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Compliance Implications for CLO Managers

By Joseph DiBartolo and Guy F. Talarico

In 2018, Collateralized Loan Obligations ("CLOs") were the biggest buyers of leveraged loans. "More than $121 billion of US CLOs have been raised as of November 23, just behind the all-time high of $123.6 billion in 2014, according to LPC Collateral data. An additional $146 billion of CLOs have been reset, refinanced or reissued in 2018 to date."[1] The question you may be asking is what are CLOs? And, how did they grow to become a major provider of capital to U.S. companies?

Collateralized Loan Obligations

CLOs are structured vehicles that issue long-term debt and equity to finance the purchase of a portfolio of, primarily, senior secured bank loans from a diverse range of borrowers—which could include over 200 issuers. A CLO's governing contract (the indenture) consists of an agreement between the issuer and the trustee. The trustee is a bank whose role is to represent the CLO noteholders.[2] The CLO hires the manager subject to a collateral management agreement. The debt issued by the CLO is divided into separate tranches. "Each CLO tranche has a different priority of claim on cash-flow distributions and exposure to risk of loss from the underlying collateral pool. Cash-flow distributions begin with the senior-most debt tranches of the CLO capital structure and flow down to the bottom equity tranche."[3]

The most senior and highest-rated tranche has the lowest yield but the highest claim on the cash-flow distributions. Mezzanine tranches pay higher yields but are more exposed to loss and have lower ratings. The most junior tranche, equity, is the most risky, and represents a claim on all excess cash flows once the obligations for each debt tranche have been met.[4] The principal and interest on the CLO debt and returns to equity holders are paid in accordance with "waterfall" instructions that are included in legal documents, such as the trust indenture.

"The credit risk of a CLO is dependent on the underlying assets within the portfolio. For "traditional" CLOs, the collateral pool primarily consists of below investment grade, first lien, senior secured broadly syndicated bank loans (usually at least 90% of the total portfolio), and it may include a pre-determined allowable portion of other asset types such as second lien bank loans (which are highly leveraged) and unsecured debt, as well as middle market loans. Some CLOs consist predominantly of middle market loans as the underlying collateral."[5]

CLOs are actively managed. The manager of a CLO will buy and sell individual bank loans for the underlying collateral pool in an effort to create trading gains and minimize losses. CLOs have structural features that serve as protection for the debt and equity investors, the CLO manager's investors, such as overcollateralization and interest coverage tests on the debt. The established coverage tests help ensure the cash flows generated by the underlying bank loan collateral meet the distribution obligations in the various CLO tranches.[6]

In addition, CLOs are subject to a variety of other limitations, as well as tests on these limitations, that are designed to protect debt investors from loss. For example, these include: measurements of the industry diversification in the underlying collateral pool of bank loans; the CLO's exposure to non-senior secured loans; diversity of borrowers underlying each CLO and set single obligor limits; and the amount of CCC-rated debt that can be included in the underlying collateral pool.

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1. https://www.reuters.com/article/us-clo-forecast/u-s-clo-market-poised-for-new-record-and-busy-2019-idUSKCN1NZ04J.
2. http://cloguide.creditflux.com/chapter_2.php
3. https://www.guggenheiminvestments.com/perspectives/portfolio-strategy/collateralized-loan-obligations-clo.
4. IBID.
5. https://www.naic.org/capital_markets_archive/primer_180821.pdf.
6. The CLO structure also benefits from certain structural features such as credit enhancement. To ensure sufficient credit enhancement supports the transaction, the CLO capital structure is subject to overcollateralization (O/C) tests at each tranche level, whereby the principal value of the underlying portfolio must be greater than the principal value of the outstanding tranches. In addition, to ensure sufficient funds are generated by the underlying portfolio for timely interest payments to bond holders, the CLO structure is also subject to another structural feature in the form of an interest coverage (I/C) ratio, whereby the income generated by the pool of assets is compared to (and must be greater than) the interest due on the outstanding debt. https://www.naic.org/capital_markets_archive/primer_180821.pdf

The Credit Risk Retention Rules

Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act authorized regulation of the asset-backed securitization market.[7] On December 24, 2016, credit risk retention rules became effective for all asset-backed securities. However, as a result of a 2014 lawsuit brought by the Loan Syndications and Trading Association, the U.S. Court of Appeals for the D.C. Circuit recently found that the credit risk retention rules do not apply to managers of open market CLOs. The court held that an open market CLO manager is not a "securitizer" within the meaning of the credit risk retention rules.[8] (CLO's created by the originators of loans are still subject to the credit risk retention rule.)

CLO managers are now focusing on what they do so well: providing capital to U.S. companies. However, not all regulations go away, as many CLO managers, who are required to be registered with the SEC as investment advisers, must maintain a compliance framework and perspective that not only satisfies the regulators, but also protect and serve its investors in the best light.

Compliance Implications

Due to the nature of CLOs and underlying investments involving bank loans and similar investments, firms registered with the SEC must adapt the Investment Advisers Act Rule 206(4)-7 compliance program rule requirements to reflect their firm's business activities and operations. CLO managers operate independently and within a framework where transactions are subject to various credit risk and performance metrics as defined in the CLO indenture and the collateral management agreements.

The compliance policies and procedures should be customized to the management of CLOs and the recognition of the "hot-button" issues, risks and key differences that distinguish CLO's from private funds, hedge funds or traditional advisers. These include, but are not limited to, the following:

(a) Credit default risks and compliance with the CLO indenture investment guidelines that are trade-specific;
(b) Obtaining material non-public information and misuse of that information;
(c) Allocations among multiple CLO's in different life cycles;
(d) Best execution associated with the bank loan markets and the liquidity in the markets and the recognition of conflicts of interests with third-party dealers and other conflicts; and
(e) Impact to compliance policies when investors are unknown to the CLO manager.

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These compliance and risk issues might elicit somewhat different approaches when establishing a Rule 206(4)-7 compliance program. Accordingly, the compliance program should take into account the role of the Trustee and the CLO indenture obligations and variance (investment guidelines). Compliance officers may team up with portfolio operations to perform the oversight and testing of the Trustee reports. A CLO manager must monitor the compliance of each loan investment with the indenture asset eligibility criteria and the impact of each loan investment on portfolio concentration tests and other portfolio tests. In one sense, the CLO manager is independent from the oversight of the trustee, but, as a key service provider with the utmost responsibility to manage CLO assets on a day-to-day basis.

Fixed income managers including CLO managers have access to sensitive issuer information, including certain financial projections for public companies. This requires additional compliance reviews and testing of the code of ethics policies and procedures, strict maintenance and protection of restricted lists and issuer credit files regarding material non-public information and insider trading.

7. The Credit Risk Retention Rule was adopted by the Securities and Exchange Commission and five other U.S. regulators (collectively, the "Agencies") to implement Section 941 of the Dodd-Frank Act. It requires that a "securitizer" retain not less than five percent of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party. https://www.linklaters.com/en/insights/publications/us-publications/2018/february/us-risk-retention-decision
8. BID.

Trade allocation policies and procedures should address policies, reviews and testing of trade allocations among multiple CLOs in different phases of its life cycle; the ramp-up phase vs reinvestment period vs post investment period of the CLO life cycle. Recognition of these phases and the imbalances inherited with trade allocations among CLO's with different life cycles requires additional reviews to ensure fair and equitable allocations especially in markets where liquidity could be an issue.

In situations where there are only a select group of broker-dealers that may provide liquidity, best execution policies and procedures should take into account the differences between bank loan markets compared to the equity markets, a dealer to customer to dealer market in opaque markets and pricing for new issues and secondary trades. Certain types of transactions such as amend to extend transactions and reorganization/loan workout transactions that could be part of the CLO investment strategy generally do not apply but need to be recognized.

CLO managers, who trade with broker dealers, may face potential conflicts of interests with third-party dealers that require mitigation and possible disclosures in the Form ADV brochure and/ or CLO governing documents. For example, the CLO manager or its affiliates may have other business or personal relationships with a third party-dealer where there is an incentive to trade with that third-party dealer to do so would be in conflict with the CLO manager obligations to obtain best execution on the trade.

The investors of a CLO may be unknown to the CLO manager. As a result, the compliance policies and procedure relating to the onboarding of new investors, the completion of the Form ADV and investor reporting, will require customization.

A new CLO manager should expect investors to conduct thorough due diligence reviews on all activities of the manager including systems, cybersecurity, back office operations and the compliance program. This review will extend to the activities of third-party firms, including the placement agent and rating agencies. In preparation for these reviews the manager may consider conducting a mock audit, risk assessment or, at a minimum, a focused topic review to carefully evaluate the business, operations, compliance processes, procedures and testing protocols that are currently in place relative to all apparent material conflicts of interest, pertinent regulatory requirements and prevailing industry best practices to uncover material gaps and/or weaknesses in the firm's overall regulatory compliance control environment.