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“Risk Retentionizing” Your CLO: A Post-Effective Date Guide to Risk Retention Compliance

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“Risk Retentionizing” Your CLO: A Post-Effective Date Guide to Risk Retention Compliance

Over the last year and a half, asset managers of collateralized loan obligations (“CLO Managers”) have been focused on developing various strategies to enable them to comply with the retention requirements of the final U.S. risk retention rules (“U.S. Risk Retention Rules”)[1] which become effective on December 24, 2016 (the “Effective Date”). Because most CLO Managers of broadly syndicated CLOs historically operated as independent fee for service agents (akin to mutual fund managers as opposed to the “originate to distribute” sponsors envisioned by the US Risk Retention Rules), these risk retention compliance strategies have invariably required some capital formation component, including the capitalized manager vehicle (“CMV”), majority-owned affiliate (“MOA”) or capitalized majority owned-affiliate (“C-MOA”), a hybrid of the two, each of which have been discussed in previous Dechert OnPoint articles.[2] Such capital formation activities have in turn provided the impetus for an increasing number of collateralized loan obligations (“CLOs”) issued prior to the Effective Date that are designed to be “structurally” compliant with the U.S. Risk Retention Rules (i.e., with the CLO manager or a majority-owned affiliate owning a 5% vertical or horizontal interest (the “Retention Interest” or “eligible vertical interest” or “eligible horizontal residual interest,” as applicable) in the CLO upon closing). For sponsors with regulatory capital constraints, the eligible vertical interest may result in better capital treatment and therefore be preferable, whereas sponsors seeking a potentially higher return may prefer an eligible horizontal residual interest.

While capital raising to ensure structural compliance with the U.S. Risk Retention Rules has understandably been the primary focus of attention for CLO managers, there are a number of other requirements contained in the U.S. Risk Retention Rules that continue to rise in importance as we inch closer to the Effective Date. It is important to remember that a robust compliance program will include not only the economic component of retaining the Retention Interest but also an adherence to the disclosure and ministerial requirements set forth in the U.S. Risk Retention Rules. Therefore, in this OnPoint, we have attempted to provide insight on the additional disclosures, changes and issues CLO market participants will or may need to include in their CLOs. For purposes of this OnPoint, we have assumed the relevant CLO is being executed on or after the Effective Date.[3]

What additional items need to be disclosed in the offering circular of a CLO issued after the Effective Date?

The U.S. Risk Retention Rules require a sponsor to make certain specified disclosures to potential investors in the offering circular a reasonable period of time **prior** to the time of sale of the asset-backed securities in the securitization transaction and, in certain circumstances, after the closing of the securitization transaction.[4]

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[1] Credit Risk Retention, 12 C.F.R. § 43.

[2] *See* Dechert OnPoint, US Risk Retention Final Rule: Capitalized Manager Vehicles, Majority Owned Affiliates and Other FAQs (January 2015) and Dechert OnPoint, The Rise of the C-MOA (July 2015).

[3] We do not address the question of whether a CLO that has priced prior to the Effective Date but will close after the Effective Date is required to be in full compliance with the U.S. Risk Retention Rules. In the absence of guidance from the Agencies, we expect market participants’ views on when the time of sale occurs in a CLO will be largely determinative of this question. Please see pages 7-8 for the portion of this OnPoint related to the “time of sale” question.

[4] 12 C.F.R. § 43.4(c).

If the Retention Interest is held as an eligible horizontal residual interest, the disclosure requirements, although similar to those required for an eligible vertical interest, also require disclosure of (i) the fair value methodology and (ii) key inputs and assumptions used to value the ABS interests issued. This is due to the fact that, in order to satisfy the U.S. Risk Retention Rules, the amount of the eligible horizontal residual interest must be at least 5% of "the fair value of all ABS interests in the issuing entity issued as a part of the securitization transaction, determined using a fair value measurement framework under GAAP."[5]

Disclosure requirements for eligible vertical interests and eligible horizontal residual interests, respectively, are summarized below:

	Eligible Vertical Interest	**Explanatory Note**
Reasonable time prior to sale	The form of the eligible vertical interest being retained.	In most cases, we expect this to take the form of "an interest in each class of ABS interests," although a "single vertical security" is also permitted.
	The percentage that the CLO Manager is required to retain as an eligible vertical interest.	This will typically be 5%, unless the eligible vertical interest is part of an "L-shaped" combined eligible vertical interest/eligible horizontal interest.
	A description of "the material terms of the vertical interest."	To the extent the eligible vertical interest comprises an interest in each class of ABS interests issued (i.e., the notes issued), the "material terms" of each of these classes are generally already described in the offering circular in some detail.
	The amount that the CLO Manager expects to retain at the closing of the CLO.	This amount may vary but must be at least 5%.[6]
Reasonable time after the closing	The amount of the eligible vertical interest retained at closing, if that amount is materially different from the amount disclosed prior to sale.	Disclosure is only required if there was a material change in the amount disclosed, which we would not expect to occur.

[5] *Id.* at § 43.4(a)(2).

[6] *Id.* at § 43.4(c)(2)(i).

	Eligible Horizontal Interest	Explanatory Note
Reasonable time prior to sale	The fair value of the eligible horizontal residual interest that the sponsor expects to retain, expressed as a percentage of the fair value of all of the CLO interests issued in the CLO and a dollar amount (or equivalent in the foreign currency in which the CLO interests are issued).	If the specific pricing of any class of CLO interests is not available in order to estimate fair value, the CLO Manager must disclose the estimated fair value or a range of fair values (by percentage and dollar (or foreign currency) amount) of the eligible horizontal residual interest based on bona fide estimates of the estimated pricing, and the method by which it determined the range of estimated pricing. The agencies[7] have stated that they assume that this range "will correspond closely to" the "price talk" typically provided to potential buyers by the placement agent.[8]
	A description of the material terms of the eligible horizontal residual interest.	The agencies have specified that this should include "contractually pre-determined events that would reasonably be likely to result in a materially disproportionate payment of principal to the holder of the residual interest, as well as any reductions in overcollateralization." To the extent the eligible horizontal residual interest comprises all or a portion of the first loss class issued (i.e., the subordinated notes, preference shares, membership interests or other form of economic equity in the CLO), we would expect that for most CLOs, the material terms of these securities would generally already be described in the offering circular.

[7] 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").

[8] *See* Credit Risk Retention, 79 Fed. Reg. 77,602, at 77,619 n. 63 (December 24, 2014).

	A description of the valuation methodology used to calculate the estimated fair value or range of fair values.	This may include discounted cash flow analysis based on the expected returns from the CLO; pricing from other recent comparable securities; and/or "internal-model based analysis." All key inputs and assumptions that were used in measuring the estimated total fair value or range of fair values must be disclosed. A summary description of the reference data set or other historical information used to develop the key inputs and assumptions must be disclosed. [9]
Reasonable time after the closing	The fair value of the eligible horizontal interest that the CLO Manager actually retained, expressed as (i) a percentage of the fair value of all of the CLO interests issued in the CLO, based on the actual sales prices and finalized class sizes and (ii) a dollar amount (or equivalent in the foreign currency in which the CLO interests are issued). The fair value of the eligible horizontal residual interest that the CLO Manager was required to retain. A description of any "material differences" between the valuation methodology or key inputs and assumptions used to calculate the estimated fair value (or range of fair values) prior to closing and the methodology and inputs and assumptions used to calculate the fair value at closing.[10]	We expect that holders of eligible horizontal residual interest will want to hold an amount in excess of the 5% fair value requirement to make sure that any changes to the GAAP fair value analysis that may occur between pricing and closing do not inadvertently result in their owning less than the required 5% amount when fair value is calculated as of the closing date.

What is a "reasonable time" prior to the time of sale and after closing?

As noted in the above chart, certain information is required to be delivered to investors a "reasonable time" prior to the time of sale and after closing; however, the U.S. Risk Retention rules do not specify what constitutes a "reasonable

[9] 12 C.F.R. § 43.4(c)(1)(i).

[10] *Id.* at § 43.4(c)(1)(ii).

time". Analogizing to the public context, one would expect a "reasonable time" prior to sale to be two to three business days,[11] as this would give investors sufficient time to consider the risk-retention related disclosure prior to making an investment decision. With respect to a "reasonable time" after sale, in which the information is not needed to make an investment decision, a reasonable time would likely be the practicable amount of time that it will take to confirm the valuation after the closing (which may be more than three business days).

What form can the relevant disclosure take?

Other than requiring such disclosure to be written and under the caption "Credit Risk Retention," the U.S. Risk Retention Rules do not specify any specific form for disclosure, although we expect the disclosure required prior to the time of sale to be included in the preliminary offering circular and, if necessary, in a post-closing supplement thereto in most cases. However, delivering disclosure after the closing in a less formal manner via, electronic means, such as "Bloomberg screens" (a subscription-based email system maintained by Bloomberg LLP), may also be sufficient as long as there is some assurance that the relevant investors receive the information in a timely manner and under the caption "Credit Risk Retention".

For CLOs in which eligible horizontal residual interest is retained, who is responsible for providing a description of the "valuation methodology" used?

We would expect the sponsor to make the determination of fair value and provide this description. The sponsor may engage an accounting firm or valuation firm to assist it. Although we expect CLO underwriters may assist sponsors in developing the valuation methodology, we believe the Agencies will view the responsibility of formulating and accurately describing the valuation methodology to be that of the sponsor. With that in mind, and as we approach the Effective Date, we would encourage CLO Managers to begin having discussions with their accounting or valuation firms, as applicable, now regarding the process of making such determinations.

For purposes of the fair valuation, what kinds of "key inputs and assumptions" should be disclosed?

The required disclosures are intended to roughly track disclosure required by accounting standards, and should include "all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculations."[12] The agencies specifically mention that the disclosure should include, at a minimum, quantitative information about each of the following to the extent relevant: discount rates, loss given default (recovery) rates, prepayment rates, default rates, the lag time between default and recovery, and the basis of forward interest rates used, as well as a summary description of the reference data set or other historical data used to develop these inputs and assumptions (which "may include the number of data points, the time period covered by the data set, the identity of the party that collected the data, the purpose for which the data was collected and, if the data is publicly available, how the data may be accessed").[13]

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[11] In the public context, all required disclosure other than pricing-related information is required to be filed with the SEC at least three business days before the first contract of sale is entered into with an investor, and if there is any material change in the information contained in the preliminary prospectus, then a prospectus supplement that clearly delineates the change must be filed at least 48 hours before the time of the first contract of sale.

[12] *See* 12 C.F.R § 43.4(c)(1)(i)(F).

[13] *Id.* at § 43.4(c)(1)(i)(E); Credit Risk Retention, 79 Fed. Reg. at 77,620.

Is there a safe harbor from liability for the fair value calculations?

No, the Agencies declined to provide a new safe harbor from liability for the required fair value information,[14] but did point out that sponsors may provide additional disclosure to take advantage of the existing safe harbor for forward-looking statements under section 27A of the Securities Act,[15] if applicable, and the ''bespeaks caution'' defense developed through case law.[16] Courts applying the "bespeaks caution" doctrine generally hold that meaningful, specific cautionary language accompanying forward-looking statements make it less reasonable for an investor to rely on such forward-looking statements. Thus, we recommend that the discussion on fair valuation, and any forward-looking statements or projections included in the description of the fair valuation analysis, be accompanied by meaningful, cautionary statements which identify and describe "important factors that could cause actual results to differ materially from those in the forward-looking statement[s]."[17] In order for the cautionary language to be meaningful, we would suggest that the language be tailored to risks specific to the projections and assumptions employed in the fair valuation analysis for a CLO. For instance, in a CLO context, this may include factors such as cash-flow projections failing to materialize because the asset composition may change over time, or the deal experiencing more or less reinvestment of principal than expected, or the manager trading on a discretionary basis more frequently than expected. We recommend the CLO manager and the relevant accounting or valuation firm discuss and identify such factors well in advance of the kickoff to the related CLO so that disclosure can be properly presented.

What is the "time of sale" of CLO securities for purposes of the disclosure required by the U.S. Risk Retention Rules?

Practically speaking, we expect that most sponsors will include initial disclosure of information required under the U.S. Risk Retention Rules in the first and/or second preliminary offering circular sent to potential investors prior to pricing even though for some CLOs the closing date for the issuance of the CLO securities may be considered the time of sale, particularly if there is additional material information to be filled into the final offering circular after pricing and prior to closing when the rating process and investor negotiations are completed.

As noted above, the U.S. Risk Retention Rules require specific disclosures to be made to investors a reasonable period of time prior to the sale of an asset-backed security. The nature of these disclosures will depend on the type of retention method used, and, in each case, records must be kept (and be available upon request of the SEC) for **three years** following the date the asset-backed securities are no longer outstanding. Under the applicable guidance, the time of sale in offerings of asset-backed securities is the time at which an investor enters into a contract of sale and becomes committed to purchase the security. Unlike other types of asset backed transactions (and in particular public asset backed securitization transactions), in CLOs it is not always clear when the time of sale occurs, and moreover the answer itself may differ depending on the practices of the particular underwriter involved.

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[14] "[A]s long as the methodology and assumptions used to make such calculations are reasonable and made in good faith, the agencies do not believe a new safe harbor is necessary. The final rule does not alter any existing antifraud liability provisions of the Federal securities laws." Credit Risk Retention, 79 Fed. Reg. at 77,621.

[15] *See* 15 U.S.C. 77z–2.

[16] *See, e.g., Polin* v. *Conductron Corp.,* 552 F.2d 797, 806 n.28 (8th Cir. 1977); *Luce* v. *Edelstein,* 802 F.2d 49, 56 (2d Cir. 1986); *In re Donald J. Trump Casino Sec. Litig.,* 7 F.3d 357, 364 (3d Cir. 1993); *P. Stolz Family P'ship L.P.* v. *Daum,* 355 F.3d 92, 96–97 (2d Cir. 2004); and *Iowa Pub. Emps.' Ret. Sys.* v. *MF Global Ltd.,* 620 F.3d 137, 141–142 (2d Cir. 2010).

[17] *See* 15 U.S.C. 77z–2.

Under the applicable guidance the dispositive factor with respect to determining the time of sale is when the investor is contractually bound to purchase the security.[18] Such determination will necessarily depend on the terms of the specific agreements the CLO underwriter has in place with its investors (i.e. whether any investors are irrevocably committed to purchase on the date of the pricing date or the closing date) and when the underwriter in question executes the purchase agreement with the CLO Issuer. For example, it is commonplace in CLOs for there to be modification in the business terms up until the final offering circular is delivered, which is when the purchase agreement is frequently executed. Thus, it may be the case in such instances that the time of sale in many transactions would be when the purchase agreement becomes effective. However, practically speaking, we expect that most sponsors will include initial disclosure of information required under the U.S. Risk Retention Rules in the first and/or second preliminary offering circular sent to potential investors prior to pricing. If such a practice develops, then we would similarly expect all business and other terms (other than price-dependent information) to be embodied in the preliminary offering circular delivered prior to pricing, and a shortening of the time frame between pricing and closing.

How do the sponsor and its accountants determine the "fair value of all ABS interests issued" as of the "closing date" for a CLO?

In most cases for CLOs, we expect that this will be the actual prices at which the ABS interests were issued on the closing date. However, as the issuance price is set on the pricing date for the CLO, which typically occurs 2-4 weeks prior to the closing date, it is possible that there could be issuances or secondary sales of comparable CLO securities from comparable CLOs that close between pricing and closing. Under GAAP, differences between the issue price of these comparable CLO securities and the price of the ABS interests issued in the instant CLO may be considered relevant for purposes of establishing the fair value of the ABS interests, notwithstanding the actual issuance price. Because of this possible change in fair value of the ABS interests between pricing and closing of a CLO, we would advise that the retention holder either elect to hold more than the required 5% to give it a cushion for a possible change in fair value or reserve the right in the offering circular and relevant transaction documents to reallocate prior to closing

[18] For example, in the adopting release accompanying Rule 159 in 2005, with respect to liability under Section 12(a)(2) of the Securities Act, the SEC placed "time of sale" at the time an investor has "entered into a contract of sale" as the time it "has taken the action the investor must take to become committed to purchase the securities . . . ." Securities Offering Reform, Securities Act Release No. 33-8591, at 175 (July 19, 2005). The SEC noted in the same release that the time of contract of sale may be either the time an investor "enters into the contract (including by virtue of acceptance by the seller of an offer to purchase) or completes the sale". *Id.* at 175 n. 394. Further, in an adopting release with respect to revisions to Form D in 2008, the SEC took the position that the time of sale occurs when an investor becomes "irrevocably contractually committed" to purchase the security, which date will depend upon the terms and conditions of the contract and can be when an investor returns a subscription agreement to an issuer or when the issuer receives the investor's check. *See* Electronic Filing and Revision of Form D, Securities Act Release No. 33-8891, at 30 (Feb. 6, 2008). It is important to note the SEC's position that "a contract of sale under the federal securities laws can occur before there is an unconditional bilateral contract under state law, for example when a purchaser has taken all actions necessary to be bound but a seller's obligations remain conditional under state law." Release No. 33-8591, at 181-82. The SEC has also taken the position that where sellers "convey additional or changed information after the time of the contract of sale", the old contract is terminated and a new contract of sale must entered into based on the new information, which could be analogous to the ability to "break and rescind" in CLO private placements. *Id.* at 182-184. In *Finkel v. Stratton Corp.*, the Second Circuit held that "a sale occurs for §12(2) purposes when 'the parties obligate[ ] themselves to perform what they had agreed to perform even if the formal performance of their agreement is to be after a lapse of time'" which under the facts occurred when purchasers made a 10% deposit which terminated their cancellation rights. *Finkel v. Stratton Corp.*, 962 F.2d 169 (2nd Cir. 1992). In *Radiation Dynamics, Inc. v. Goldmuntz*, the Second Circuit held that "the time of a 'purchase or sale' of securities within the meaning of Rule 10b-5 is to be determined as the time when the parties to the transaction are committed to one another". *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876 (2nd Cir. 1972).

amounts being sold to investors so that the Retention Interest held by the retention holder at closing satisfies the U.S. Risk Retention Rules.

Are there any ongoing reporting requirements for the sponsor under risk retention rules?

No, unless the CLO undergoes a repricing, refinancing, new issuance or material amendment that constitutes a new issuance of ABS securities.[19] If that is the case, all of the U.S. Risk Retention Rules would apply to the securities that are offered and sold by the CLO issuer in such repricing, refinancing, new issuance or material amendment.

How does one determine who the "sponsor" is for a CLO?

Under the U.S. Risk Retention Rules, the "sponsor" is a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.[20] In the adopting release, the Agencies explained that their intent through the "organize and initiate" standard was to distinguish a "sponsor" from parties that were merely passive investors. The adopting release further provides that to be a "sponsor" an entity must have actively participated in the organization and initiation activities that would be expected to impact the quality of the securitized assets, typically through active participation in underwriting and/or asset selection. Each of the following were identified as examples of entities that would not qualify as a "sponsor": (i) an entity that only serves as a pass through conduit for assets that are transferred into a securitization vehicle; (ii) an entity that only pre-approves the assets before selection; (iii) an entity that only approves the purchase of assets after such purchase has been made; (iv) an entity that solely negotiates underwriting or asset selection criteria; and (v) an entity that is merely acting as a "rubber stamp" for decisions made by other transactions parties.[21]

In other words, the Agencies contemplate that the "sponsor" entity is an entity that has both the economic and personnel wherewithal to enable it to select the assets, underwrite the credit risks of those assets and make investment decisions with respect thereto and monitor the positions on an ongoing basis. A "shell" entity that is specially created for a single purpose or that relies on another asset management entity for essential credit decision-making activities would not appear to be the type of entity contemplated by the Agencies. To ensure the appropriate entity is identified as the "sponsor", transaction parties are encouraged to contact counsel to discuss the structure of the transaction and the relevant factors for making the appropriate determination.

Does the offering circular need to disclose who the sponsor is and, if the Retention Interest is held by a majority-owned affiliate, the identity of that affiliate and its relationship to the sponsor?

While the U.S. Risk Retention Rules do not specify that the sponsor be disclosed, since the disclosure requirements are obligations of the sponsor, it begs the question of how a sponsor would satisfy those requirements without at least disclosing its identity. Moreover, since the disclosure provision requires disclosure around how much of the Retention Interest the sponsor will retain (majority-owned affiliates are not mentioned in the disclosure provision),[22] we expect

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[19] For a discussion of what types of material amendments would trigger a "new issuance," *see supra note 2,* Dechert OnPoint, US Risk Retention Final Rule: Capitalized Manager Vehicles, Majority Owned Affiliates and Other FAQs.

[20] *See* 12 C.F.R. § 43.2.

[21] Credit Risk Retention, 79 Fed. Reg. at 77,609.

[22] 12 C.F.R. § 43.4(c).

that, in cases in which the majority-owned affiliate is retaining the Retention Interests, the sponsor will disclose the fact that a majority-owned affiliate of the sponsor holds the Retention Interest, as well as the relationship between the sponsor and the majority-owned affiliate. This comports with the general goals set forth in the adopting releases accompanying the U.S. Risk Retention Rules in not only aligning interests of the sponsor with the securitizations but also providing more visibility into the sponsor's economic interest in the securitization so that investors can assess the degree to which a sponsor is exposed to the risk of the securitized assets.

We note that, where a sponsor owns a "controlling financial interest" ("CFI") in its MOA or C-MOA in order to comply with the "majority-owned affiliate" definition,[23] accounting firms assisting the sponsor in providing the analysis under GAAP have shown sensitivity to being named or referred to in the offering circular. Thus, we expect a market practice to evolve around the need to balance the sensitivity of the accountants to liability with the market desires of placement agents and investors to ensure that such an analysis has been responsibly performed. This may take the form of a factual disclosure by the sponsor in the offering circular that it has made the determination that it has a controlling financial interest in the MOA or C-MOA in consultation with a nationally-recognized accounting firm, without naming such accounting firm or referring to any report provided to it by such accounting firm.

Additionally, while not required by the U.S. Risk Retention Rules, any financing arrangement entered into by the retention holder for purposes of acquiring the Retention Interest should be disclosed.

If there are two entities which could be considered the "sponsor" of a CLO, how should this be disclosed in the offering circular?

In situations in which a traditional asset manager has formed a majority-owned affiliate to act as the collateral manager under a CLO, with the traditional asset manager providing a portion of the capital and other support to the majority-owned affiliate (i.e., the "C-MOA option"), it is possible that either or both could be considered the "sponsor." If both are considered sponsors, the U.S. Risk Retention Rules require at least one of them to hold the Retention Interest.[24] If the traditional asset manager is considered the "sponsor," the majority-owned affiliate could hold the Retention Interest, and if the majority-owned is itself the sponsor, it could hold the Retention Interest. We anticipate that, in such situations, this would be disclosed; i.e., the offering circular would describe both the traditional asset manager and the C-MOA entity, their relationship with each other and, assuming both are sponsors, the functions each performs in connection with the organization and initiation of the CLO and the credit underwriting of, and investment decision making with respect to, its assets. The disclosure would then describe that either the traditional asset manager or the C-MOA could hold the Retention Interest, and that, in such case, both the traditional asset manager and the C-MOA have agreed that the C-MOA will be holding the Retention Interest.

What kinds of undertakings (if any) should the sponsor be required to provide with respect to U.S. Risk Retention Rules?

Compliance with the U.S. Risk Retention Rules is an obligation of the sponsor under applicable law. Thus, in deals in which the collateral manager is the sponsor, we would expect that the collateral manager would provide a representation in the collateral management agreement that the execution, delivery and performance of the collateral

[23] *Id.* at § 43.2.

[24] *Id.* at § 43.3(b) ("If there is more than one sponsor of a securitization transaction, it shall be the responsibility of each sponsor to ensure that at least one of the sponsors of the securitization transaction (or at least one of their majority-owned or wholly-owned affiliates, as applicable) retains an economic interest in the credit risk of the securitized assets . . . .").

management agreement, collateral administration agreement and provisions of indenture applicable to it would not violate any existing law in a manner that would have a material adverse effect on it. If the collateral manager is not the sponsor, we would expect the offering circular to include a statement that the sponsor intends to comply with the U.S. Risk Retention Rules, directly or indirectly through its MOA or C-MOA.

What kinds of changes (if any) would be needed to the engagement letter or underwriting agreement after the Effective Date?

After the Effective Date, the entity that intends to be considered a "sponsor" should execute the engagement letter and be involved in negotiating the CLO transaction documents and in underwriting and making an investment recommendation or decision with respect to each of the loans in the CLO's portfolio, since the definition of sponsor refers to the entity which "organizes and initiates a securitization transaction."[25] Substantively, however, the U.S. Risk Retention Rules do not require anything in particular be included in the engagement letter or underwriting agreement.

What types of modifications should be made to the collateral management agreement for a CLO? How should collateral manager removal, resignation or assignment be addressed?

The U.S. Risk Retention Rules are unclear as to whether the obligation to hold the Retention Interest would go to a successor collateral manager in the event of a collateral manager removal, resignation or assignment, or whether the original collateral manager is still considered the "sponsor" given its initial role in "organizing and initiating" the CLO. Certain industry groups have been seeking guidance from regulators on this point. Absent further guidance, we recommend that if the initial manager is replaced (whether due to removal, resignation or assignment), the replaced manager continue to hold the Retention Interest until such time, if any, as there is formal guidance otherwise, at which time the successor manager would agree to buy and the replaced manager would agree to sell, at the then fair value determined in accordance with GAAP, such portion of the Retention Interest that the U.S. Risk Retention Rules require be held by the successor manager. To effectuate this, the collateral management agreement should be revised to include an ability for the replaced collateral manager to transfer its Retention Interest to a successor collateral manager at such price, which transfer could be made contingent on applicable law or guidance in effect at the time of transfer or any reasonable belief by the replaced collateral manager or the successor collateral manager that such a transfer would be advisable or necessary.

What types of modifications should be made to the Indenture?

Since repricing, refinancing, additional issuances or certain material amendments would trigger a new obligation to hold a Retention Interest against the securities being refinanced, repriced, additionally issued or amended, provisions in the indenture which allow for repricing, additional issuance, refinancing or material amendment should either provide for collateral manager consent to such actions, or, as a condition precedent to the effectiveness thereof, provide the collateral manager or other retention holder with a unilateral right to acquire any necessary Retention Interest contemporaneously with the execution of such actions and, if any portion of such Retention Interest must be acquired from existing investors in the CLO, obligate them to sell the same to the collateral manager or other retention holder, at the then fair value of the related ABS interests determined in accordance with GAAP. Otherwise, the collateral

[25] *Id.* at § 43.2.

manager may find itself in a position in which it is required by law to hold a Retention Interest but does not have the contractual ability to satisfy such requirement.

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