September 2013

Securities and Derivatives Group

Navigating the Regulatory Route Map - A Guide for CLO Managers and Arrangers

As the CLO market shows signs of what is hopefully a sustained recovery on both sides of the Atlantic, managers and arrangers are grappling often for the first time with the avalanche of regulation which has hit the financial services industry, and in particular asset-backed securities, since the financial crisis of 2008. Finding a way through the new rules can seem daunting, especially as transactions often have to consider separate and conflicting sets of regulation from the European Union and the U.S. Not only do sponsors have to comply with existing regulation, but increasingly they have to take account of rules which, whilst not yet in force, are on the statute book and could impact transactions during their term.

In the EU, the creation of the new omnibus regulatory bodies - the EBA, ESMA and EIOPA - and the move away from guidance to binding technical standards, has meant that whilst on one level there is better harmonisation of regulation across the Union, the ability for home-state regulators to apply a flexible approach to interpretation of EU Directives and Regulations is much diminished. Where once some comfort could be sought from the policies of a home regulator in relation to a transaction structure, increasingly the burden is falling on structurers, and their legal teams, to interpret primary legislation and technical standards which remain untested and without further guidance.

In the U.S, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in July 2010, and rulemaking by the Federal Agencies pursuant to it will continue for some years to come. The resulting web of rules will affect virtually every area of the U.S. capital markets, including swaps and securitisations. Not only do these rules impact CLO managers and arrangers within the U.S. but they will often need to be considered by our non-U.S. clients to ensure that transactions outside the U.S. are either exempt or are able to comply. Our London and U.S. CLO practices are in daily contact and work closely to ensure we are staying informed of developments in both continents.

At Ashurst, we have invested significantly in ensuring that we are able to cover the latest developments as they happen, and adapt quickly to the continually moving regulatory environment. We actively look for opportunities to liaise with regulators through participation in industry working groups, involvement in consultation on regulatory proposals, and direct meetings wherever possible. We are confident that this commitment will help to prevent you from getting lost in the complex world of regulation. In this briefing, you will find short, easy to follow guides to the main regulations which are changing the route to issuance and beyond. We hope you find it useful.

Contents

Article 122a Capital Requirements Directive/Article 404-410 Capital Requirements Regulation (The "EU Retention Requirements") 2

Credit Rating Agencies Regulation 3 ("CRA 3") 3

The Alternative Investment Fund Managers Directive ("AIFMD") 4

European Markets and Infrastructure Regulation ("EMIR") 5

Proposed Revisions to the Basel Securitisation Framework 6

Foreign Account Tax Compliance Act ("FATCA") 8

Risk Retention Under Dodd-Frank Act S941 9

Commodity Pool Regulation – Dodd Frank Act/Commodity Exchange Act 11

"Volcker Rule" (Dodd-Frank Act) 12

SEC Rule 17G-5 13

SEC'S Rules on Disclosure for Asset-Backed Transactions 14

U.S. Clearing Requirements – Dodd-Frank Act 15

Contacts 16

Article 122a Capital Requirements Directive/Article 404-410 Capital Requirements Regulation (The "EU Retention Requirements")

Rules requiring risk retention and due diligence for securitisation transactions (including CLOs).

In Force
Article 122a current until 31 December 2013

Articles 404-410 from 1 January 2014 (replacing Article 122a)

Scope
Applies to "securitisation" transactions, which are widely defined to include transactions in which the credit risk on an exposure or pool of exposures is tranched and losses on the pool are allocated according to the tranching. No need for a sale of the assets, so synthetics are caught.

Affects investors in CLOs who are EU banks and, from 1 January 2014, affects other regulated investment firms.

CLO managers and sponsors need to comply due to need to meet investor requirements.

Possible extra-territorial effect as securitisation exposures of consolidated affiliates of EU regulated investors are caught. Thus U.S subsidiaries investing in U.S. securitisation transactions/CLOs will need to consider these provisions.

Limited exemptions for assets of or guaranteed by government or related entities.

"The EBA has removed the possibility of third party investors from acting as retention-holder, and made it clear that they expect the manager to retain. Investors are now expecting to see retention by the manager."

Effect
"Originator", "Sponsor" or "Original Lender" of a securitisation transaction must hold 5% of the economic risk in order that affected investors can invest without capital penalties. Other due diligence requirements also apply to investors, and underwriting standards apply to originating banks securitising balance-sheet assets.

Definitions of "Sponsor" and "Originator" do not clearly include CLO managers, even though CLOs are caught by the definition of securitisation and must comply. EBA guidance on Article 122a allowed third party equity investors to hold the retention, but recent EBA Consultation on Articles 404-410 removes that concession. CLO managers will be required to hold the retention as a "Sponsor" or "Originator". In order to qualify as a Sponsor, CLO managers must have certain authorisations other than solely asset management.

The definition of "Originator" in this context is either an entity which was involved in the original agreement which created the underlying assets (which will not be the CLO manager), or en entity which purchases a third party's exposures onto its balance sheet and then securitises them (which again is not the CLO manager).

As a result there are difficulties for many managers in meeting the definitions.

If the retention is held in a "first loss position", it is measured against par value of the underlying assets. If a significant amount of "par building" in respect of the portfolio occurs, the retention may need to be increased to reflect the increase in the par value if the underlying assets. If the retention is held by way of a "vertical slice", it is measured based on the nominal value of the notes issued, thus par building is not an issue.

Position on grandfathering of existing transactions which complied with EBA guidance on Article 122a after new rules come into force on 1 January 2014 (through a third party equity investor holding the retention) is unclear. Currently, there is no grandfathering proposed though the EBA has indicated that they are considering the point and what, if any, authority they have to effect any change on grandfathering.

In addition, the flexibility provided in the EBA guidance on 122a in respect of transactions with revolving portfolios which continue to substitute assets after 31 December 2014 has been removed. If the current proposed changes are adopted as written, any transaction which substitutes asset after 31 December 2014 will no longer get the benefit of grandfathering.

The EBA consultation closed 22 August 2013 and final regulatory technical standards are due to be published before 1 January 2014.

Detailed due diligence requirements also apply to credit institution and investment firms who invest in securitisations. Investors must have formal policies in place to analyse and record risk characteristics of the underlying assets and the securitisation, structural features, valuation methodology and information required to perform stress tests. Information must generally be provided on a loan-by-loan basis. Investors must also monitor certain performance information on the underlying assets on an ongoing basis.

Similar requirements to both the retention and due diligence requirements outlined here apply to Alternative Investment Fund Managers investing in securitisations, as discussed under *The Alternative Investment Fund Managers Directive*, below. Note the more onerous requirements for due diligence in that section.

In future, these requirements will also extend to insurance companies and UCITS funds investing in securitisations, once the relevant provisions of Solvency II and the UCITS directive come into force.

Credit Rating Agencies Regulation 3 ("CRA 3")

New rules on rating of and information to be published in respect of structured finance instruments (**"SFIs"**).

In Force
20 June 2013

Application of individual provisions unclear, but requirement for two ratings for rated SFIs is in force now.

Information requirements for SFIs are in force but detailed regulatory technical standards are outstanding and in consultation (see below).

Scope
Scope is currently unclear:

Disclosure requirements apply to SFIs "established in the Union" and the obligation is on the issuer, sponsor and originator. There is no explicit requirement that the SFI even needs to be rated for the disclosure obligation to apply.

ESMA consultation says "established in the Union" includes SFIs whose issuers, sponsors and originators are established in the EU, and also SFIs which are traded in the EU although established elsewhere. It is not clear whether "traded in the EU" means traded on a regulated market or has a wider meaning.

"ESMA surprised everyone with treating structured finance instruments traded in the EU but issued by entities established elsewhere as falling within the disclosure requirements in CRA3."

Effect
Unclear in many respects:

Article 8(c) requires issuers and "related third parties" soliciting a rating for a SFI to obtain independent ratings from at least two rating agencies unconnected with each other. They must also consider appointing as the second agency an agency with less than 10% of the market share when measured against agencies "capable of rating the relevant issuance or entity".

Article 8(b) requires the issuer, sponsor and originator of an SFI jointly to publish information on the performance of the underlying assets, the structure, cash flows, collateral, and information for performing stress tests, on a website established by ESMA (although as yet there is no such website). There is an

exemption for information which would breach confidentiality. ESMA is currently consulting on the detailed regulatory technical standards which will govern the information required, and these are due to be finalised in June 2014. ESMA consultation focuses on content of information and frequency of disclosure and discusses suitability of existing ECB disclosure templates. No guarantees are given that the ECB templates will be sufficient.

Article 6(b) also imposes a requirement that a rating agency cannot issue ratings on re-securitisations based on assets from one originator for a period longer than four years, unless "at least four credit rating agencies each rate more than 10% of the total number of outstanding rated re-securitisations". It is not clear whether this exemption is currently applicable, or will be at any time in the future. However, existing re-securitisation ratings are caught, so potentially rotation could be required for ratings of re-securitisations coming up to the four year limit.

There are provisions for investors to seek damages from agencies for loss resulting from breach of the requirements of CRA 3, although it is not clear how such a loss would be established.

The Alternative Investment Fund Managers Directive ("AIFMD")

Requirements for authorisation and conduct of alternative investment fund managers **("AIFMs"**), including retention requirements for investing in securitisations.

In Force
22 July 2013 (subject to transitional provisions)

The retention requirements in AIFMD discussed below apply to new securitisations issued on or after 1 January 2011.

Scope
Regulates the management of Alternative Investment Funds (**"AIFs"**), which are defined as collective investment undertakings which do not require authorisation under the UCITS Directive – i.e. what were unregulated collective investment undertakings – which have a defined investment policy and raise capital from a number of investors with a view to investing it for the benefit of those investors.

AIFMD applies 1) to EU AIFMs whether the AIFs they manage are EU AIFs or non-EU AIFs; 2) non-EU AIFMs marketing AIFs in the EU, and 3) non-EU AIFMs who manage one or more EU AIFs.

"AIFMD has re-opened the thorny issue of whether a CLO vehicle is a collective investment undertaking, just as we thought the CLO identity crisis was resolved with treatment as a securitisation in various other regulations."

Effect
Two issues concern CLOs:

1) Retention – AIFMD requires AIFMs investing in securitisations on behalf of AIFs to ensure that the "Originator", "Sponsor" or "Original Lender" (the **"Retainer"**) of a securitisation retains 5% of the economic risk. While the retention requirements are broadly the same as Article 122a there are significant differences. It also requires AIFMs to ensure the Retainer meets certain underwriting and originating criteria in granting credit. It also imposes more extensive due diligence requirements on AIFMs investing in securitisations than are imposed on credit institutions under Article 122a of CRD and Articles 404-410 of CRR – see *Article 122a Capital Requirements Directive/Article 404-410 Capital Requirements Regulation* above. In particular they are required to monitor and report risks arising from

mismatches between the assets and liabilities of the AIF. They must also ensure the Retainer has sound underwriting systems and policies for the granting of credit.

AIFMs who discover after the assumption of a securitisation exposure that the retained interest does not meet the requirements, or subsequently falls below 5% of the economic risk, are required to take such corrective action as is in the best interests of investors.

This affects managers structuring CLO transactions wishing to sell to AIFs. If requested to give different levels of disclosure to AIFMs than to other investors, CLO managers will need to address whether they can provide such additional information and if such additional information should be provided to all investors.

2) Definition of AIF – if a CLO is considered to be an AIF under AIFMD, the CLO manager would need authorisation as an AIFM and would be subject to strict regulatory obligations, including risk management and liquidity requirements, capital requirements, the need to appoint a custodian, remuneration restrictions, reporting requirements, disclosure requirements, etc. As yet, despite questions from the industry, there has been no statement from ESMA or the European Commission as to whether a CLO is prima facie caught by the definition of an AIF. The FCA in the UK however does take the view that transactions which issue debt instruments are not caught by this definition.

There is also an exemption for "securitisation special purpose entities" (**"SSPEs"**). The definition of SSPE is taken from a regulation of the ECB, and is not the same as that used in the Capital Requirements Directive. There been no guidance from ESMA as to which transactions will fall within this exemption. Whilst this has been the cause of some concern in the market that CLOs could be outside the exemption and therefore potentially caught by the requirements of AIFMD, the better view is that CLOs will be exempt or will, in any event, not be caught by the definition of an AIF (see above). However the issue needs to be addressed when drafting CLO transaction documents.

Note – if a CLO considered to be an AIF, it will be a financial counterparty under EMIR (see *European Markets and Infrastructure Regulation* below).

European Markets and Infrastructure Regulation ("EMIR")

Sets out requirements for reporting and clearing of OTC derivatives through central counterparties, and related collateral exchange requirements.

In Force
16 August 2012

Commission delegated regulations supplementing EMIR came into force on 15 March 2013.

Provisions effective in stages – clearing obligation subject to a current consultation by ESMA. Reporting obligations have currently been postponed until the relevant trade repositories are in place. Once reporting obligations are effective they apply retrospectively from 16 August 2012.

Scope
Mandatory clearing and reporting obligations under EMIR will apply to a) financial counterparties and b) to non-financial counterparties such as securitisation SPVs and CLOs if the gross notional value of all derivative contracts entered into by the SPV and its "group" – see below, exceed certain thresholds. These thresholds are Euro 1bn for credit or equity derivatives, and Euro 3 bn for interest rate, currency and commodity derivatives and all others. If one party to the derivative is a financial counterparty (such as in a typical CLO swap transaction), the clearing requirement will not apply unless the other is also a financial counterparty or exceeds the thresholds for a non-financial counterparty.

In each case, the counterparty must be established in the EU to be caught. EMIR purports to have effect on non-EU entities which would be subject to the clearing obligation if they were established in the EU but this is unlikely to be effective without further international co-operation.

"EMIR is an example of a regulation where compliance by securitisation SPVs cannot have been intended, yet the carve-outs for such vehicles have not been made sufficiently clear."

Effect
Securitisation entities such as CLOs are expected to be treated as non-financial counterparties under EMIR (unless they are treated as AIFs under AIFMD – see below), so are prima facie not subject to clearing unless they exceed the thresholds. In calculating the notional value of derivatives, the SPV must take into

account transactions entered into by entities in the same "group". The definition of "group" for this purpose includes entities which could exert a dominant influence over the SPV. It is possible, though unlikely in the context of a CLO, that this could bring other entities, such as the Collateral Manager into the SPV's "group" which may result in the clearing threshold being exceeded. There has been some commentary to the effect that entities which would consolidate the SPV under the accounting test in the seventh Company Law Directive could be treated as being within the same group for the purpose of EMIR. Thus accounting advice should be taken as to whether a CLO manager and the SPV would be consolidated on this basis.

The clearing obligation requires derivatives to be marked to market and collateral to be exchanged. In the event that the clearing threshold is exceeded, a CLO would be unable to make the required collateral exchange.

However, derivatives which are entered into for hedging purposes – i.e. objectively to reduce risks directly related to commercial or treasury activity – will not count toward the threshold. It is expected that most interest rate and currency derivatives entered into by CLOs should meet this requirement and be exempt, but this will need to be considered in each case.

If CLOs were treated as AIFs under AIFMD, they would automatically be financial counterparties for the purposes of EMIR. If that were the case, they would be subject to the clearing obligation without the thresholds being reached. The CLO would be unable to comply with the clearing and margining requirements.

Proposed Revisions to the Basel Securitisation Framework

Consultation papers setting out proposals for alternative approaches to calculating capital charges on securitisation exposures.

In Force
Some way off – the Basel Committee is consulting on two alternative approaches and has asked for input from the industry as to which it should pursue, or whether it should consider other alternatives.

Once Basel publishes final revisions to the framework, it will then need to be implemented at EU, where applicable, and national level.

Scope
Basel accords have a global application among jurisdictions who have joined the committee, although individual jurisdictions (particularly the U.S.) have in the past made changes to the Basel agreements when implementing or have delayed implementation.

Applies to investors calculating capital charges on securitisation exposures, and to transaction parties who assume credit risk on securitised exposures (such as certain liquidity facility providers and credit support providers).

"The Basel proposals aim to make capital requirements more risk-sensitive, but the industry has questioned whether the complexity of the proposed models means that many banks would be forced back into using a ratings-based approach."

Effect
Unclear at the moment.

The consultation suggests two proposals – Alternative A and Alternative B. These will replace the current IRB and Standardised approaches to calculating risk-weights. Both approaches incorporate a Modified Supervisory Formula Approach (**"MSFA"**) and either a Revised Ratings Based Approach (**"RRBA"**) (or the current IAA), or a Simplified Supervisory Formula (**"SSFA"**), although Alternative B uses these new approaches only for Senior High-Quality securitisation tranches. The two alternative hierarchies of approach are set out in the following table:

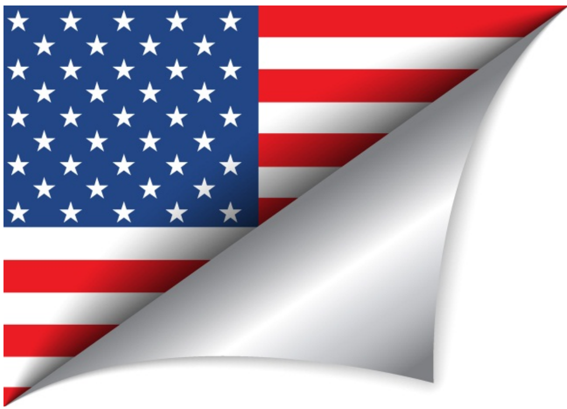
Alternative A	Alternative B	
MSFA	Senior High Quality Tranches	Other Tranches
RRBA (or IAA) or SSFA (choice up to jurisdiction)	RRBA/IAA or MSFA/SSFA	Concentration Ratio
BCRA	BCRA	
Deduction/1250 % RW	Deduction/1250% RW	

The detail of the paper is too complex to summarise here, and we do not purport to advise on the mathematical models used, however some of the highlights are:

- The MSFA uses asset by asset probability of default and expected loss to produce pool-level parameters for input into a formula which inputs KIRB (the capital charge on the pool), the attachment and detachment points of the tranche, and complex parameters designed to reduce "cliff" effects.
- The SSFA is similar to the MSFA but uses the Standardised approach for calculating the capital charge on the underlying exposures, and is based on simpler calculations with fewer inputs.
- The RRBA excludes inputs for granularity (which are included currently in the Supervisory Formula) and includes a maturity input and an input for thickness of the tranche.
- The Concentration Ratio is similar to the previous "look-through" in the current standardised approach, but is only used for non-senior tranches under Alternative B and does not give credit for credit enhancement to the tranche.
- The Back-stop Concentration Ratio (**"BCRA"**) approach is a default approach before resorting to deduction from capital, and must be used for all re-securitisation exposures.
- There is an overall floor on risk weights for securitisation exposures of 20%. This would be a significant change for banks currently using the internal ratings based approach under Basel.

Commentary from the industry has so far been fairly negative, and it is understood that Basel may be working on a simplified version of the MSFA, or using just the SSFA. There is some way to go before any firm decision on the proposals.

Risk Factors should highlight to investors that they are responsible for analysing their own regulatory capital position when investing in the notes.



Foreign Account Tax Compliance Act ("FATCA")

Requires foreign (to the U.S.) financial institutions (**"FFIs"**) to disclose details of U.S. account-holders to the U.S. or local tax authority in order to combat U.S. tax evasion. FATCA imposes a 30% withholding on certain U.S.-sourced payments paid to FFIs who do not comply.

In Force
FATCA was enacted 18 March 2010 and final regulations were published in January 2013. However, there are significant aspects of FATCA that have yet to be finalised and implemented.

There are various grandfathering provisions (see "*Effect*" below). Otherwise, withholding begins on U.S. source interest, dividends and other passive income paid on or after 1 July 2014 and of gross proceeds from the sale of certain U.S. assets made on or after 1 January 2017. Withholding on non-U.S. source payments is expected to begin no earlier than 1 January 2017.

Scope
FFIs are defined in such a way that CLOs and their managers are expected to be caught, as well as account banks, swap counterparties and other transaction parties. FATCA applies regardless of whether the FFI conducts any business in the U.S. or has any U.S. account holders.

Effect
FATCA imposes a 30% withholding on a broad range of U.S.-sourced payments paid to FFIs who do not comply with certain reporting and withholding obligations. These payments include, among others, U.S. sourced interest, dividends, royalties, proceeds from disposals of U.S. securities and repayment of principal on U.S. debt instruments.

Even where a CLO holds U.S. assets, the CLO is usually structured so that payments on its notes are not treated as U.S. source.

FFIs can comply with FATCA (and therefore receive payments without withholding) by entering into an agreement with the IRS (an **"IRS Agreement"**) under which the FFI accepts various obligations to report information about U.S. accountholders, and to withhold on any "passthru payments" made to any accountholder which fails to provide required information (a **"recalcitrant accountholder"**), or any other FFI if it has neither entered into an IRS Agreement nor is a resident of a jurisdiction that has entered into an intergovernmental agreement (**"IGA"**) with the U.S. Passthru payments are comprised of U.S. source income and proceeds or principal repayments of certain U.S. assets and "foreign passthru payments." The U.S. Treasury has not yet published guidelines as to what constitutes a "foreign passthru payment" which will be subject to withholding, and thus all payment flows in a CLO transaction may need to be considered once this is finalised.

In general, 1) U.S. source obligations (other than equity or other obligations lacking a defined term) that are outstanding as of 30 June 2014; and 2) non-U.S. source obligations that are outstanding on the later of 30 June 2014 and the date that is six months after the adoption of the final regulations addressing withholding on foreign passthru payments, in each case that are not modified after the respective relevant date, will not be subject to withholding. Derivative transactions are also eligible for grandfathering, subject to the sourcing and modification rules discussed above.

In 2012, the U.S. Treasury agreed to enter into IGAs with other governments to facilitate the implementation of obligations under FATCA. These IGAs alleviate concerns over conflict with local confidentiality laws and also may centralise information reporting for financial institutions of a particular jurisdiction. Under one model of IGA, the local tax authority gathers the required information and reports to the IRS under the IGA and tax information exchange arrangements. This IGA also provides that as long as FFIs report the relevant information to their own tax authority, they will be deemed compliant with FATCA and will not be required to enter into an IRS Agreement directly with the IRS, and will generally not be required to withhold on payments to recalcitrant accountholders. Under another model of IGA, a jurisdiction will require its FFIs to enter into reporting and withholding agreements with the IRS directly. The exact terms of IGAs across jurisdictions may differ, however, and the effect of FATCA and the IGA (if any) in the jurisdiction of establishment of each relevant entity in a CLO transaction will need to be considered.

The U.S. has concluded IGAs with Germany, Spain, Norway, Switzerland, Ireland, Mexico, Denmark and the UK and has initialled an IGA with the Cayman Islands, which is expected to be signed by both countries. The U.S. has also concluded a FATCA-related "arrangement" with Japan and announced that it is in the process of negotiating an IGA with the Netherlands.

Risk Retention Under Dodd-Frank Act S941

Directs federal agencies to adopt rules requiring securitizers of asset-backed securities to hold at least 5% of the credit risk of the underlying assets.

In Force
Draft rules proposed by 5 federal agencies[1] and the SEC in March 2011. Revised proposal published 28 August 2013. Comments on revised proposal are to be submitted by 30 October 2013.

No guidance as yet on timing of final rules (although they are expected end of 2013). Compliance is required for CLOs two years after publication of final rules.

Summaries below refer to proposed rules as revised by the 28 August 2013 proposal.

Scope
Applies to any "securitization transaction" which is a transaction involving the offer and sale of asset-backed securities by an issuing entity – but as asset-backed securities are defined as those backed by self-liquidating assets, synthetic securitisations are out of scope.

Transactions backed by certain qualifying residential mortgages, certain qualifying commercial loans (which may include certain CLOs with underlying assets which meet strict LTV, leverage and other criteria, although in practice unlikely given the requirements), qualifying commercial real estate loans, qualifying auto loans, and certain types of ABS where the assets benefit from agency guarantees (such as Fannie Mae and Freddie Mac) are subject to reduced requirements or zero retention.

"Securitizer" of the transaction must retain the 5%. A "securitizer" is defined as either the "sponsor" or the "depositor" of the ABS, but it is likely to be the sponsor who retains. A "sponsor" is defined as a person who organises and initiates a securitisation transaction by selling or transferring assets either directly or indirectly, including through an affiliate, to the issuing entity.

It is confirmed that CLO managers are treated as a sponsor in the revised proposal, and will therefore, to the extent they are the risk retaining sponsor, need to

---

[1] The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Housing Finance Agency and the Department of Housing an Urban Development.

retain the required risk retention (however note new retention option for "open-market CLOs" below).

Non-U.S transactions that meet certain limits on U.S investors (no more than 10% of dollar value of the ABS) and U.S-originated assets (no more than 25%), and are not issued or sponsored by a U.S. entity and do not require registration under the Securities Act are exempt.

Transactions existing on the date the final rules come into force will be grandfathered.

"The revised proposal for U.S. risk retention affords greater flexibility in meeting the general 5% retention standard applicable to most securitizations, but in practice is unlikely to afford relief to CLOs."

Effect

Proposed rule can be complied with by retaining the 5% in one of three ways; 1) 5% vertical slice through each class of securities issued; 2) 5% first-loss tranche; and 3) horizontal and part cash reserve equivalent to the first loss, funded by the sponsor. However, the revised proposal allows the first 2 options to be combined in any way that amounts to 5% of the fair value (as contrasted with par value, as provided by the original draft proposal) of all the ABS interests in the issuer, measured according to U.S. GAAP, such as by means of an "L"-shaped interest consisting in part of a vertical and in part of a horizontal tranche.

The revised proposal also sets out several transaction-specific risk retention options, including with respect to revolving asset master trusts, asset-backed commercial paper conduits, commercial mortgage backed securitizations, municipal bond repackagings and open-market CLOs, which are discussed in greater detail in the next paragraph.

An "open-market" CLO is one which holds senior secured syndicated loans, 50% or more of which must be acquired from sellers in the open market, and not originated by an affiliate of the CLO. These CLOs can meet the overall 5% retention requirement if the lead arranger of each underlying syndicated loan retains at origination at least 5% of the face amount of the loan tranche bought by the CLO (the **"CLO-eligible tranche"**). However, to qualify, the lead arranger who retains must also hold, at initial allocation, at least 20% of the wider syndicated credit facility, and no other lender can hold more than 20%. Voting and other rights of the CLO-eligible tranche must also be on a par with the rights of holders of the rest of the credit facility.

Other requirements which apply to this additional option are that the CLO doesn't hold any assets other than CLO-eligible tranches, doesn't invest in ABS or credit derivatives (other than permitted hedges), and all asset purchases by the CLO are made in the open market.

Additional disclosure requirements apply if this retention option is being used, including disclosure of the underlying obligor for each asset.

Under the wider risk retention rule, the retained portion cannot be transferred nor can the risk relating to it be hedged. The new proposal introduces a "sunset" provision which allows certain hedging or disposal when unpaid principal falls below 33% of the original amount, however the 5% retained portion of CLO-eligible tranches must generally be held until maturity or repayment of the tranche, which may limit the benefit of the sunset clause for CLOs.

The rules are not yet final and when finalised do not apply for two years. There is no look-back in respect of transactions entered into prior to the effective date of the rules.

Commodity Pool Regulation – Dodd Frank Act/Commodity Exchange Act

Requires a "commodity pool" operator (**"CPO"**) to comply with onerous registration, conduct, record-keeping and disclosure (both to investors and the Commodity Futures Trading Commission (**"CFTC"**)) requirements, with serious consequences for breach, including the requirement to make a rescission offer to investors with respect to the securities.

In Force
Technically applies to all outstanding securitisations that meet the definition of "commodity pool", due to the rescission of CFTC Rule 4.13(a)(4) on 29 February 2012.

Securitisation vehicles formed before 12 October 2012, issuing debt securities backed by and paid by proceeds from (cash or synthetic) assets owned by the issuer, and which don't issue further securities after that date, are grandfathered.

Non-exempt securitisation vehicles had to register by 13 March 2013.

Scope
Definition of "commodity pool" has been widened so its effect is now to include a range of pooled investment vehicles that enter into swaps, potentially capturing securitisation vehicles such as CLOs.

Extra-territorial effect – no express exemptions for pools with no U.S. investors, or for non-U.S originators or assets.

"CFTC guidance and evolving market practice have significantly lessened the risk that a securitization could be subject to regulation as a "commodity pool" or require registration of a CPO, provided that swaps are limited to interest rate and currency hedges and certain guidelines are followed."

Effect
The effect of the definition is that securitisation vehicles could potentially be classed as commodity pools and if so, one or more entities "engaged in a business that is of the nature of a commodity pool or similar enterprise and in connection therewith, solicits, accepts, or receives from others, funds, securities, or property for the purpose of trading in commodity interests, including any swaps", including CLO managers would be required to register as the CPO in respect of such commodity pool, and to comply with onerous disclosure and reporting requirements.

Certain securitisation vehicles have been protected by "no-action" letters from the CFTC. These give securitisation vehicles a safe harbour if they meet certain stringent conditions, which are:

- the issuer operates within the conditions set out in SEC Regulation AB or Rule 3a-7 of the Investment Company Act of 1940;
- the issuer's activities are limited to passively owning the pool of receivables or financial assets, which can be fixed or revolving, but must convert to cash within a finite time period; and the issuer uses derivatives only to provide credit enhancement or interest or currency swaps which alter the payment characteristics of the cash flows from the issuer, and not swaps which provide investment exposure. (However, if the credit enhancement provided by swaps is deemed commercially unreasonable, the CFTC may still conclude that a commodity pool exists.);
- the issuer makes payments to security-holders only from cash generated by the pool assets and related rights and not from changes in value of the pool assets (i.e. no synthetics); and
- the issuer is not permitted to acquire additional assets or dispose of assets for the primary purpose of realising gain or minimising loss due to market value of the vehicle's assets.

CLOs which permit up to 20% of the underlying assets to be traded per year, for three years, where the swaps are hedging currency or interest rates and cannot be terminated before the assets are liquidated, are also protected by the "no-action" letters. Initially market participants were concerned that CLOs which did not strictly meet these criteria would fall out of the scope of the no action letter. However, market participants now view these criteria as descriptive rather than mandatory caps. The current view is that if a CLO is only entering into currency and interest note hedges (no synthetics) then it should be able to rely on the "no–action" letters referenced above.

There are limited exemptions in the rules themselves (as opposed to the no-action letters). The main exemption which could apply to securitisation vehicles is the *de minimis* exemption, which would apply if the securities are exempt from registration under the Securities Act of 1933, are not marketed to the public in the U.S. and:

1) the initial margin and premiums required to establish positions in the swaps will not exceed 5% of the liquidation value of the portfolio; or

2) the aggregate net value of the swap positions does not exceed 100% of the liquidation value of the portfolio; and in either case

3) the claimant of the exemption must reasonably believe that each investor belongs to certain classes of investor (largely comprising qualified and expert investors).

"Volcker Rule" (Dodd-Frank Act)

Prevents banking entities from engaging in proprietary trading and acquiring ownership rights in hedge funds and private equity funds.

In Force
Statutory basis for the rule (under Dodd Frank Act) effective July 2012.

Implementing regulation still a proposal. Timing of final rule unclear.

No grandfathering of transactions entered into prior to July 2012, but there is a two year conformance period to bring non-compliant transactions into compliance. It is unclear if the two year conformance period is tolled from the effective date of the regulation, or from the publication date of the final rule. Many market participants believe it is from the July 2012 effective date.

Scope
Applies to "banking entities" – which are generally federally-insured banks and their holding companies, and any entity controlled by them. Non-U.S. banks with a branch in the U.S are also considered banking entities.

Does not apply to non-U.S. banking entities that are not controlled by a U.S. banking entity or certain qualifying foreign banking organisations who conduct proprietary trading or hold interests in funds covered by the rule in either case solely outside the U.S.

Effect
The first limb of the rule prevents banking entities from trading as principal for the bank's own trading account in a range of "covered financial positions" which include all long, short and synthetic positions in securities, derivatives, commodities contracts etc. unless the transaction is an excluded transaction.

Excluded transactions include purchases and sales of government obligations, market-making activity, transactions on behalf of customers, hedging activity, and proprietary trading conducted solely outside the U.S. by entities which are not controlled by U.S. banking entities. However excluded transactions will not be excluded if they result in a conflict of interest with clients or customers, result in material exposure to high-risk assets, or pose a threat to U.S. financial stability.

More relevant to managed CLOs is the second limb of the rule, which prevents banking entities from

acquiring or retaining any interest in or sponsoring any "hedge fund" or "private equity fund", (together "covered funds") subject to certain exceptions.

"Hedge fund" and "private equity fund" are defined widely, by reference to issuers which would be investment companies but are exempt from registration under section 3(c)(1) or 3(c)(7) of the Investment Company Act 1940. This could potentially include CLO issuers which rely on those exemptions (most CLOs rely on 3(c)(7) "qualified purchasers"). Note that "sponsoring" such a fund generally involves the ability to control the decision-making and operational functions of the fund, and is not the same as the meaning of "sponsor" for the purpose of the Dodd-Frank risk retention provisions. It should also be noted that, an issuer that meets the requirements of the 3(c)(1) or 3(c)(7) exemptions, but relies on one or more other exemptions (e.g., 3a-7) would not be treated as a covered fund. However, from a practical perspective, it may be difficult for most managed CLOs to use the 3a-7 exemption.

However an exemption allows U.S. banking entities to hold interests in or sponsor a fund if certain conditions are met. These include a condition that the bank does not hold more than a 3% ownership interest in the fund for longer than a year after the fund's establishment (a "de minimis" interest). There is also a separate exemption which allows a holding of greater than 3% in order to comply with the 5% risk retention requirement under the Dodd-Frank Act. However, holdings of interests in excess of 3% in order to comply with retention requirements imposed by regulators outside the U.S. are not explicitly exempted.

The rule also prohibits a banking entity from entering certain transactions (set out in section 23A of the Federal Reserve Act, and which include derivatives) with a covered fund which it owns, sponsors, advises or manages. As a result, a U.S. banking entity may not be able to provide interest rate and currency swaps to a CLO which it sponsors or in which it holds a de minimis interest. This provision is known as "Super 23A".

SEC Rule 17G-5

Requires disclosure of information provided to rating agencies in respect of rated asset-backed securities.

In Force
From 2 June 2010, but transactions with a non-U.S. issuer, where securities are issued only to non-U.S. persons, are currently excluded until 2 December 2013.

Scope
Applies to both U.S. and non-U.S. issuers even if the rated securities are sold entirely outside the U.S. if rated by a "nationally recognised statistical rating organization" (an **"NRSRO"**). As mentioned above, where a non-U.S. issuer issues only to non-U.S persons, there is an exclusion currently in place until 2 December 2013. However this exclusion will not apply where there securities are for instance placed under Rule 144A or Regulation D , as is the case with many European CLOs.

"SEC Rule 17g-5 imposes new requirements for communications and relations between securitizers and rating agencies, and increases the likelihood of a deal attracting an unsolicited rating."

Effect
Rule 17g-5 requires one of the issuer, sponsor or underwriter (each an **"Arranger"**) of asset-backed securities (such as notes issued by a CLO) where the Arranger has paid a NRSRO to issue and/or maintain credit ratings on such securities to establish and maintain a password-protected website containing all information provided to an NRSRO in connection with the rating, including information provided orally and discussions and negotiations with the NRSRO and its counsel relating to applicable transaction documents. Such information will be accessible to other NRSROs which were not hired to rate the securities, but will not be accessible by the general public. These provisions are designed to allow an NRSRO that is not hired by the Arranger to initially determine and subsequently maintain a credit rating for a structured finance product.

Which party will be the Arranger should be determined up front in the engagement letter, and that party should be required to sign the NRSRO engagement letters. If the Arranger does not comply with its undertakings to such NRSROs with respect to a given transaction, such NRSROs may withdraw their ratings of any transaction of the Arranger. In addition, if the

Arranger has acted as Arranger of one or more other transactions, and does not comply with its undertakings to any NRSRO with respect to any such transaction, such NRSRO may withdraw its ratings of securities issued in all such transactions.

It is recommended that a risk factor concerning Rule 17g-5 be included in the offering circular or private placement memorandum relating to structured finance products.

The CLO issuer should always execute a raging agency engagement letter specifying, among other things, the party that will act as the Arranger with respect to the CLO. This will ensure the underwriter or CLO manager is not the Arranger and thus is not at risk of having the ratings of its transactions withdrawn for non-compliance with Rule 17g-5. All communication to rating agencies should go through the Arranger until closing. An information agent will normally be appointed in the investment management agreement. Commencing on the issue date of the CLO, the information agent will be responsible for posting all relevant information it receives onto the website. The transaction parties should agree to provide relevant information to the information agent for posting on the website.

SEC'S Rules on Disclosure for Asset-Backed Transactions

Various additional rules apply besides Rule 17G-5 – there are very brief summaries below.

In Force
Rules are final and in force.

Scope
Scope differs for each rule.

Effect

1) Rule 15Ga-1 requires securitizers to disclose information about repurchase requests relating to assets which breach representations and warranties in the underlying agreements. Information must be filed quarterly unless there are no such requests in which case the obligation to file can be deferred. Information on repurchase requests in the last three years relating to assets securitised by the same sponsor in other securitisation transactions must be included in prospectuses.

2) Rule 17g-7 requires "Nationally Recognized Statistical Rating Organizations" or "NRSOs" to include in any rating report for ABS a description of the representations, warranties and enforcement mechanisms for the rated securities and how they differ from those in similar securitisations.

3) Rule 193 requires ABS issuers in a registered public offering to perform due diligence reviews of the underlying assets, to ensure that the disclosure on the pool is accurate. Applies to the issuer or the sponsor of the securitisation, but the documentation must state which entity has been responsible for the review.

Rating Agencies will prepare 17g-7 reports.

U.S. Clearing Requirements – Dodd-Frank Act

Sets out requirements for reporting and clearing of OTC derivatives through central counterparties, and related collateral exchange requirements. The Dodd-Frank Act makes it unlawful to engage in any swap that the CFTC requires to be cleared, unless it is submitted to a registered clearing organisation for clearing.

In Force
Clearing provisions become effective in stages. The CFTC subjects classes of swaps to mandatory clearing by describing them in a clearing determination. To date, there has been only one final clearing determination (28 November 2012).

Once a final clearing determination has been issued and published in the Federal Register, the relevant swap types are subject to mandatory clearing on a phased-in timeline based on the type of entity involved. "Category 1 Entities" (swap dealers and major swap participants), 90 days after publication; "Category 2 Entities" (commodity pools and most funds), 180 days after publication; and "Category 3 Entities" (all other entities), 270 days after publication.

Scope
Mandatory clearing and reporting obligations will generally apply to all persons entering into swap transactions, with a narrowly-tailored exemption for "non-financial end users". It is unlikely that a CLO or other securitisation will be able to satisfy the requirements of this exemption, as the definition of "financial entity" is extremely broad and will likely pick up most securitisation vehicles. However, is should be noted that the bulk of clearing obligations (reporting requirements, etc.) will generally fall on the swap dealer party to the swap, rather than the counterparty.

Generally applicable to any swap transaction that involves a "U.S. Person", which would include swaps entered into with a branch or agency of a U.S. Person, or where a counterparty's obligations are guaranteed by a U.S. Person.

To date, the only swaps subject to mandatory clearing are interest rate swaps in USD, EUR, EUR or JPY, and specified untranched index swaps on specified CDX and iTraxx indices.

"U.S. mandatory clearing requirements are slowly coming into effect, with only interest rate and currency swaps, and CDS on certain specified index transactions currently being subject to mandatory clearing."

Effect
There are no exemptions that would generally exempt securitisation entities such as CLOs from applicable mandatory clearing requirements and, therefore, swaps in a CLO or other similar securitisation, if designated by the CFTC, would be required to be cleared. In such event, the issuer would be required to enter into clearing documentation with one or more members of a clearing house, including a Client Agreement, Cleared Derivatives Addendum and Execution Agreement. Pursuant to such documentation, the issuer would be required to initial and variation margin as required by the applicable clearing house and clearing member on a "legally segregated, operationally commingled" basis.

Due to the recent phase-in of the only final clearing determination issued by the CFTC to date, it is presently unclear as to how CLO managers will generally be dealing with this issue.

Contacts

David Quirolo
Partner, London
T: +44 (0)20 7859 2955
E: david.quirolo@ashurst.com

Michael Smith
Partner, London
T: +44 (0)20 7859 1421
E: michael.smith@ashurst.com

James Perry
Partner, London
T: +44 (0)20 7859 1214
E: james.perry@ashurst.com

Anne Tanney
Counsel, Professional Development
T: +44 (0)20 7859 2004
E: anne.tanney@ashurst.com

Claire Puddicombe
Senior Associate, London
T: +44 (0)20 7859 3084
E: claire.puddicombe@ashurst.com

William Gray
Partner, New York
T: +1 212 205 7010
E: william.gray@ashurst.com

Scott Faga
Partner, Washington DC
T: +1 202 912 8001
E: scott.faga@ashurst.com

Eugene Ferrer
Partner, New York
T: +1 212 205 7048
E: eugene.ferrer@ashurst.com

Patrick Quill
Partner, New York
T: +1 212 205 7011
E: patrick.quill@ashurst.com

David Nirenberg
Partner, New York
T: +1 212 205 7007
E: david.nirenberg@ashurst.com

Steven Kopp
Partner, New York
T: +1 212 205 7070
E: steven.kopp@ashurst.com

Michael Miran
Counsel, New York
T: +1 212 205 7038
E: michael.miran@ashurst.com

Sharon Kim
Counsel, Washington DC
T: +1 212 205 7021
E: sharon.kim @ashurst.com

Nicole Skalla
Senior Associate, New York
T: +1 212 205 7028
E: Nicole.skalla@ashurst.com

This publication is not intended to be a comprehensive review of all developments in the law and practice, or to cover all aspects of those referred to. Readers should take legal advice before applying the information contained in this publication to specific issues or transactions. For more information please contact us at Broadwalk House, 5 Appold Street, London EC2A 2HA T: +44 (0)20 7638 1111 F: +44 (0)20 7638 1112, Times Square Tower, 7 Times Square, New York, NY 10036 T: +1 212 205 7000 F: +1 212 205 7020; 1875 K Street NW, Washington, DC 20006 T: +1 202 912 8000 F: +1 202 912 8050 www.ashurst.com.

Attorney advertising; prior results do not guarantee a similar outcome.

Ashurst LLP and its affiliates operate under the name Ashurst. Ashurst LLP is a limited liability partnership registered in England and Wales under number OC330252. It is a law firm authorised and regulated by the Solicitors Regulation Authority of England and Wales under number 468653. The term "partner" is used to refer to a member of Ashurst LLP or to an employee or consultant with equivalent standing and qualifications or to an individual with equivalent status in one of Ashurst LLP's affiliates. Further details about Ashurst can be found at www.ashurst.com.
© Ashurst LLP 2013 Ref: 30596155 13 September 2013