Collateralized loan obligations (CLO)

Accounting. Tax. Regulatory.

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CLO overview

The CLO market has once again proved to be resilient in the face of regulatory headwinds as it registered its second best year on record in terms of new issuance last year. Coupled with a huge volume of refinancings and resets, all of the market participants had a very busy year. With a strong year behind us and an optimistic forecasted issuance this year, CLOs continue to demand over half of the domestic leveraged loan issuance.

As regulation continues to impact the leveraged loan and CLO markets and their participants, new CLO asset managers and investors still continue to enter into the market. Contrary to expectations of many that the final risk-retention rules that went into effect on December 24, 2016, would shrink the market, most market participants have been able to assess, adapt, and incorporate the new rules into their business model. Furthermore, the need for third-party financing for risk retention solutions actually brought new investors and capital into the market, with demand for funding at times outpaced by supply. That said, on February 9th, the US Court of Appeals ruled that risk retention does not apply to managers of open market CLOs. While subject to appeal, at this writing it appears likely that CLO managers will have relief from complying with the risk retention rules.

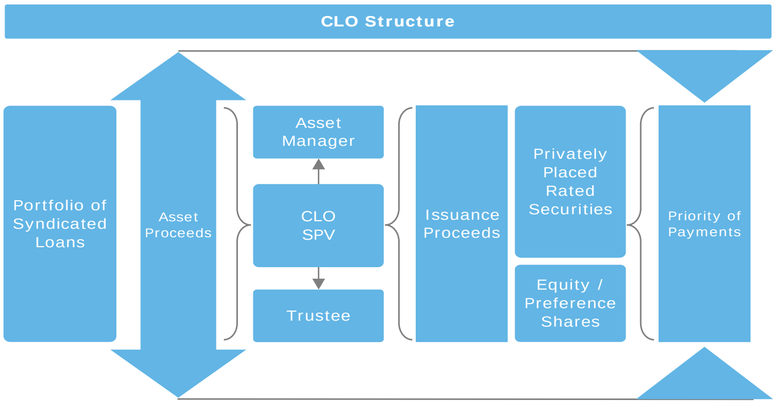
The purpose of this booklet is to provide an overview of a CLO, its market participants, and roles and review tax, accounting, and regulatory implications to asset managers and investors.

What is a CLO?

A CLO is a special purpose vehicle (SPV) that acquires a portfolio of diversified syndicated leveraged loans through the private placement of rated debt and equity securities, providing investors with differentiating risk and reward profiles.

A leveraged loan is a commercial financing provided by a group of creditors. Such loans generally consist of revolving credit and/or term loan facilities and are traded in the open market.

CLO structures are designed to provide (a) credit enhancement through portfolio overcollateralization, (b) priorities of payments designed so that higher-rated securities receive available funds prior to subordinated securities, (c) a reinvestment period in which available principal proceeds are used to acquire additional portfolio assets, and (d) mechanisms to protect investors from portfolio deterioration.



A typical CLO structure is depicted above.

CLO market participants and roles

The CLO Fund—A bankruptcy remote corporate entity with an independent board of directors. The CLO typically employs the following parties or their equivalents to perform the services enumerated below:

The Placement Agent—A commercial or investment bank hired by the CLO or asset manager to structure and place the CLO's privately placed securities. The placement agent may provide warehouse financing and will lead the CLO's marketing, pricing, and closing-date activities, monitoring that related parties' roles are performed in accordance within the indenture's conditions for closing and the offering memorandum provides a complete description of the CLO to investors.

The Collateral Manager—A public or private asset manager employed by the CLO to acquire and then trade the CLO's portfolio of syndicated leveraged loans in compliance with the CLO's indenture criteria: the concentration limitations, eligibility criteria, collateral quality thresholds, and overcollateralization/interest coverage tests throughout the CLO's life cycle.

The Trustee—Acts as fiduciary agent for the CLO's investors, maintaining custody of the CLO portfolio assets and cash flows and accounts and remitting available funds to investors on payment dates in accordance with the indenture's priority of payments. The trustee approves and reconciles the collateral manager's trades to monitor compliance with the indenture's portfolio requirements and acts on behalf of the investors with certain voting rights during the CLO's life cycle events. The CLO indenture is executed by the CLO and the trustee.

The Collateral Administrator—Typically, an affiliate of the trustee who acts as the CLO's bookkeeper, generating and posting periodic reports for investors and rating agencies. These monthly and quarterly reports detail a CLO's portfolio composition and characteristics, purchases and sales, balances and reconciliation of accounts, informing investors of required portfolio compliance, and distributions due to investors on a payment date.

The Investors—Have different motivations for purchasing various privately placed CLO debt securities and preference share equity securities of the CLO fund. Investment-grade noteholders of a CLO fund include mutual funds, commercial banks, pension funds, and insurance companies. Investors in the CLO funds below investment-grade bonds and preference share equity investments include hedge funds, private equity funds, and funds created by such entities for investors seeking yield.

The Credit Rating Agencies—Assign ratings to syndicated leveraged loans comprising a CLO's fund based upon the obligor's ability to repay the respective credit facility's debt. On a CLO's closing date, the rating agencies assign respective ratings to the CLO's rated securities that are reaffirmed on the CLO's effective/ramp-up period date upon confirmation of portfolio compliance. Over the life of a CLO, the rating agencies monitor the CLO fund's performance, probability of default, and ability to pay principal and interest timely to the CLO investors.

The Attorneys—A CLO's bond counsel provides legal advice and tax opinions and oversees the drafting of the private placement offering memorandum and indenture. A CLO fund's deal counsel is responsible for drafting the CLO fund's articles of incorporation, bylaws, and motions/minutes of a CLO funds board of directors' meeting. The collateral manager and trustee each employ counsel for respective duties and engagement document execution.

The Accountants—Provide various accounting services over the CLO life cycle, comprising of agreed-upon procedures; reports foreclosing date, effective date, and investor payment dates; and passive foreign investment company (PFIC) or partnership tax reporting services.

Investor accounting

Classification and measurement considerations

All interests in securitized financial assets, including CLOs, should be initially recorded at fair value. In addition, the investor will need to make at least one and perhaps several accounting elections immediately upon recognizing its investment.

The first accounting election is whether the investor wants to continue to report the interest at fair value on subsequent balance sheets, thereby recognizing unrealized gains and losses due to fair value changes currently in earnings. This “fair value option” is available for most financial instruments, including CLOs. The election generally must be made on an item-by-item basis when each investment is first recognized, and is irrevocable once made. The election, however, cannot be used as an alternative to consolidation. If the investor decides not to use the fair value option, then the decision of what to do requires more thought.

Most interests in CLOs will meet the definition of a “debt security” and, therefore, are governed by the accounting guidance in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 320, *Investments—Debt and Equity Securities*. However, at times, transferors will structure a transaction so that they obtain financial interests that do not meet the definition of a debt security. This generally does not occur in the CLO market, but investors may consult their advisor on the application of other accounting principles generally accepted in the United States of America (US GAAP) that may be necessary to consider.

Assuming the CLO investment is a debt security, and the investor has not availed itself of the fair value option, it must elect to classify debt securities as either trading, available for sale (AFS), or held to maturity (HTM). For the most part, this initial classification cannot be changed so long as the holder retains the security. Only transfers from the AFS category to the HTM category are readily permitted.

Trading securities

Trading securities are carried at fair value, with unrealized gains and losses recognized currently in earnings. Securities that are acquired to be sold in the near term, and are therefore expected to be held only for a short period of time, must be classified as trading securities. An investor may also voluntarily designate other debt securities as trading securities. Thus, the trading category is essentially similar to the fair value option[1].

[1] ASC 825-10-15-4 considerably expands the availability of fair value accounting to financial liabilities and financial assets other than securities. ASC 320-10- 25-1 allows for an initial election to classify debt securities as “trading securities,” even if the investor is not actively trading in the position.

AFS securities

AFS securities are also carried at fair value in the balance sheet. However, changes in fair value are recognized on the balance sheet, net of tax effects, in a separate component of equity known as other comprehensive income (OCI) rather than in current earnings. If an individual security's fair value declines below its amortized historical cost and that decline is considered to be other than temporary, the security is impaired and some or all of the charge that would otherwise appear in OCI must be recognized as a loss on earnings. This establishes a new historical cost basis for the security, which means that any subsequent increase in fair value cannot be used to offset losses previously recognized. The analysis of other-than-temporary impairments (OTTI) is discussed further in this chapter.

HTM securities

HTM securities are carried at their amortized historical cost, subject to write-downs for OTTIs. In order to classify a security as HTM, the holder must have the positive intent and ability to hold the security until its maturity. There are strict limitations on the ability of an investor to sell HTM securities without impugning management's ability to claim the intent to hold other securities until they mature. The permissible reasons to sell or reclassify HTM securities that are most frequently applicable to holders of securitized products, such as CLOs, are:

- Evidence of a significant deterioration in the issuer's creditworthiness, such as a rating agency credit downgrade.
- A significant increase in the holder's regulatory capital requirement, causing it to downsize its portfolio.
- A significant increase in the risk weights (RWs) associated with the particular securities.
- A sale near enough to contractual maturity so that interest rate risk is no longer a pricing factor (e.g., within three months of contractual maturity).
- Collecting a substantial portion of the principal balance outstanding at the date the security was acquired, either due to prepayments or scheduled payments over its term.

In contrast, sales or reclassifications due to changes in interest rates, prepayment rates, liquidity needs, alternative investment opportunities, and funding or foreign currency exchange rates are not permissible reasons to sell a security classified as HTM. The Securities and Exchange Commission (SEC) staff has expressed the view that selling even one HTM security for an impermissible reason would call into question management's ability to make a credible assertion about the intent to hold other securities to maturity. In that case, the SEC staff have indicated that all other HTM securities should be reclassified to AFS and no new securities may be classified as HTM for a period of two years (commonly referred to as the tainting period).

Impairment and interest recognition

Impairment and OTTI

Positions that have an OTTI will require a write-down of one sort or another. At every balance sheet date, the investor needs to identify individual security positions whose fair values are "underwater," (i.e., below their amortized cost), even if they are already carried at fair value as AFS securities. Once these "impaired" positions are identified, the next step is to determine whether the impairment is other than temporary (which does not mean "permanent"). Finally, the investor may need to estimate how much of the OTTI results from credit losses as compared to all other factors.

For debt securities, such as securitization interests, OTTIs comes in two basic varieties. If the investor either intends to sell a security or is more likely than not to be required to sell the underwater security before it recovers (e.g., for regulatory reasons), then the investor must write down the security to its fair value. The entire write-down is charged to earnings. Thereafter, the investor accounts for the security as if it were purchased at fair value at the date of the write-down.

Alternatively, if the investor does not intend to sell a security, and it is not more likely than not that it will be required to sell the security, the impairment may nonetheless be deemed other than temporary if the investor does not expect to recover the security's entire amortized cost through the present value[2] of future expected cash flows. In that case, the write-down is split between the portion representing credit losses and the remainder related to all other factors.

Investors should also ensure they consider the guidance in ASC 320 and ASC 325 that was formerly referred to as "Emerging Issues Task Force (EITF) 99-20". Under this guidance, an investor is required to record an OTTI as a realized loss through earnings when it is "probable" that an adverse change in the holder's estimated cash flows from the cash flows previously projected has occurred, which is consistent with the impairment model in ASC 310.

Impacts of the Volcker Rule

One of the impacts of the Volcker Rule[3] is its prohibition on banking entities from owning, sponsoring, or having certain relationships with hedge funds or private equity funds ("covered funds").

This rule caused quite a stir in late 2013 and the beginning of 2014, as many CLOs - because of their potential holdings of securities, rather than loans - appeared to meet the definition of a covered fund, as provided for in the Volcker Rule. Furthermore, holders of these interests found that, in many cases, their holdings may have constituted an "ownership interest" in those covered funds, which banks would have to dispose to comply with the Volcker Rule once the conformance period ended.

[2] This present value calculation would be based on the yield currently being used by the investor to recognize interest income on the security.
[3] Section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act.

As a consequence, many banks and other regulated entities had to carefully assess the Volcker Rule and whether it would require them to dispose of their interests in CLOs by the end of the conformance period and whether that would constitute an OTTI. Since the issuance of the Volcker Rule, the CLO market has adapted, with modifications to existing structures and changes to new ones, that helped alleviate many of the concerns in the marketplace.

PCI assets

Impairment considerations for assets that are purchased when credit impairment has historically been included in Statement of Position No. 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. In the marketplace, this is commonly referred to as “SOP 03-3”. That said, SOP 03-3 requires that for purchased loans that both have evidence of credit deterioration since origination and for which it is probable not all of the contractually due cash flows will be able to be collected, the net investment in the loans is recorded at the lower of the acquisition cost of the loan or the estimated fair value at the date of acquisition.

Interest income when there is significant prepayment and/or credit risk

Generally, interest income recognition on investments in CLOs will be accounted for under ASC 325-40. Under this model, investors (as of the purchase date) need to estimate the timing and amount of all future cash inflows from the security using assumptions that were used in determining fair value. The excess of those future cash flows over the initial investment is the accretable yield to be recognized as interest income over the life of the investment using the effective yield method.

When an investor acquires a CLO that has demonstrated evidence of credit quality deterioration since its inception, investors may need to recognize interest income on their investment in a securitization using the guidance found in ASC 310-30. That guidance is similar to ASC 325-40 except that it differs in how updates to cash flow estimates affect yield. For example, after initial recognition, the estimated cash flows used to accrete interest income for a debt security are required to be updated only if (1) the estimated cash flows have increased significantly, (2) the estimated cash flows have declined (in which case, an impairment would be recognized), or (3) if the actual cash flows received are significantly greater than previously projected.

Changes to OTTI and impairment on the horizon

The FASB issued its long-anticipated proposed changes to financial instrument impairment, ASU 2016-13, Measurement of Credit Losses on Financial Instruments, in June 2016. These changes, more commonly referred to as current expected credit losses (CECL), will have wide-ranging impacts to all entities and how they estimate credit losses on a number of financial instruments. Under the CECL model, an entity would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce complexity of US GAAP by decreasing the number of different credit impairment models for debt instruments. The CECL model would apply to most debt instruments (that are not carried at fair value through net income), leases, reinsurance receivables, financial guarantee contracts, and loan commitments.

Further, AFS debt securities are excluded from the model's scope and will continue to be assessed for impairment under ASC 320. However, the FASB tentatively decided to revise ASC 320 by:

- Requiring an entity to use an allowance approach (versus permanently writing down the security's cost).
- Limiting the allowance to the amount at which the security's fair value is less than its amortized cost basis.
- Removing the requirement that an entity must consider the length of time that fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.
- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

Regarding non-AFS debt securities, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity would recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment would be recognized as an allowance—or contra-asset—rather than as a direct write-down of the amortized cost of a financial asset. An entity would, however, write off the carrying amount of a financial asset when it is deemed uncollectible, which is consistent with existing US GAAP.

Other changes that should be highlighted include:

- For purchased credit impaired (PCI) assets, an entity will measure expected credit losses consistently with how it measures expected credit losses for originated and purchased non-credit-impaired assets. The changes proposed for PCI assets includes purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows.
- Further, an impairment allowance for "purchased or retained beneficial interests for which there is a significant difference between contractual and expected cash flows" should be measured in the same manner as PCI assets under the CECL model. Therefore, at initial recognition, a beneficial interest holder would present an impairment allowance equal to the estimate of expected credit losses (i.e., the estimate of contractual cash flows not expected to be collected). For CLO investments, where contractual cash flows may not exist, an entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Effective date

For public business entities that meet the US GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For public business entities that do not meet the US GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years beginning after December 15, 2021. In addition, entities are permitted to early adopt the new guidance for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Consolidation

Consolidation analysis

Collateralized financing entities (CFEs) are unique securitizations in that there is typically no transfer of assets from the sponsor to the securitization entity. Instead, the CFE purchases financial assets (e.g., senior syndicated loans) from the open market by using proceeds from a warehouse line (warehousing phase). Once the legal entity has accumulated loans of a quality sufficient to permit securitization, it will issue beneficial interests and use the proceeds from the sale of its securities to pay off the warehouse line and purchase any remaining financial assets needed (securitization phase).

The CFE employs a collateral manager (typically a bank or an investment manager that sponsors the CFE) that performs various functions for the CFE during its different stages. For example, during the initial loan-accumulation phase, the collateral manager is responsible for acquiring the assets for the CFE and ensuring that the asset composition complies with the transaction documents. During the securitization phase, the collateral manager is responsible for determining the appropriate action when there is a default or other event as well as how to reinvest the principal proceeds received from the underlying loans.

Because a substantive contingent event may need to be resolved (e.g., market receptivity to the securitization or consent granted by all parties involved) before the CFE's transition from the warehousing phase to the securitization phase, a separate consolidation analysis may need to be performed for each distinct phase. That is, because the securitization of the CFE may be considered a fundamental redesign of the CFE, there may be different activities that most significantly affect the potential variable interest entity's (VIE's) economic performance during each phase.

Determining whether the CFE is a VIE

A reporting entity is required to apply either the VIE model or the voting interest entity model in performing its consolidation assessment. To determine which model to use, the collateral manager must decide whether any of the following conditions apply:

- The CFE has insufficient equity at risk to finance its activities.
- The equity holders (as a group) lack any of the three characteristics of a controlling financial interest.
- Members of the equity group have nonsubstantive voting rights.

If any of these conditions apply, the equity is not considered substantive, and the CFE should be evaluated under the VIE model.

Although a CFE may issue equity interests that provide credit support to the legal entity's senior investors, the tranched capital structure of the CFE, as well as the multiple series of debt instruments typically issued by a CFE, will usually serve as qualitative evidence that the legal entity has insufficient equity at risk.

In addition, although ASU 2015-02, *Amendments to the Consolidation Analysis* ("ASU 2015-02"), clarified how to evaluate whether the equity investors have the power to direct the activities of a CFE (which is part of the second condition above—i.e., that the equity holders (as a group)) lack any of the three characteristics of a controlling financial interest), this clarification would most likely not change the conclusion that a CFE is a VIE. This is because even if a CFE has sufficient equity investment at risk, the equity interests do not typically have voting rights that give those investors power to direct the activities of the legal entity. Rather, the decision-making ability is typically granted to the collateral manager, and the ability to remove the collateral manager is often shared with holders of debt interests issued by the CFE. Unless a single equity holder has the unilateral ability to remove the collateral manager, or the collateral manager is acting as an agent on behalf of the equity group (i.e., the decision-making rights are not considered a variable interest), the CFE would be a VIE.

Determining the primary beneficiary of a CFE

The chart below illustrates the steps a collateral manager would take in determining whether it is required to consolidate a CFE. The sections that follow the chart discuss the steps in detail.

* A collateral manager must also assess whether it would be required to perform the related-party tiebreaker test (see step 4 below).

Step 1: Does the collateral manager have a variable interest in the CFE?

Before ASU 2015-02, a collateral manager's decision-making arrangement was a variable interest unless the following six criteria under ASC 810-10-55-37 were met:

a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
b. Substantially all of the fees are at or above the same level of seniority [in the waterfall on distribution dates as other expenses of the entity].
c. The decision maker or service provider does not hold other interests in the [entity] that individually, or in the aggregate, would absorb more than an insignificant amount of the [entity's] expected losses or receive more than an insignificant amount of the [entity's] expected residual returns.

d. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.
e. The total amount of anticipated fees are insignificant relative to the total amount of the [entity's] anticipated economic performance.
f. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the [entity's] anticipated economic performance.

A collateral manager's fees are typically structured with a portion at the top of the waterfall (senior fee), a portion at the bottom of the waterfall (subordinated fee), and an additional "contingent" management fee if the CFE performs well (incentive fee). Under US GAAP before ASU 2015-02, a collateral manager's decision-making arrangement was often deemed to be a variable interest because it did not meet criterion (b) above, under which the fees received must not have been subordinated. Further, if an incentive fee was present, the arrangement may not have met conditions (e) or (f).

ASU 2015-02 eliminated the criteria related to the fees' priority level (criterion (b)) and significance (criteria (e) and (f)). Therefore, the evaluation of whether fees paid to a collateral manager are a variable interest focuses on whether the fees "are commensurate with the level of effort" (criterion (a)), (2) whether the collateral manager has any other direct or indirect interests (including indirect interests through its related parties and certain interests held by its related parties under common control) that absorb more than an insignificant amount of the CFE's variability (criterion (c)), and (3) whether the arrangement's terms are customary (criterion (d)).

Another of ASU 2015-02's significant changes is the requirement regarding how a collateral manager should consider interests held by its related parties or de facto agents when evaluating whether a decision-making arrangement is a variable interest. When a collateral manager evaluates its economic exposure to a VIE (criterion (c)), it should consider its direct interests in the CFE together with its indirect interests held through its related parties (or de facto agents) on a proportionate basis unless the related party is under common control with the collateral manager. For example, if a collateral manager owns a 20 percent interest in a related party and that related party owns 40 percent of the residual tranche of the CFE being evaluated, the collateral manager's interest would be considered equivalent to an 8 percent direct interest in the residual tranche of the CFE.

By contrast, if a collateral manager has an indirect interest in a CFE **through** a related party that is **under common control** (i.e., the collateral manager holds a direct variable interest in the related party under common control), it must include the related party's entire interest in its evaluation of its economic exposure rather than just its proportionate share. (However, in ASU 2016-17[4],

[4] Entities that have already adopted the amendments in ASU 2015-02 are required to apply the guidance in ASU 2016-17 retrospectively to all relevant prior periods, beginning with the annual period in which the amendments in ASU 2015-02 were initially adopted. Entities that have not yet adopted the amendments in ASU 2015-02 must adopt ASU 2016-17 at the same time they adopt ASU 2015-02 and apply the same transition method they elected for the application of ASU 2015-02. The guidance is effective for annual periods beginning after December 15, 2016, with early application permitted.

the FASB has amended the guidance on entities under common control to make it consistent with the proportionate-basis guidance that applies to other related parties.) In situations in which the collateral manager does not hold an interest through the related party under common control, the collateral manager would exclude the related party's interest unless the interest was provided to the related party under common control to circumvent the consolidation guidance.

ASU 2015-02 did not amend the current threshold used in the evaluation of whether the collateral manager's other interests absorb more than an insignificant amount of the CFE's variability. As a general guideline, this criteria would be met if the variability absorbed by the collateral manager through its other variable interests in the CFE exceeds, either individually or in the aggregate, 10 percent of the CFE's expected variability. However, because of the subjective nature of the calculation of expected losses and expected residual returns, this is not a bright-line requirement or safe harbor.

The evaluation of a collateral manager's economic exposure through its other interests should take into account the CFE's purpose and design. In addition, all risks and associated variability that are absorbed by any of the CFE's variable interest holders should be considered. The type of interest held by a collateral manager will affect its economic exposure to the CFE and, accordingly, the collateral manager's conclusion about whether its decision-making arrangement is a variable interest. For example, a first-loss piece is more likely to expose the collateral manager to a significant amount of expected losses or the potential to generate significant expected residual returns than a senior interest.

These changes will have significant implications for collateral managers of CFEs. We expect that substantially all fees charged by collateral managers for services are commensurate with the level of effort required to provide those services and that their fee arrangements contain only customary terms and conditions. Therefore, as long as a collateral manager does not have other interests in the CFE (including interests through its related parties and certain interests held by its related parties under common control) that would absorb more than an insignificant amount of the CFE's variability, the collateral manager will not have a variable interest in the CFE and will not consolidate the CFE.

Step 2: Does the collateral manager have the power to direct the activities that most significantly affect the CFE?

When the collateral manager has other interests in the CFE (including interests through its related parties and certain interests held by its related parties under common control) that would absorb more than an insignificant amount of the CFE's variability, the collateral manager would have a variable interest in the CFE and must determine whether it has power over the CFE's most significant activities. The economic performance of a CFE is generally most significantly affected by the underlying assets' performance. Some of the factors that can affect the underlying assets' performance may be beyond the direct control of any of the parties to the CFE (like voluntary prepayments) and, therefore, do not enter into the power analysis. The activities that most significantly affect the underlying assets' performance in a CFE are typically related to the collateral manager's selection, monitoring, and disposal of collateral assets.

In the analysis of which party has the power to direct those activities, questions that should be answered include the following:

- Does the collateral manager hold the power unilaterally?
- Alternatively, do other parties also have relevant rights and responsibilities? For example:
  - Is there another party or other parties that direct other important activities of the CFE? If so, which activities are the most important?
  - Is there another party that has to consent to every important decision?
  - Is there another party that can direct the collateral manager to take certain actions?
  - Is there another party that can replace the collateral manager without cause?
  - Is there another party or other parties that direct the same activities as the collateral manager but for a different portion of the CFE's assets?
- Is the collateral manager's right to exercise power currently available or contingent on the occurrence of some other event(s)?

Circumstances in which a collateral manager might not have power

The collateral manager might not have power in the following situations:

Situation	Corresponding discussion
The collateral manager can be replaced without cause by a single unrelated party.	See discussion below of kick-out rights.
All important decisions require the consent of one or more unrelated parties.	See discussion below of shared power and participating rights.
The collateral manager manages less than a majority of the assets in the VIE.	See discussion below of multiple parties with power.

Kick-out rights

Although not common for CFEs, substantive kick-out rights (i.e., those that can be exercised at will and not upon a contingent event) held by a single unrelated party prevent the collateral manager from having power because the collateral manager could be removed. Such rights would generally be considered substantive if there are no significant financial or operational barriers to their exercise.

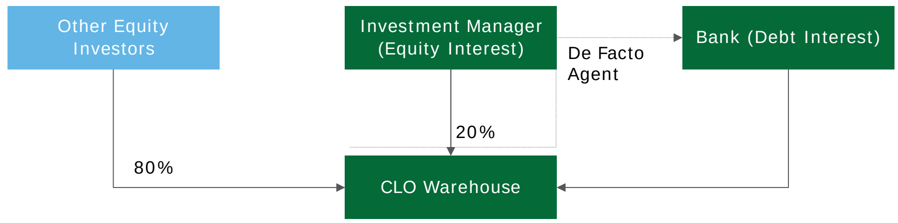
Shared power and participating rights

The right of an unrelated party to veto all the important decisions made by the collateral manager would, if substantive, prevent the collateral manager from satisfying the power condition since power would be shared. The requirement to obtain consent is considered a substantive participating right when the consent is required for all the activities that most significantly affect the legal entity's economic performance. When the consent is related only to activities that are unimportant or only to certain of the significant activities, power would not be considered shared. In addition, a reporting entity would need to closely analyze the legal entity's governance provisions to understand whether the consent requirements are substantive (e.g., the consequences if consent is not given).

While ASU 2015-02 diminishes the effects of a related party's (or de facto agent's) interest in evaluating a collateral manager's economic exposure to a CFE, it retains the guidance prohibiting parties in a related-party group (including de facto agents) from concluding that they share power. Accordingly, if power is considered shared (e.g., the collateral manager is required to obtain approval from the residual holder for any significant decisions), the collateral manager will need to determine whether the other party (residual holder) is a related party (or de facto agent). If power is considered shared within a related-party group, and the group as a whole has the characteristics of a controlling financial interest, the collateral manager must perform the related-party tiebreaker test to determine which party in the group must consolidate the CFE. ASU 2015-02 provides the following four criteria, which are the same as those under prior US GAAP, for consideration in this assessment:

- "The existence of a principal-agency relationship between parties within the related party group."
- "The relationship and significance of the activities of the [legal entity] to the various parties within the related party group."
- A party's exposure to the legal entity's variability.
- The legal entity's design.

Example 1
A collateralized loan entity is formed to acquire commercial loans, drawing down on a line of credit as it identifies new loans. Once the CLO has accumulated sufficient loans to permit securitization, the entity will issue beneficial interests and use the proceeds from the sale of its securities to pay off the warehouse line and purchase any remaining assets needed. The CLO is sponsored by the investment manager. During the warehousing stage, the investment manager invests $1 million for 20 percent equity ownership in the entity, and other investors provide $4 million for the remaining equity interests in addition to the $95 million provided by the bank in the form of a line of credit. The investment manager cannot (1) make any decisions (e.g., loan purchases or issuances of beneficial interests) without approval from the bank or (2) transfer its equity interest in the CLO (the bank is not similarly constrained). Further, the entity is unable to transition from the warehousing phase to the securitization phase without the agreement of all the equity investors and the bank.



The investment manager has determined that the arrangement should be evaluated as a multiphase entity because of the significant uncertainty about the CLO's ability to transition from the warehousing phase to the securitization phase. In addition, the investment manager has determined that the CLO is a VIE during the warehousing phase since the bank (a nonequity holder) has the ability to participate in the entity's most significant decisions during this phase. This determination will need to be reevaluated when the CLO proceeds to the securitization phase and issues beneficial interests in the securitization entity (redesign of the CLO).

Under the VIE model, the restrictions imposed on the investment manager's ability to transfer or encumber its equity interest create a de facto agency relationship between the investment manager and the bank. Therefore, although the decisions that most significantly affect the entity during the warehousing phase require the consent of both parties, because the investment manager shares power with the bank, the investment manager cannot conclude that there is no primary beneficiary of the CLO. Rather, because the related-party group (including de facto agents) meets both criteria in ASC 810-10-25-38A, the investment manager would apply the related-party tiebreaker test in ASC 810-10-25-44 to determine whether it should consolidate the CLO. Note that a different consolidation conclusion may be reached after the CLO's transition from the warehousing to securitization phase.

Multiple parties with power

The concept of multiple parties with power can manifest itself in two ways:

- *Multiple parties performing different activities*—It is possible that in certain CFEs, one service provider is engaged to manage investments and another is engaged to manage funding. In such situations, the reporting entity must use judgment and analyze all the facts and circumstances to determine the activity that most significantly affects the economic performance of the legal entity.
- *Multiple parties performing the same activities*—If the joint consent of multiple unrelated parties is required for decisions regarding directing the relevant activities of a legal entity, power is shared, and no party would consolidate. However, when multiple parties individually perform the same activities over separate pools of similar assets, and consent is not required, the party that has unilateral decision making over a majority of the assets would have power over the CFE.

Step 3: Does the collateral manager have a potentially significant interest?

If a collateral manager determines that its decision-making arrangement is a variable interest as a result of any direct or indirect interests **through** its related parties, its interests will usually represent an obligation to absorb losses of the VIE or a right to receive benefits from the VIE that could potentially be significant to the VIE. That is, if a collateral manager's fee is a variable interest because the collateral manager has other direct interests (or indirect interests **through** its related party) in the CFE that represent a more than insignificant economic interest in the CFE, it would meet the "economics" criterion (ASC 810-10-25-38A(b)) in the primary-beneficiary analysis.

However, if the collateral manager's fee is a variable interest solely because (1) the fee arrangement is not customary or at market but the collateral manager does not have any direct interests (including the fee) or indirect interests through its related parties that meet the economics criterion or (2) the collateral manager's related party under common control holds an interest in the CFE in an effort to circumvent the consolidation guidance, the collateral manager may not meet this requirement[5]. The collateral manager would only include interests held by its related parties under common control in the primary-beneficiary analysis if it has a direct interest in those related parties. Accordingly, if the collateral manager's fee arrangement is a variable interest solely for one of these two reasons, and the collateral manager does not have an interest in those related parties, the collateral manager individually would not have both of the characteristics of a controlling financial interest. However, the collateral manager would still need to assess whether it should consolidate the CFE under the related-party tiebreaker test (step 4)[5].

Step 4: Is the collateral manager required to perform the related-party tiebreaker test to determine whether it has a controlling financial interest?

Related parties under common control

A collateral manager and its related parties must individually determine which party should consolidate a CFE. Each member of a related-party group with a variable interest in the CFE may determine that it individually does not possess both characteristics of a controlling financial interest but that the related-party group as a whole possesses both characteristics. A reporting entity would perform the related-party tiebreaker test in this situation only if both characteristics of a controlling interest reside within a related-party group that is under common control.

We expect that the related-party tiebreaker guidance will apply in extremely limited circumstances to a collateral manager and its related parties under common control. A determination that the collateral manager meets the power criterion through a fee arrangement is most likely to have been made if the collateral manager has a direct or indirect economic interest in the CFE that absorbs more than an insignificant amount of the CFE's variability. In addition, when performing the economics-criterion assessment, the collateral manager is required to consider interests held through related parties under common

[5] In addition, once ASU 2016-17 is adopted (see footnote 4), the collateral manager may not meet the economics criterion if its interest held through a related party under common control is considered on a proportionate basis.

control as if they were held directly by the decision maker. Therefore, the related-party tiebreaker guidance would apply to the collateral manager and its related parties under common control only if either (1) the collateral manager fees were not commensurate or at market but the collateral manager does not have any direct interests (including the fee) or indirect interests through its related parties that meet the economics criterion or (2) it was determined that the collateral manager's decision-making arrangement was a variable interest because a common parent designed the CFE in an effort to circumvent consolidation in the stand-alone financial statements of the collateral manager or related party under common control.

Note that in instances in which the collateral manager does not have a variable interest through the fee arrangement in a VIE but the related parties under common control collectively would, if aggregated, have met the power and economics criteria collectively, the parent of the related parties under common control would consolidate the VIE. That is, although the CFE may not be consolidated by either of the subsidiaries in their stand-alone financial statements, the parent must assess the VIE on the basis of its aggregate direct and indirect interests.

Related parties not under common control

If neither the collateral manager nor a related party under common control is required to consolidate a CFE, but the related-party group (including de facto agents) possesses the characteristics of a controlling financial interest, and substantially all of the CFE's activities are conducted on behalf of a single entity in the related-party group, that single entity would be the primary beneficiary of the CFE.

Interests held by the reporting entity's de facto agents (typically as a result of a one-way transfer restriction) would not be included in the consolidation analysis on an indirect basis unless the reporting entity has economic exposure to the VIE through its de facto agents. Accordingly, these restrictions are less likely to result in consolidation.

Reconsideration of who controls

The VIE guidance in ASC 810 requires a reporting entity to continually reconsider its conclusion regarding which interest holder is the CFE's primary beneficiary. The collateral manager's conclusion could change as a result of any of the following:

- A change in the legal entity's design (e.g., a change in its governance structure, management, activities, purpose, or in the primary risks it was designed to create and pass through to variable interest holders).
- The addition of terms to the variable interests, or the modification or retirement of terms.
- A change in the holders of a legal entity's variable interests (e.g., a reporting entity acquires or disposes of variable interests in a VIE), causing the reporting entity to have (or no longer have), in conjunction with its other involvement with the legal entity, a variable interest in the CFE.

- A significant change in the anticipated economic performance of a legal entity (e.g., as a result of losses significantly in excess of those originally expected) or other events (including the legal entity's commencement of new activities) that cause a change in the reporting entity's responsibilities such that it now has the power to direct the activities that most significantly affect the legal entity's economic performance.
- Two or more variable interest holders become (or are no longer) related parties.
- A contingent event that transfers, from one reporting entity to another reporting entity, the power to direct the activities of the legal entity that most significantly affect the legal entity's economic performance.

Because continual reconsideration is required, the collateral manager will need to determine when, during the reporting period, the change in primary beneficiary occurred. If the collateral manager determines that it is no longer the primary beneficiary of a CFE, it would need to deconsolidate the CFE as of the date the circumstances changed and recognize a gain or loss.

Accounting for consolidated CFEs

Collateral managers are required to measure a CFE's assets and liabilities at fair value when they initially consolidate a CFE. While some collateral managers subsequently account under ASC 320 for the financial assets of a consolidated CFE as trading, AFS, or HTM, many elect the fair value option and subsequently account for both the financial assets and financial liabilities at fair value. In August 2014, the FASB issued ASU 2014-13, which allows a reporting entity that measures both the financial assets and financial liabilities of a consolidated CFE at fair value to use a measurement alternative to determine the fair value. ASU 2014-13 is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the amendments are effective for annual periods ending after December 15, 2016, and interim periods beginning after December 15, 2016. Early adoption of ASU 2014-13 is permitted.

Risk retention rules

On October 22, 2014, the SEC and five other federal agencies[6] adopted a final rule that requires sponsors of securitizations, under certain conditions, to retain a portion of the credit risk associated with the assets collateralizing an asset-backed security.[7]

The rule was initially proposed in April 2011 and reproposed in September 2013. Both proposals received significant feedback, much of it negative. In response, the final rule eliminated the proposed cash flow restriction on eligible horizontal residual interests and the need to perform a fair value calculation to determine an eligible vertical interest (but retains the requirement for a horizontal interest). However, the rule did not address a number of concerns,

[6] The other federal agencies are the Office of the Comptroller of the Currency in the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Department of Housing and Urban Development.
[7] The final rule was issued in response to a mandate of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added new credit risk retention requirements to Section 15G of the Exchange Act.

such as the request by many constituents that the requirements provide a broad exemption for “open-market CLOs” in which the underlying assets are acquired in the market rather than originated by the sponsor.

Under the final rule, sponsors of securitizations are:

- Required to retain no less than 5 percent of the credit risk of assets in an ABS offering (unless they qualify for certain exemptions).
- Prohibited from financing (other than on a full recourse basis), hedging, or transferring the credit risk they are required to retain for most of the life of the security retained.

Under the risk retention requirements, a sponsor is prohibited from hedging or transferring any interest it is required to retain under the rule to any person other than a majority-owned affiliate. The majority-owned affiliate aspect of the requirement is receiving much attention. Of particular interest to constituents is whether a collateral manager could comply with the risk retention rule by transferring the retained interest to a consolidated affiliate (i.e., the sponsor either owns a majority (51 percent) stake or a controlling interest of a VIE) whose third-party investors own the other interests in the consolidated affiliate. If so, the sponsor’s exposure could be effectively decreased (below 5 percent) when a portion of the risk is absorbed by the third-party investors of the consolidated affiliate. Companies should not only consider the accounting implications of establishing these types of structures but also consult with their legal and regulatory advisers to ensure that they won’t be viewed as hedging the credit risk they are required to retain.

The final rule permits sponsors of securitizations to select the form of risk retention obligation, which could be:

- An eligible vertical interest (a proportionate 5 percent interest in every tranche of a securitization).
- An eligible horizontal residual interest (an interest in the first loss tranche of a securitization with a market value equal to at least 5 percent of the market value of all the securities issued).
- A combination of both or an “L-shaped” interest (the combined interest is no less than 5 percent of the market value of all securities issued).

The type of interest retained by the sponsor (i.e., vertical, horizontal, or L-shaped) will affect the sponsor’s economic exposure to the securitization structure and, accordingly, the sponsor’s consolidation conclusion. If a sponsor holds the subordinate horizontal tranche of a securitization structure rather than a vertical interest (or a combination), there is a greater risk that the structure would be consolidated by the sponsor.

At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, *Professional Accounting Fellow Chris Rickli*, provided the following example:

> In 2014, several federal agencies adopted final rules to implement the Dodd-Frank credit risk retention requirements for asset-backed securities. [Footnote omitted] Over the past several months, OCA has received

accounting consultations related to the application of Topic 810 [footnote omitted] to a registrant's involvement with a so-called collateralized manager vehicle. CMVs are designed to sponsor various types of securitization transactions.

In one particular fact pattern, the CMV itself was required to hold an ownership interest in the underlying securitization to which it acted as a sponsor. The registrant made an initial equity contribution to the CMV, and obtained one of three seats on the CMV's board of directors. The remaining equity capital was funded by third party investors, several of which were individually significant.

The registrant also entered into a services agreement to provide certain support functions to the CMV, including middle and back office operations, investment research, and other administrative activities.

An aspect of the registrant's consolidation analysis related to whether the CMV was a voting interest entity under Topic 810. The analysis focused heavily on the ownership of the CMV and the role of the CMV's board of directors. The equity holders of the CMV, as represented by the board of directors, had power over the most significant activities of the CMV, including the development of the investment strategy, the hiring and firing of service providers, and the appointment of individuals to the CMV's investment committee. Based on these factors, we did not object to the conclusion that the CMV was a voting interest entity under Topic 810.

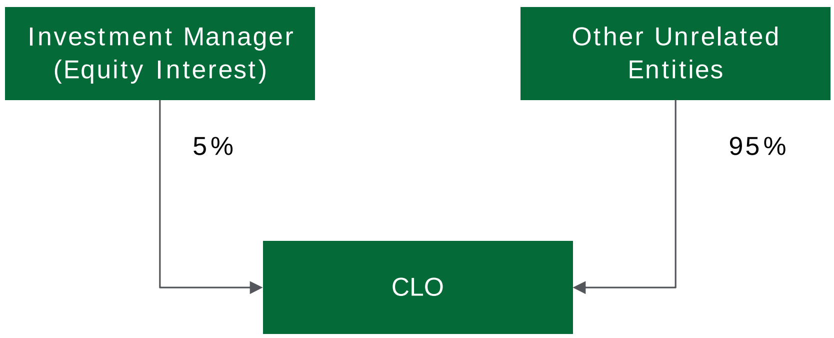
We understand that many variations of this type of entity exist in the marketplace. Therefore, it is possible that several of the most significant factors to the analysis may vary greatly from CMV to CMV, and therefore may result in different accounting conclusions. As a result, it would not be appropriate to analogize our conclusions to other fact patterns that involve a CMV.

I would also like to note that our conclusions did not extend beyond the registrant's US GAAP accounting analysis. A critical part of the registrant's legal analysis would likely include whether the CMV would qualify as a legal sponsor. This is a legal question and was not addressed as part of the accounting consultation. To the extent there is uncertainty related to legal questions, entities should consult with their primary regulator. [Emphasis added]

Example 2

An investment manager sponsors a CLO and retains a 5 percent vertical interest (i.e., an interest in each class of ABS interests issued as part of the CLO). The investment manager designed the vertical tranche to be compliant with the new risk retention rules. For its role as collateral manager, the investment manager receives remuneration that is customary and commensurate with services performed, including a senior management fee that is paid senior to the notes, a subordinate management fee that is paid senior to the CLO's preferred shares, and an incentive fee.

Further, the investment manager is the reporting entity that has the power to direct the activities that most significantly affect the CLO's economic performance. The vertical interest owned by the investment manager does not absorb more than an insignificant amount of the CLO's variability (since it owns only 5 percent of all tranches).



The fees received by the investment manager are customary and commensurate with remuneration for services performed (i.e., negotiated at arm's length). In addition, because the investment manager's vertical interest would never absorb more than 5 percent of the CLO's economic performance, once the investment manager appropriately excludes the fees from its variable interest assessment, it would never possess the right to receive benefits or the obligation to absorb losses that are more than insignificant to the CLO (under ASC 810-10-55-37(c)). Therefore, the investment manager's decision-making agreement would not represent a variable interest. Although the investment manager's 5 percent vertical interest is a variable interest in the CLO, because the decision-making arrangement is not a variable interest, the investment manager would not be required to consolidate the CLO.

In this example, it is assumed that the other investors are not related parties or de facto agents of the investment manager; if they were, the consolidation conclusion could be affected.

Changes coming to management fees

In May 2014, the FASB issued its final standard on revenue from contracts with customers. The standard, issued by the FASB as ASU 2014-09, *Revenue from Contracts with Customers*, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most-current revenue recognition guidance, including industry-specific guidance. CLO managers will need to evaluate their revenue arrangements (including performance-based fees and up-front fees) under the revised requirements to determine how to recognize revenue related to their services.

The FASB's changes are built on five sequential steps to recognizing revenue:

- Identify the contract(s) with a customer.
- Identify the performance obligations in the contract.
- Determine the transaction price.
- Allocate the transaction price to the performance obligations in the contract.
- Recognize revenue when (or as) the entity satisfies a performance obligation.

The FASB has previously indicated in the final standard that the core principle of the new revenue recognition guidance is that an *"entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."*

Impacts to performance-based fees

CLO manager fee arrangements may include performance-based fees that are calculated on the basis of the performance of the underlying assets being managed. Sometimes, the performance of the underlying assets is evaluated against external factors, such as a market index, and the fee arrangements may include complexities, such as a high watermark or performance hurdles. Performance-based fees include carried interests and incentive fees.

In each reporting period, there may be uncertainty about the amount the asset manager will ultimately receive in performance-based fees, until the fees are finalized or close to being finalized. In addition, performance-based fees paid to an asset manager may be subject to claw-back provisions for underperformance in future periods. These claw-back provisions may exist until the underlying assets are liquidated (which could be several years after the payment).

The SEC staff guidance in EITF D-96 (codified in ASC 605-20-S99-1) provides two alternatives for recognizing performance-based management fees. Accordingly, an asset manager elects an accounting policy to do either of the following:

- Defer recognizing performance-based fee revenue until the end of the contract ("Method 1").
- Recognize revenue as of an interim date on which it is considered realizable because of termination provisions in the arrangement ("Method 2").

While the amendments released by the FASB do not supersede the guidance in EITF D-96, it provides specific requirements for contracts that include variable consideration (including arrangements whose consideration fluctuates depending on changes in the underlying assets managed by an asset manager). Specifically, it indicates that the estimated variable consideration (or a portion thereof) is included in the transaction price (and therefore eligible for recognition) only to the extent it is probable that the cumulative amount of revenue recognized will not be subject to significant reversal. This concept is commonly referred to as the "constraint." Entities may use judgment in determining whether to include variable consideration in the transaction price; however, the FASB notes that if the variable consideration is highly susceptible to factors outside the entity's influence (including volatility in a market), the consideration could be subject to significant future reversal.

As an asset manager's performance-based fees may be affected by the future performance of the underlying assets it manages, it is difficult to accurately predict how much of the performance-based revenue payable to the asset manager is not subject to future reversal until the fees are finalized or close to being finalized. Accordingly, for asset managers that currently apply Method 2, the timing of revenue recognition for these fees may be significantly delayed by the constraint on the amount of revenue that may be recognized as of a reporting date.

Increased use of judgment

Management will need to exercise significant judgment in applying certain of the requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for asset managers to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Even though the new guidance is not effective until December 15, 2016 (with a maximum deferral of one year for nonpublic entities that apply US GAAP), asset managers should start carefully examining the changes and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

Tax issues for CLO investors and issuers

CLOs issue multiple classes of interests, each taxed differently for US federal income tax purposes[8]. Understanding the tax implications of each class of ownership allows issuers and investors to properly assess the after-tax return, clearly vital to all involved. When considering taxes, it is essential to understand both the timing and the character of taxable income or loss that may result from the transaction.

- **Timing**—Determination of the proper tax-reporting period requires application of the correct tax accounting methodology, such as cash versus accrual method or the application of mark-to-market principles.
- **Character**—Categorization of income as ordinary versus capital, determination of any special tax rates, limitations, or other rules that may apply.

Debt classes

CLOs typically issue multiple classes of notes that are debt for US tax purposes. The Tax Rules[9] provide special rules for interest, discount, and premium and distinguish between debt instruments acquired at the issue date and those purchased in the secondary market. While discount or premium that results from an investor's purchase of a debt instrument in the secondary market (i.e., after the issue date) does not affect the issuer's taxable earnings and profits, they must be considered in determining the ongoing income of the investor. Typically, investors must account for each of the following items separately, based upon the applicable Tax Rules. However, the Tax Rules provide an election that allows for all interest, discount, and premium of a debt instrument to be accounted for in aggregate.

Interest

For tax purposes, interest falls into two general categories: qualified stated interest (QSI) and nonqualified stated interest ("non-QSI"). QSI is considered to be interest income for tax purposes. All payments, other than QSI and principal, are non-QSI payments and, typically, are accounted for as part of original issue discount (OID). Deferrable interest classes in CLOs typically have non-QSI, and thus, the interest must be recognized as it economically accrues, without regard to the holder's method of accounting because it is not unconditionally payable at least annually. Therefore, a cash-method taxpayer that owns a deferrable interest class will be required to recognize deferred interest as it accrues, regardless of the timing of payment.

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[8] Unless otherwise specified, this discussion will address only US federal income tax issues and, thus, references to "income tax" or "tax" refer to US federal income tax only.
[9] "Tax Rules" refers to the Internal Revenue Code of 1986, as amended, and regulations thereunder as of November 30, 2017.

Discount

Subject to certain de minimis rules, a debt instrument with an issue price that is less than its stated redemption price (SRP) at maturity is generally considered to have OID. The SRP of a debt instrument equals the sum of all payments expected to be made with respect to the debt instrument other than QSI (i.e., the sum of principal and non-QSI payments). OID is amortized over the life of the instrument using the constant yield method and must be recognized in income each period.

A debt instrument has market discount when it is acquired subsequent to its date of issuance for a price that is less than its SRP (or, in the case of a debt instrument issued with OID, for a price less than its adjusted issue price (AIP)). Market discount is very important to many investors, as these rules serve to recharacterize all or part of the holders' gain to ordinary income that is not eligible for the beneficial capital gain rates. In short, the Tax Rules require that any gain upon sale is ordinary income to the extent of market discount accrued prior to the sale date. Additionally, any payments on the instrument are recognized as ordinary income to the extent of market discount accrued prior to the payment date. Holders may also elect to recognize market discount as it accrues, which may be beneficial to holders seeking to maximize taxable income or minimize differences between US GAAP and tax.

Premium

There are two types of premium under the Tax Rules: (1) market premium and (2) acquisition premium. Market premium occurs when a debt instrument is acquired at a price that is greater than its SRP. If the debt instrument was issued with OID, only the market premium is accounted for by the holder, because the holder is not required to account for the OID. While holders are not required to amortize market premium for taxable debt instruments, they may elect to amortize it based upon the debt instrument's yield to maturity (e.g., its tax yield).

Acquisition premium occurs when a debt instrument is purchased at a premium to its AIP, but at a price equal or less than its SRP. The AIP is the issue price of the debt instrument, increased for previous accruals of OID and decreased for payments of principal and non-QSI. In this case, the holder must continue to account for OID from the debt instrument. The amortization of acquisition premium is mandatory, and the amount amortized each period equals the product of the OID accrual for the period and the fixed ratio of acquisition premium to the OID remaining at the holder's date of acquisition.

Equity classes

One or more classes at the bottom of the capital structure will generally be treated as ownership of equity in the CLO for tax purposes. This is usually the classes labeled as income notes, subordinated notes, or preference shares. The status of a class as equity for tax purposes is typically disclosed in the tax section of the offering memorandum.

The tax impact of ownership of the equity class depends on the legal and tax structure of the CLO. The most common CLO legal entity in a US-marketed CLO is a Cayman-exempted company incorporated with limited liability. This entity is an eligible business entity for tax purposes and, therefore, could be treated as a disregarded entity, a partnership, or a corporation, depending on the number of owners and the elections, if any, that have been filed with respect to the status.

The most common tax characterization of a CLO is as a corporation. A CLO treated as a foreign corporation is either a PFIC or controlled foreign corporation (CFC) for US tax purposes—as all income typically is considered to be from passive activities (interest, dividends, etc.). US investors that hold interests in a PFIC or CFC that are not characterized as debt for US income tax purposes generally are subject to special rules. A US holder of less than 10% of the CLO's equity or any holder of a CLO that is not a CFC will be subject to the PFIC regime. A US investor that owns 10% or more of the equity of a CFC on the last day of the CLO's tax year is required to currently include its pro rata share of the CFC's net income (but not losses) in taxable income as subpart F income. The CLO will be characterized as a CFC if the total holdings of all such 10% shareholders are greater than 50% of CLO equity.

PFIC holders can choose to include currently their pro rata share of the PFIC's net income (but not losses) in taxable income by making a qualified electing fund (QEF) election on Internal Revenue Service (IRS) Form 8621. If the QEF election is not made, the investor may be subject to certain unfavorable interest charges when the CLO makes cash distributions.

Other tax characterizations—partnership or disregarded entity

A CLO can be treated as a partnership or a disregarded entity for tax purposes. A CLO with only one equity holder may be treated as a disregarded entity, in which all of the assets and liabilities of the CLO are treated as if they are held directly by the equity investor. A CLO with multiple equity holders may elect to be treated as a partnership. Partnerships are treated as flow-through entities for tax purposes, and therefore, all items of income, deduction, gain, and loss recognized by the partnership are allocated to the holders.

Flow-through status may be beneficial to certain holders of equity that have structured themselves to benefit from the ability to combine the income and deductions from multiple CLO investments, or whose tax status is such that the recognition of income from loans, rather than dividends from a foreign corporation, is beneficial.

Tax return filings, required disclosures, and related penalties

Depending on the tax status of the CLO as outlined above, the entity itself and/or its US shareholders will have requirements to file various forms with the IRS and the Financial Crimes Enforcement Network. Some common requirements are listed below, but entities should consult a tax advisor to determine the requirements for its specific situation.

- **Form 926**—must be filed by all US taxpayers investing more than $100,000 in a foreign corporation, or anyone holding a 10% or greater interest in the stock of a foreign corporation. Certain partners in partnerships investing in a CLO may need to file directly. Penalty for failure to file is generally the lesser of $100,000 or 10% of the total amount transferred[10].
- **Form 8938**—The Statement of Specified Foreign Financial Assets is currently required only for individual taxpayers. This form is required if the total value of foreign assets exceeds filing thresholds[11]. Penalty for failure to file is a minimum of $10,000. Additionally, the statute of limitations with respect to this information does not expire if a complete and accurate form is not filed[12].
- **Form 8621**—annual requirement for owners of stock in a PFIC[13].
- **Form 5471**—Annual report for US owners of certain foreign corporations. Must be filed by US shareholders of CFCs and, also, must be filed by certain 10% shareholders for non-CFCs in certain circumstances. Penalty for failure to file is a minimum of $10,000. Additionally, the statute of limitations with respect to this information does not expire if a complete and accurate form is not filed[14].
- **Form 1065**—Partnership Return of Income. CLOs structured as partnerships may need to file this form and report taxable income to US holders on Schedule K-1.
- **Form 8865**—Annual report for US owners of certain foreign partnerships.
- **Form 8858**—Annual report for US owners of certain foreign disregarded entities.

It is important to note that investors generally will not have sufficient information available to comply with the US tax-reporting requirements. Accordingly, CLO managers should consider the need for the CLO to engage a US tax professional to provide the necessary information to US investors in CLO equity.

Phantom income

CLO equity frequently produces earnings and profits greater than the distributions of cash to the equity class. The excess of earnings and profits over cash distributions is often called “phantom income”. Tax planning to minimize phantom income is important to maximize after-tax return to the equity class. Additionally, it is important to note that net losses are not recognized by the equity holders of corporate entities, and thus, planning to avoid taxable losses whenever possible is advantageous to the equity holders.

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[10] IRC Section 6038B.
[11] IRC Section 6038D
[12] IRC Section 6501(c).
[13] IRC Section 1298(f)
[14] IRC Section 6501(c)(8).

Phantom income can result from structural features that result in the utilization of cash for purposes other than distribution to the equity holders. For example, it is common in CLO structures for cash from sales of assets to be reinvested in additional assets during the reinvestment period. Any net gain, market discount, or OID associated with these positions, therefore, results in phantom income to the equity investors during this period.

Phantom income can also result from straightforward differences between tax accounting methods and cash distributions. For example, accruals of OID will result in taxable income without receipt of corresponding cash amounts. Additionally, taxable items must be reported using the accrual method, while securitization entities make distributions only on specific payment dates. Also, the costs associated with debt issuance are amortized for tax purposes and deducted over the weighted-average life of the debt.

Finally, phantom income can result from simple differences between the timing of cash receipts and distributions to the equity class.

Example: Phantom income

Investor owns 40% of the preference shares of RCLO, Ltd. (RCLO), a CLO that is still in the reinvestment period. Investor has been informed that RCLO is not a CFC. Investor receives a PFIC annual information statement informing him that the earnings and profits (E&P) of RCLO are $13,950,000. Investor received cash distributions of only $4,900,000 from RCLO during the taxable year. Upon inquiry, Investor learns from the collateral manager and RCLO's tax advisor that the E&P of RCLO is calculated as follows:

Interest/fee income	$26,500,000
Market discount	800,000
Gains on sale of loans	3,000,000
Interest expense	(12,000,000)
OID expense on issued notes	(1,000,000)
Management/administrative expenses	(2,250,000)
Amortization of debt issuance costs	(1,100,000)
Earnings and profits	**$13,950,000**

If Investor makes a QEF election with respect to RCLO, then he/she will need to file Form 8621, and report $5,580,000 of taxable income (40% of $13,950,000) with respect to his/her ownership in RCLO. His/her tax basis in RCLO will be increased by this amount and decreased by the cash distributions that he/she received during the taxable year.

Warehouse periods

Many CLOs currently in formation have a Cayman vehicle that will issue notes and hold loans during the warehouse period. It is important to recognize that the provider of the first-loss piece will generally be treated as the tax owner of the CLO during the warehouse period. Incomes earned, including realized gains, during this period are included in the E&P of the CLO and, in some cases, occur in a taxable year prior to the closing of the CLO. This party is required to file Forms 926, 8621, 5471, etc., and to report its share of the income. It may be advantageous to carefully consider the tax form of the entity (corporation versus partnership or disregarded entity) during the warehouse period, recognizing that the CLO can change its status upon closing.

FATCA

CLOs are defined as foreign financial institutions (FFIs) under the Foreign Account Tax Compliance Act (FATCA), enacted by the US government in 2010. Accordingly, they are subject to the reporting and potential withholding obligations under the act. A CLO's obligations under the act vary depending on its status under the act, as defined in the final regulations. The technical application of the FATCA provisions is complex, and one should confirm each CLO's status with a tax professional. The following information will provide a general overview of the provisions applicable to CLOs.

CLOs in existence on or before January 17, 2014, which meet certain requirements, will generally qualify as a Limited Life Debt Investment Entity. If this is the case, then they will be classified as Certified Deemed Compliant FFIs and do not need to register. Depending on the jurisdiction in which they are formed, the requirements that must be met to meet this exception may vary.

Entities formed in the Cayman Islands, Ireland, or other Model 1 Intergovernmental Agreement (IGA) countries

CLOs formed in the Cayman Islands, Ireland, or other countries with a Model 1 IGA with the United States in place that do not meet the exceptions, are classified as Reporting Model 1 FFIs, meaning that they must register with the IRS and obtain a Global Intermediary Identification Number and provide required information to the relevant government in accordance with the IGA and the standards published by that country, including US account identification and documentation. CLO managers should work with the offshore administrator and trustee to determine whether exceptions are met and, if not, to ensure that required reporting occurs. Guidelines regarding required Cayman Islands reporting may be found at http://tia.gov.ky/pdf/FATCA_Guidance_Notes.pdf.

Regulatory impacts for CLOs

CLOs are securitization structures where the underlying loans are primarily leveraged loans, and thus they exist at the intersection of securitization and leveraged loans; both of these types of asset classes have been subject to heightened supervisory focus over recent years. Securitization has always been a topic of regulatory guidance (e.g., Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities[15]), and after the economic downturn, regulators have introduced additional regulatory requirements though Basel III regulations, and also, directly and indirectly, through Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) regulations. Regulators had issued Interagency Guidance on Leveraged Lending in 2013[16], and in November 2015 issued a report noting that "Leveraged Lending Remains a Concern"[17].

Banks typically manage, originate, or invest in CLOs and are subject to various regulatory requirements defined by the US regulatory agencies, depending on the role. This chapter focuses on providing an overview of the following key US regulatory areas:

- Regulatory capital requirements (credit and market risk)
- Leverage requirements
- Liquidity risk requirements
- Volcker Rule
- Securitization risk-retention rule

Regulatory capital requirements (credit and market risk)

As noted above, as a response to the downturn, regulators overhauled the regulatory capital treatment—broadly known as Basel III—that generally resulted in much higher capital requirements, especially for securitization exposures. Broadly, the US Basel III regulations subject banking institutions to two types of approaches:

- Advanced Approach (effective January 2014) which replaces Basel II regulations, and is applicable to the large domestic and international banks (> $250 billion in size or > $10 billion in foreign exposure).
- Standardized Approach (effective January 2015) which replaces Basel I regulations, and is applicable to all other banks (> $100 million).

[15] http://www.federalreserve.gov/boarddocs/srletters/2007/SR0705.htm
[16] http://www.federalreserve.gov/bankinforeg/srletters/sr1303.htm
[17] https://www.federalreserve.gov/newsevents/press/bcreg/20151105a.htm

Additionally, market risk banks (trading portfolio > $1 billion, or 10% of total assets) are also subject to capital requirements under the market risk framework. The market-risk-framework-related changes in Basel III (sometimes referred to as Basel 2.5), apply to both Advanced and Standardized Approach banks, and have been effective since January 2013.

Basel III enhancements to the securitizations framework include revisions to the definition of securitization and resecuritization. More importantly, it introduces a new hierarchy of calculation approaches, and imposes stringent due diligence requirements. As such, treatment of securitization exposures under Basel III framework can be operationally complex.

Hierarchy of methodologies for securitization risk-based capital

Securitization exposures are subject to a hierarchy of treatment approaches for determining regulatory capital. The hierarchy of approaches has changed significantly under Basel III, including the elimination of the Rating-Based Approaches, which was available under Basel I and Basel II, as required by Section 939A of the DFA. Basel III retains the Supervisory Formula Approach (SFA) that was available under Basel II, and for the Standardized Approach (for nonmarket risk banks), retains the Gross-up Approach defined under Basel I, and introduces a new Simplified SFA (SSFA) methodology.

SFA—It is only available to Advanced Approach banks and must be applied unless data is not available, in which case SSFA may be applied. SFA capital is based on the capital estimate of the underlying pool of assets as if held directly on the balance sheet (“Kirb”), adjusted for the degree of subordination (i.e., loss absorbance by junior tranches) of a given tranche. SFA uses a supervisory prescribed formula to calculate the capital requirement. It results in 1250% risk weight (RW) for portions of the tranche with subordination level below the Kirb threshold, and applies progressively lesser capital to more senior tranches above the Kirb threshold, subject to a 20% risk-weight floor.

SSFA—The SSFA is a newly introduced treatment approach under Basel III rules, and is available under both the Standardized and Advanced Approaches. SSFA represents significant simplification of calculations vis-à-vis the SFA approach. Under Advanced Approaches, banking institutions can implement SSFA only if it is not possible to calculate regulatory capital using the SFA approach; while under Standardized Approaches, SSFA is the primary option, especially for market-risk banks. Additionally, as per the Collins Amendment[18], Advanced Approach banks, if applying SFA for any transaction, will still need to calculate capital based on SSFA for that transaction, for Standardized Approach capital floor calculation.

As the name indicates, SSFA uses a similar approach to SFA, and is also based on the capital estimate of the underlying pool of assets as if held directly on the balance sheet, adjusted for the degree of subordination (i.e., loss absorbance by junior tranches) of a given tranche. Similar to SFA, SSFA also results in 1250% RW for portions of the tranche with subordination level below the

[18] The Collins Amendment mandates leverage and risk-based standards that are applicable to US insured depository institutions on US bank holding companies. This includes US intermediate holding companies of foreign banking organizations, thrift holding companies, and systemically important nonbank financial companies.

weighted-average risk-weight of the underlying exposures (“Kg”) threshold, and applies progressively lesser capital to more senior tranches above the Kg threshold, subject to the RW floor of 20%.

Gross-up—Nonmarket risk Standardized Approach banks also have the option of using the Gross-up Approach, instead of the SSFA, as long as it is applied across all securitization exposures. The Gross-up Approach, similar to Basel I, is also based on the subordination of the tranche and the RW applicable to the underlying pool of assets. The final risk-weighted asset (RWA) is calculated by applying the average RW to the sum of the exposure amount, plus pro rata share times the enhanced amount, subject to a RW floor of 20%.

1250% RW—Securitization exposures to which none of these approaches can be applied, or if the bank cannot meet due-diligence requirements, must be assigned a 1250% RW (i.e., 100% capital charge).

In addition to the above main securitization approaches, the framework also prescribes specific treatment for certain types of exposures, including: gain on sales, credit enhancing interest only strips, derivatives with SPE counterparties, resecuritizations, etc.

Further updates to the securitization framework rules have been internationally agreed upon, which will more closely align other jurisdictions to the US Basel III enhancements. These further updates have not yet been proposed by US regulators and will include additions such as incorporating tranche maturity as a risk driver.

Treatment of securitizations exposures under the market risk framework

Generally, securitization exposures in the trading book, as per market risk rules under Basel I and Basel II, required lower capital than similar exposures in the banking book, which were subject to credit risk rules.

However, Basel III introduces multiple changes aimed at overall increase of market risk capital in the trading book, with a focus on securitizations. In particular, it imposes due diligence requirements, and also, outside of the correlation trading portfolio, increases the specific risk add-on to be equal to the banking book credit RWA charges (i.e., as per SSFA and SFA) as applicable. Also, Basel III strengthens the eligibility criteria for market risk covered treatment, such that certain trading book portfolios are no longer eligible for market risk treatment. For market risk covered correlation trading portfolio positions, an internally modeled approach is allowed, but with strict qualification criteria. Thus, securitization exposures under market risk now receive an equal number of governance requirements, and in most cases, higher capital than similar exposures under credit risk treatment.

Banks that invest in CLO positions will be subject to the above capital treatment. In particular, under SFA, banks will typically be required to perform risk rating for individual loans, which can be operationally burdensome.

Additionally, there are other provisions that can indirectly impact CLO exposures. For example, if banks act as sponsors or originators, implicit guarantee considerations (i.e., to provide excess of contractual loss support, for reputational reasons) may require banks to hold capital on the entire group of underlying assets, as if held in the balance sheet.

Capital benefit for synthetic securitization structures (e.g., synthetic CLOs) will also be limited to eligible financial collateral pledged to the bank. Under a synthetic CLO, banks typically will not sell the underlying assets, but will purchase tranched credit protection from a SPV via a credit linked note. However, SPVs do not qualify as eligible securitization guarantors, and thus banks may not realize any capital benefit on the guarantee obtained, unless collateral is pledged.

Updates to the market risk rules have been internationally agreed upon, known as the Fundamental Review of the Trading Book (FRTB) changes, but have not yet been proposed by US regulators.

Leverage requirements

There is already a leverage ratio requirement as part of Basel I, which has also been retained under Basel III, defined as the ratio of Tier 1 capital to total on-balance-sheet assets, less assets deducted from capital. Additionally, the Basel III Advanced Approach also includes a supplementary leverage ratio requirement, which is similar to the leverage ratio, but also includes a measure for off-balance-sheet assets, generally calculated as per the credit conversion factors defined in Basel III Standardized Approach, subject to a 10% minimum.

Both leverage ratios require total on-balance-sheet assets to be measured as per US GAAP or any other accounting framework no less stringent than US GAAP. Consequently, for any securitization program, including CLOs, if the originating and sponsoring bank has to consolidate the underlying loans, these will be included in the leverage ratio measures.

Liquidity risk framework

Liquidity risk regulations mandate banks to satisfy two ratios—a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR), to cover for liquidity risk over a short (30-day) and longer (one year) horizon. The US regulations for LCR were finalized in September 2014, and a proposed version of the NSFR was released in the US in May 2016 (expected to be effective January 2018). Under both the LCR and NSFR, securitization exposures will not count as high quality liquid assets, and thus, will become more expensive for banks to hold. The liquidity regulations in United States only apply to the larger banks (holding companies > $50 billion in assets), and more stringent requirements for the largest international banks (holding companies > $250 billion in assets or > $10 billion in foreign exposure and their consolidated depository institutions > $10 billion in assets). Smaller banks are not impacted by such constraints.

The Volcker Rule

A key component of the DFA, the Volcker Rule, generally prohibits the investment in covered funds, primarily hedge/private equity funds. The final rule exempts most securitization structures, including CLO structures consisting solely of loans. However, most CLO structures have historically also included a certain amount securities as underlying assets—and these CLO structures will not be exempt. In the face of intense industry pressure, regulators provided additional permanent grandfathering exemptions[19] to trust preferred securities collateralized debt obligations (TRUPs CDOs), but such grandfathering relief was not extended to CLO structures. However, regulators granted an additional two-year extension of the conformance period from July 2015 to July 2017 for CLOs in place as of December 31, 2013[20]. Providing managers time to restructure them, if desired. Failing exemption, banks had to divest their holdings in such Volcker Rule ineligible funds by 2017 and deduct any permissible investments from Tier 1 capital.

Risk retention

Various regulatory authorities in the United States passed risk retention rules for the sponsor or an originator or a majority-owned affiliate of either to retain a 5% economic interest in the credit risk of the assets in a securitization. These rules significantly impacted the CLO market, but provided a two-year effective date window ending December 24, 2016, exempting CLOs issued prior to then. Subsequently, the US Court of Appeals ruled that managers of open market CLOs are not subject to risk retention. As the implementation of that ruling is forthcoming, we provide an overview of the risk retention rules.

Such rules dictate that:

- A sponsor is deemed to be an entity that actively participates in the securitization transaction through underwriting or asset selection, with the CLO asset manager being identified as the sponsor.
- An originator is an entity that creates an asset through financing, selling such credit assets to the issuer of a securitization.
- A majority-owned affiliate is an entity that directly or indirectly controls a majority of or is under common majority control with the sponsor, as determined under US GAAP.
  A qualifying sponsor can satisfy the risk-retention requirements through either ownership interests in (i) a single or vertical security representing a 5% face value interest in each class of issued securities, (ii) an eligible horizontal residual interest equal to 5% of the fair value (US GAAP) of all interests, (iii) a cash reserve account funded in an amount equal to 5% of the fair value (US GAAP) of all interests, or (iv) any combination of clause (i) above and 5% of the fair value (US GAAP) of all interests.
- A sponsor is able to offset its risk-retention requirement by selling amounts of qualifying eligible interests obtained by an originator who has originated at least 20% of the underlying loans in a CLO and has acquired at least 20% of the required risk retention of the sponsor.

To comply with the rules, some management firms have had to rethink the way they are structured. Some firms have pursued raising third party capital, others are making purchases through a majority-owned affiliate entity (MOA) or a more capitalized collateralized majority-owned affiliate entity (CMOA) with the added ability to comply with European risk retention requirements that would be required to hold the risk. Another lengthier option being explored is investing in a standalone company, referred to as a capitalized manager vehicle (CMV), which would manage the CLOs and retain the required risk.

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[19] http://www.federalreserve.gov/newsevents/press/bcreg/20140114b.htm
[20] https://www.federalreserve.gov/newsevents/press/bcreg/20160707a.htm

In addition to CLOs issued following the regulation's effective date, the requirements apply to any transactions to be refinanced or reset following the effective date, though relief was granted by SEC to any CLOs that refinance following the effective date and adhere to the following conditions in connection with the refinancing:

- Refinancing must be completed within four years of original issuance date
- Applicable interest rates of refinanced notes must be lower than the interest rates on the original notes
- CLO's capital structure may not change
- Principal amount of notes may not change
- Priority of payments and voting rights may not change
- Stated maturity of the notes may not change
- The CLO issuer's investment criteria may not change

In summary, given the current environment of regulatory overhang, banks have to deal with the impact of higher regulatory capital, leverage and liquidity charges for CLOs and other securitizations, and increased risk retention and compliance challenges. The combined effect of these regulations, together with heightened regulatory expectations and ambiguities, will have the impact of limiting banks' participation in CLO structures, and as an unintended consequence, nonbanking (or shadow banking) entities that are outside of such regulatory constraints are expected to fill the gap.

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