SEC Proposals for Private Fund Advisers Would Increase Costs for CLOs

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On February 9, 2022, the U.S. Securities and Exchange Commission (SEC) issued proposed rules (the "Proposed Rules") for private fund advisers that, if adopted in their current form, could impose significant additional costs on collateralized loan obligation (CLO) transactions and their managers. As described in more detail in our client alert at Akin Gump_A Transformation in SEC Regulation of Private Fund Managers_February 2022, the Proposed Rules represent an aggressive and controversial potential expansion of regulation of private funds by the SEC. While the Proposed Rules primarily target traditional private equity and hedge funds, CLOs are also in scope because most CLOs rely on Section 3(c)7 for their exemption from registration under the Investment Company Act of 1940, rendering them "private funds" and therefore covered by the Proposed Rules.

What is at stake?

The Proposed Rules in their current form would require CLOs to comply with at least the following new obligations:

- Delivery of plain English, concise quarterly statements that include specific new disclosures regarding CLO manager compensation (both before and after any fee sharing or offsets), other fees and expenses paid by the CLO, certain CLO investment-level information and standardized performance information (including the criteria used and assumptions made in calculating such performance).[1]
- Annual financial statement audits—a new requirement that would be based on and nearly identical to Rule 206(4)-2 under the Advisers Act (the so-called "Custody Rule").
- An independent fairness opinion for certain "adviser-led secondary transactions", which could include transactions commonly known in the CLO market as "re-issues" in which an existing CLO's assets are sold to a new issue CLO managed by the same manager, where the existing CLO's investors have the option either to obtain liquidity or to roll all or a portion of their investment into the new CLO vehicle.
- Prohibitions on charging fees and expenses (x) associated with examinations, investigations, and regulatory or compliance matters, or (y) on a non-pro rata basis

for investments in which other clients advised by the CLO manager are participating.

- Prohibition on a CLO manager's reimbursement, indemnification, exculpation or limitation of its liability for mere negligence, which are common features of existing CLO management agreements that would require costly amendment processes to modify.
- Prohibition on (x) selectively disclosing to only certain investors information about investments in a CLO or in a "substantially similar pool of assets" (which could include another CLO) if the CLO manager reasonably expects that providing the information would have a material, negative effect on other investors in that CLO or in a "substantially similar pool of assets" and (y) providing any other preferential treatment to any investor unless the CLO manager discloses the same to all "prospective and current" investors—a prohibition that would cover side letters effecting management fee sharing arrangements.
- Documentation of annual review of compliance policies and procedures and other recordkeeping requirements.

Who invests in CLOs?

CLOs issue primarily Rule 144A-eligible securities that require purchasers to be "qualified institutional buyers" for purposes of that rule that are also "qualified purchasers" for purposes of the '40 Act, or non-U.S. investors pursuant to Regulation S—an investor base that is very sophisticated in nature; that includes investment banks, insurance companies, global asset managers and hedge funds; and that routinely and actively negotiates material terms of the CLO documents.

Would CLO investors materially benefit from these rules?

One subject of legitimate debate concerning the Proposed Rules as they would impact the CLO market is whether they would justify the significant added compliance cost burden given that their stated objectives—primarily (1) increased transparency and disclosure, (2) reduced fraudulent conduct through independent accountant review and (3) minimization of conflicts of interest—are arguably already achieved through existing applicable law and regulation or established market practice. For example:

Transparency & Disclosure

- CLOs have independent trustees that, together with their affiliates, produce monthly reports and quarterly distribution reports for investors that describe key performance and compliance data concerning the CLOs' assets that—although different from the specific reporting that would be required under the Proposed Rules—are robust, based on a form that is often negotiated by investors and viewed by CLO market participants to be the most relevant data concerning an investment in the CLO notes. The format of these reports is similar across CLOs in the market, facilitating "apples to apples" comparisons by investors across deals.
- Due in large part to the Rule 144A-eligible nature of CLO transactions, side letters are rare and when executed usually only effect management fee sharing arrangements that, to the extent material in nature, are typically disclosed in the affected CLO's offering circular for all investors to see.

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Independent Accountant Review

- CLOs require annual “agreed upon procedures reports” to be prepared by independent accountants that back-test the calculations in quarterly investor distribution reports.
- Most CLO managers are not required to comply with the Custody Rule because an independent trustee—and not the CLO manager—is the only party in the transaction that can access cash in the CLO’s accounts, under strict restrictions and in accordance with payment waterfalls set forth in the CLOs’ indentures and other operative transaction documents.

Conflicts Disclosure & Mitigation

- CLO managers (as well as all private fund advisers more generally) are already subject to federal fiduciary obligations enforceable through Section 206 of the Advisers Act (the so-called “anti-fraud provision”) and other federal securities laws designed to prevent fraud.
- CLO offering circulars and management agreements describe in detail potential conflicts of interest between the CLO manager and its affiliates, on the one hand, and the CLO issuer on the other, and the manager’s policies and procedures for managing such conflicts of interest as required by applicable law and regulation.
- CLO management fees are calculated based on assets under management; however, in most cases the value of those assets consists of the full par amount of each loan held by the CLO, with limited input from the CLO manager, and therefore limited opportunity for actions driven by potential conflicts of interest between the CLO manager and the issuer to affect the manager’s fees.
- The types of costs that can be charged to a CLO are quite limited in nature, are only paid by CLO trustees when appropriate documentation is presented and are subject to an annual cap under the CLO indenture.
- CLOs’ investment grade securities are rated by independent rating agencies that are subject to the requirements of Rule 17g-5 of the Securities Exchange Act, which requires disclosure of information material to such ratings in a data room accessible by other rating agencies that may produce their own unsolicited ratings of the same securities (a rule adopted to implement Section 943 of the Dodd-Frank Act, designed to reduce conflicts of interest in the third-party ratings process).

What is the timeline for adoption of these rules?

The Proposed Rules are subject to an initial comment period expiring on April 25, 2022. As with any SEC proposals, the comment period can be extended and the proposals are subject to potential modification and subsequent re-proposal before being adopted in final form, if at all. CLO industry participants will recall that a protracted adoption process took place for the Credit Risk Retention rules, which were initially proposed in April 2011 and not finalized until October 2014, with an effective date for CLOs of two years out. After coming into effect for CLOs, those rules were then successfully challenged in court in 2018 insofar as they would purport to apply to “open-market CLOs”. As for the Proposed Rules in this case, it is important to note that even their initial version indicates they would not take effect until a year after publication of the final rules in the *Federal Register*. That said, given the broad scope of the Proposed Rules and their significant potential impact on CLOs, industry groups

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and market participants are preparing comment letters and will continue to watch this space closely for further developments.

[1] The type of performance information that would be required for CLOs is uncertain and depends on whether CLOs will be considered “illiquid funds”, “liquid funds” or hybrids of the two. A conservative reading of the Proposed Rules suggests CLOs should be treated as liquid funds, which would need to disclose annual net total returns for each calendar year since inception, annual net total returns over the one-, five- and 10-calendar year periods, and the cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.

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