Capital manager vehicles demystified

Dechert partners John Timperio and Cynthia Williams outline what could prove to be a popular option to abide by the upcoming US CLO risk retention regime

In the half-year since the initial release of the final US risk retention rule on CLOs, market participants have been grappling with the ramifications of the coming effectiveness of the rule on 24 December 2016.

CLO collateral managers who can develop platforms that allow them to show that they will comply with the US risk retention rule on and after the December 2016 effective date will have an edge with investors today. This is because CLOs issued today will be prospectively subject to the US risk retention rule in the event of a refinancing or re-pricing or additional issuance of securities after December 2016. This is also because investors will want to develop and/or maintain relationships with CLO managers who have the ability to solve the risk retention puzzle and thus remain viable players in the market by issuing new paper and building assets under management.

Briefly, to be compliant with the US risk retention rule for CLOs means a sponsor (or a majority-owned affiliate) must retain an economic interest in the credit risk of the securitised assets which may be held vertically (as a single security or as an interest equal to 5% of the face value of each tranche issued by the CLO), or horizontally (as an interest in the first loss tranche equal to 5% of the fair value, determined using a fair value measurement framework under US GAAP) of all tranches issued by the CLO or as any combination of the two.

Identifying a sponsor

A sponsor is "a person who organises and initiates a securitisation transaction by selling or transferring assets, either directly or indirectly, through an affiliate, to the issuing entity". Regulators' commentary accompanying the US risk retention rule sought to distinguish sponsors from passive investors, indicating that simply negotiating underwriting criteria or asset selection criteria or rubber stamping decisions made by other transaction parties does not sufficiently distinguish passive investment from the level of active participation expected of a sponsor.

Similarly, the commentary indicates that entities that serve only as pass-through conduits for assets, that only purchase assets at the direction of an independent asset or investment manager, or that only approve the purchase of assets before selection or after purchase, would be impermissible third-party holders of risk retention.

In the context of CLOs, and particularly open market CLOs, the collateral manager in its traditional role would be the sponsor as it selects and manages the loans owned by CLO issuers.

Bearing the onus of an investment equal to 5% of the face or fair value of each tranche, vertically or horizontally, for each CLO managed may make the "buy in" to play in the CLO space too dear for many collateral managers.

Typically the business model for open market CLO collateral managers has been to garner fees for their related asset management services as a percentage of assets under management. While it is relatively common that a collateral manager (or an affiliated fund) will take an equity position in the CLOs it manages, most collateral managers are not sufficiently capitalised to the point of being able to hold the 5% retention interest themselves in every deal going forward without raising additional funds from strategic investors, and outsourcing the risk retention to affiliated funds which are not majority-owned affiliates of the collateral manager is impermissible.

Given the myriad options that have been floated in the previous months to enable a collateral manager to raise the wanting capital, we have seen significant interest in the capitalised manager vehicle option which permits a collateral manager to raise the funds necessary to hold the retention interest for multiple CLO transactions.

The CMV option involves the creation of a newly capitalised and self-managed entity that would both act as the collateral manager and hold retention interests on a go-forward basis for a number of transactions.

This approach involves significant commitment on the behalf of a manager sponsor to pursue the development of a novel structure bespoke to its existing platform, the formation of a robust new self-managed, independently registered collateral manager entity and the negotiation of economics and other material rights with investors in order to secure capital investments.

Balanced against the initial investment, the value for manager sponsors is, if properly structured, a solid platform enabling compliance with the US risk retention rule after the December 2016 effective date and, in the present, to attract investors concerned with collateral managers' ability to remain viable issuers of CLO paper.

In addition to compliance with the US regulatory regime, a CMV could be structured in such a way as to satisfy EU risk retention requirements, allowing a collateral manager's platform to tap European markets for investors looking for United States loan exposure and offering more attractive spreads for the collateral manager's CLO paper, defraying the initial expenses of setting up a CMV.

The capitalisation of the CMV may come in a variety of forms, including equity alone or a combination of debt and equity, which would be used to fund the expenses of the CMV as well as any capital investment undertaken by the CMV (including acquisition of the retention interests).

The CMV's earnings would in turn be distributed through a negotiated priority of payments to the debt and/or equity holders of the CMV. In the context of the CMV, it would be expected that third-party investors who historically have invested directly in CLOs would now consider doing so indirectly and on an "aggregate" basis through such a CMV, which would give such investors exposure to multiple CLOs sponsored by the CMV.

While each collateral manager's CMV structure will be idiosyncratic to the existing manager sponsor's needs and existing platform, as well as to the needs of the investors in the CMV, generally a CMV would be the collateral manager with respect to any CLO with respect to which it holds the retention interest, in light of the US risk retention rule's focus on the concept that the sponsor be a substantive, bona fide, self-managed asset management entity responsible for credit underwriting of the assets going into the securitisation. For a CLO, the upshot is that the CMV must be the entity that in fact "organises and initiates" the CLO transaction and has the requisite ability to underwrite the credit risks in the CLO portfolio and monitor and manage the positions.

A CMV, or any other entity structured to hold the retention interest, may not be a shell entity that is specially created for a single purpose or that relies on support from another adviser entity for essential credit decision-making and other material investment management activities.

Supporting factors

The CMV will need sufficient economic substance and personnel, along with other factors that support a conclusion that it is the entity that has the most control and influence over the CLO portfolio if it is to qualify as the sponsor. Generally, factors that would add support to the conclusion that a CMV is the sponsor include:

(i) the CMV's employment of its own portfolio managers (or other credit decision-making employees);

(ii) the restriction of any support services agreement with the manager sponsor to administrative and support matters such as back office and/or middle office functions;

(iii) the arm's length negotiation of any fee payable to the manager sponsor under any support services agreement;

(iv) the conduct by the CMV of its business as an independent operating company; and

(v) the CMV's registration as an independent investment adviser under the Investment Advisers Act.

A properly structured CMV should have its own portfolio managers or other credit decision-making employees. These employees could be employed simultaneously by the manager sponsor. It is important that in their role as employees of the CMV, these personnel should not rely on an external entity to make credit and asset management decisions on behalf of the CMV. The CMV's personnel should negotiate the CLO documents for each applicable CLO transaction and make credit/asset management decisions relating to the CLO platform. Finally, the CMV's personnel should be paid a salary by the CMV, which is commensurate with their applicable duties for the CMV.

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In light of and in furtherance of the foregoing, any staffing and servicing agreement with the manager sponsor (or any other entity) should not relate to credit decision or collateral management functions, but solely to matters such as back and middle office functions, loan settlement, legal and compliance, general research, providing office space and other administrative matters.

Any fee payable to the manager sponsor under such a staff and services agreement should not be effectively a pass through of the management fee from the CLOs through the CMV to the manager sponsor. Such a fee should be based on arm's-length terms negotiated between the CMV and the staff and services provider and payable at a rate that is consistent with similar third-party arrangements in the market.

The CMV should conduct itself as an operating entity of substance, acting as the sponsor/collateral manager for an ongoing platform of deals. The CMV should use management fee income earned from its CLOs and returns on its retention interests to pay its own expenses, including its employee salaries and any arm's length staff and services fees. The CMV should hold itself out to the market as the sponsor/collateral manager. To the extent the manager sponsor is referenced in marketing materials or any offering circular, it should only be in the context of describing its role as a staff and services provider which provides administrative support.

The CMV should register independently as an investment adviser under the Investment Advisers Act, rather than acting as a relying adviser under the supervision and control of the manager sponsor.

Similarly, as a corporate matter, the CMV should have a board of directors, at least a majority of whom are independent, that exercises customary oversight of the CMV, its investment management activities and its conflicts of interest. Importantly, the board of the CMV should have the power to terminate, based on arms-length negotiated terms, any staff and services agreement or any other agreement with any entity that provides services on its behalf or to which the CMV has delegated any duties.

Additional players

All of the above goes directly to the point that the CMV or any sponsor must be a self-managed entity with substantive decision-making power within itself. However, a number of additional legal, accounting and tax considerations will be at play for any collateral manager in complying with the US risk retention rules and in the structuring of a CMV, a majority owned affiliate or other qualifying entity.

We should note that the field continues to develop and the final result will be the fruit of input from the collateral managers, the investors they hope to attract and the regulators they hope to satisfy. ◻

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