. Additionally, the Diagram B approach presents some of the same drawbacks that the CMV approach entails. Similar to the CMV realm, a C-MOA which earns income from its management activities in respect of collateral management services performed within the United States or purchases assets for the purpose of selling them to the relevant CLOs (the EU "originator" function) may have to solve tax issues to the extent the C-MOA has any non-U.S. or tax exempt investors. Furthermore, just as in the CMV realm, Existing Managers who set up C-MOAs that act as collateral managers may have to forego some of the collateral management fee income that they would otherwise receive if they themselves were acting as the collateral manager instead of a service provider.

When compared with the MOA approach, the C-MOA has the added benefit of compliance under EU Rules and is not a "one-off" solution for satisfying Risk Retention Rules on a deal-by-deal basis. When compared with the CMV approach, the C-MOA approach does not require the corporate disruption associated with the establishment of a new standalone asset management company. Additionally, a C-MOA may involve less regulatory friction from the standpoint of the Final Rule than the CMV approach.

IV. Transition Option

Many market participants who are pursuing a C-MOA approach have inquired about the possibility of setting up a C-MOA initially and then transitioning into a CMV approach at some point in time when there is more market data, history with the Final Rule and, perhaps, even regulatory guidance. In such a "transition" approach, a C-MOA could initially be set up which is a "majority-owned affiliate" of the Existing Manager (whether by virtue of a "controlling financing interest" or otherwise), and, at the same time, a separate parallel company ("Parallel Co.") would also be

[22] See *Final Rule, supra* note 1, at 77,742 (Subpart A, §__.3(b)). "If there is more than one sponsor of a securitization transaction, it is the responsibility of each sponsor to ensure that at least one sponsor (or at least one of their majority-owned affiliates) retains the Retention Interest."

formed that could eventually serve as the CMV.[23] The third-party investors investing in the C-MOA would, on day one, understand that capital they commit could, in the future, go towards a separate asset management entity which the Existing Manager does not control but instead has its own independent board which answers to investors and the other attributes of a standalone asset management business (i.e., a CMV). After executing a few initial CLOs under the C-MOA approach, the Parallel Co. could be established as a CMV by installing an independent board, hiring the necessary employees, registering as an Investment Adviser, and so forth.[24] Future capital needed for the CMV for its asset management business and CLO risk retention acquisitions could come from the existing investors. The Existing Manager would not need to have a majority ownership or controlling financial interest in the CMV (although it should have some level of investment in the CMV), but it would continue to maintain its majority ownership or controlling financial interest in the C-MOA which holds the existing CLOs. Of course, the Existing Manager could also transition to the CMV approach by simply doing an entirely new capital raise for the CMV (with a new set of investors), but many market participants are looking for transition strategies that would mitigate the need to go through that additional process.

V. Conclusion

We are presently seeing a rise in the interest associated with the hybrid C-MOA option. The C-MOA option satisfies the Final Rule using MOA approach but also provides the flexibility for Existing Managers to comply with EU Rules (using one or more strategies). Furthermore, Existing Managers can take comfort in the fact that, with the appropriate back-up from the accountants the C-MOA option provides up to two ways to satisfy the risk retention rules and thereby will reduce regulatory and market static going forward.

The above discussion sets forth only a basic paradigm for understanding how the C-MOA structure may comply with the Final Rule. We encourage you to contact us with any questions you might have and we will be happy to discuss the C-MOA structure or the Final Rule in greater detail as your specific organizational needs require.

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[23] We would point out that although it is technically feasible to have the same entity which initially serves as C-MOA ultimately transition to the CMV, any CLOs done under the "C-MOA" construct may make "breaking" the majority-ownership or controlling financial interest link between the Existing Manager and the C-MOA impossible. In other words, to the extent the original or legacy CLOs done under the C-MOA approach needed to rely to some extent on the fact that the C-MOA was a "majority-owned affiliate" of the Existing Manager (i.e., there wasn't a high degree of certainty that the C-MOA was the sponsor of the CLO in its own right), any legacy CLOs could fall out of compliance if the Existing Manager no longer had a controlling financial interest or majority ownership of the C-MOA, which would inevitably happen as the C-MOA converts into a CMV as the CMV would be independent of the Existing Manager. The lack of independence between the C-MOA and the Existing Manager for the initial CLOs would make it difficult to conclusively determine that the C-MOA was in fact the "sponsor" of CLOs done under the C-MOA regime. Thus, we see more regulatory risk associated with this approach.

[24] For more details on the necessary requirements of a CMV, please see our "Capital Manager Vehicles Demystified" article, appearing in *Alt Credit Intelligence* (July 10, 2015).

This update was authored by:

Mary Bear
Charlotte
+1 704 339 3162
mary.bear@dechert.com

Cynthia J. Williams
Boston
+1 617 654 8604
cindy.williams@dechert.com

John M. Timperio
Charlotte
+1 704 339 3180
john.timperio@dechert.com

Sean Solis
New York
+1 212 649 8710
sean.solis@dechert.com

James Waddington
London
+44 20 7184 7645
james.waddington@dechert.com

Daniel J. Colaizzi
Charlotte
+1 704 339 3116
danielj.colaizzi@dechert.com

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