Article

CLOs: Ongoing Battle with Regulatory Scrutiny

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As the CLO market continues to thrive this year in both the EU and US lawmakers and regulators continue to express concern over systemic risk within CLOs. From the SEC Enforcement Actions and the introduction of FATCA over the earlier part of the last decade, right through to the impact of 2018's key regulatory initiatives, MIFID II and the European Securitisation Regulation, it is clear that doubts persist in the minds of regulators who continue to pursue increased oversight of CLOs as a product.

Increased Incremental Regulation

As the grip of regulators has gotten tighter over the last number of years, the special purpose vehicles ("SPV") used by issuers and more particularly the directors of those same entities have been burdened with a far broader scope of responsibility than was once the case. Their role can no longer be described as passive, as exposure to a more substantial degree of risk is the result of the ongoing layering of CLO regulation. We describe this gradual and incremental burdening of the SPV itself and the CLO industry more generally in detail below, showing just how focused regulatory activity in this area has been over the years and continues to be.

Market participants would agree that fears CLOs should have better tabs kept on them persist as a consequence of legacy associations with lesser performing and fundamentally differing asset classes during the financial crisis, when in fact and as per the below, the CLO industry is currently subject to more than its fair share of oversight.

Re-emergence of SEC Monitoring (2012)

Whilst the SEC has always had an interest in the CLO market post crisis and has previously taken enforcement actions around inadequate, inaccurate or misleading disclosure of information to investors, the nature of these types of cases were that they were generally fact specific "action and consequence" scenarios. Forbes reported in May of this year that the SEC has a renewed focus on the CLO space, to the extent that they have asked staff to focus on two issues:

1. whether a downturn in the CLO market could have systemic or other spill-over effects in the capital markets sphere generally or any other undetected potential effects; and
2. whether CLOs are structured in such a way that downgrades in the ratings of the securities could potentially trigger substantial selling into below investment grade markets that historically have less liquidity.

The above described transition from fact specific enforcement to a more holistic monitoring of the market generally is illustrative of how the regularity framework of CLOs has shifted to a prevention approach rather than cure.

FATCA is alive and well (2010)

Despite initially being earmarked as a catastrophe of sorts for the CLO market before its enactment, the evolution of FATCA continues. It is now well and truly established in the CLO sphere and the CLO market as it so often does when it comes to regulatory matters has absorbed the hit and adapted accordingly. This adjustment was felt particularly at issuer level whereby significant expertise was required to action the legislation and increased resources were warranted for the new reporting infrastructure that needed to be implemented. Notwithstanding FATCA has been around a while, it is still very much a present issue for those who fall within its scope. The Wall Street Journal reported in Q4 of 2018 that the first US conviction under FATCA had been secured in respect of non-compliance with the legislation and served as a timely reminder to issuers of its importance in case one was needed.

Risk Retention turns Japanese (2019)

The US CLO market caught a break in Q1 2018 and cheered the LSTA's success in securing a verdict that ended open market CLO compliance with the US Risk Retention Rules. Whilst 2016s Dodd Frank Act that originally implemented the risk retention measures necessitated increased expertise at issuer level to effectively monitor ongoing compliance, the feared "barrier to entry" for new managers wanting to enter the market never really emerged as a significant threat to the market. Just as the dust was settling on the triumph of the LSTA case last year, the Japanese Financial Services Agency ("JFSA") who was becoming increasingly concerned with Japanese investor exposure to CLOs decided to act. One specific Japanese bank that as of April 2019 was thought to hold US$61 billion of CLOs was seen by the JFSA as being particularly exposed to a downturn in the leveraged loan market. Whilst this latest intervention presents an unwanted hurdle for Japanese anchor investors, the general consensus seems to be that this intervention will not present any insuperable obstacles to their ongoing participation in the industry. As of July 2019, Bloomberg reports that the largest Japanese buyer of CLOs has re-entered the market after a brief pause to allow for the increased regulatory scrutiny. The above serves as an interesting example of where cross-border regulation can enter the fray and impact the market.

When is a Loan not a Loan? Pending litigation and Volcker Interpretation

At the time of writing a group is suing a number of Wall Street banks in a case that has the claimants urging the court to classify their loan as a "security" for the purposes of their suit. The loan transaction that went awry is an aside to the key point at issue, that the claim of securities fraud cannot apply to a loan as a loan is not a security. If a court decided that leveraged loans can in fact be considered securities, there would be massive fallout in the CLO market. Restrictions under the Volcker Rule introduced in 2013 prevented banks from investing in CLOs that own securities. If leveraged loans could be classified as securities, approximately US$90 billion of bank holdings in CLOs would need to be sold off owing to Volcker. Whilst the extent of Volcker's applicability to CLOs is well settled at this point, if the above mentioned lawsuit was successful in its attempt to expand the scope of a "security", the consequences would be significant. It serves as a clear example of the constant regulatory flux of the CLO marketplace with respect to new challenges that can arise even in the context of rules that have been long-implemented.

Standardisation on a global scale, CRS further increases Issuer burden (2016)

The introduction of a global automatic exchange of information between CRS signatory jurisdictions resulted in SPVs assuming much more onerous information sharing obligations. Issuers responded by taking the steps necessary to ensure there was an adequate level of expertise available to apply the legislation, such measures including (i) the introduction of policies and procedures and (ii) the allocation of extra resources towards the objective of CRS compliance. The Cayman Islands required the increased standards be met by 1 January 2016. The increased administrative burden on SPVs was in this instance a significant one.

Market Abuse in Europe ("MAR") comes with a silver lining for the Cayman Islands Stock Exchange ("CSX") (2017)

As of 2017, a number of compliance steps were imposed on issuers in instances where investor preference was to list on the Irish stock exchange. The necessity of producing various lists, policies and procedures in respect of different elements of "inside information" and the inclusion of anyone who could potentially access same caused a degree of concern amongst managers. Although not directly responsible themselves, there was a market wide consensus that the ongoing maintenance of MAR related administration and adherence to MAR related policies would place another significant burden on the administrator providing services to the CLO issuer. This opened up the path for market participants to consider the Cayman Islands as a listing alternative given that (a) it does not fall within the scope of MAR; (b) it is a "recognised stock exchange" for withholding tax purposes; and (c) from an investor comfort standpoint, it is considered one of the leading international specialist exchanges. The CSX consequently benefited by way of an uptick in CLO listings and continues to do so in light of the increasingly regulated European framework. Our view is that as the Cayman Islands continues to build on its already strong regulatory reputation, and with legislative initiatives such as Economic Substance and revised Data Protection rules, investors will become more and more comfortable with accepting listings on the CSX.

The devil is in the detail – Issuers attention required for changes to Agreed upon Procedures process (2017)

In 2017, an overhaul to the agreed upon procedures process meant issuers were required to provide representations as to deal specifics such as effective dates, cash flow and quarterly reports. Given the pace that CLO transactions often operate at, these representations are often required in time sensitive circumstances and with that in mind it became very important that the right expertise was in place at issuer level so as to ensure that only accurate representations were provided in this regard. At this point we can really see how slowly but surely the issuer has been very much brought from the background to the foreground as an active (and often necessarily pro-active) participant in the administration of the CLO.

Know Your CLO – KYC and AML updates in the Cayman Islands require increased vigilance from the Issuer (2018)

Ongoing changes to AML legislation and KYC processes means there are more intensive administrative burdens placed on issuers as they need to be able to (i) respond to increased KYC requests, (ii) create proper procedures and standards for implementation over the life of the transaction, (iii) appoint AML officers to maintain oversight over possible risk areas and (iv) appropriately action any related risk mitigation steps that may be necessary. The global movement to put a squeeze on terrorist financing has created a sense of urgency throughout the financial system as a whole, and CLOs as a product are not untouched by these regulatory ambitions.

There are only two certainties in law – data protection and taxes – BEPS and Data Protection updates loiter with intent

BEPS completes the triple threat of tax compliance as it looms in the distance, albeit shrouded in uncertainty. Stemming from a G20 initiative, it aims to reform the international corporate tax system, particularly where entities may have significant revenue streams but no physical presence in certain countries. Under current rules they would escape taxation in these jurisdictions, but the proposed solutions envisage a major change to taxing rights by allocating some of a company's profits to jurisdictions where its consumers or users are based. We do note that this initiative seems to be particularly focused on how digital companies are taxed and so exactly how it would impact the capital markets sphere remains to be seen.

Furthermore, the Cayman Islands welcomes the *Data Protection Law, 2019* expected to be effective as of September 2019. Based on well-established existing data protection principles and drafted with the recent European General Data Protection Regulation very much in mind, we anticipate a number of consequential responsibilities to be bestowed on the SPV as a result, e.g. directors being designated as "data controllers", existence of a responsibility to dispose of certain data within required timeframes etc.

Europe grapples with structural reform, whilst Cayman ponders applicability and scope – MIFID sweeps through the EU (2018)

Given that the Cayman Islands is not part of the EU, MiFID II is not directly impacting Cayman Islands SPVs. The directive is however very expansive and has had some extra-territorial effect on non-European entities dealing in the EU, which in the case of CLOs is US based collateral managers. Many US managers operate in both the European and US markets and have had to comply when their CLOs are being offered to European investors. The new rules were significant and fuelled significant debate as to their interpretation in Q1 and Q2 of 2018. Reporting, product governance and LEI registration are to name but a few of the ways in which the structured products market in Europe was impacted

The impact of the Cayman Islands Economic Substance ("ES") regime on CLOs (2019)

As offshore territories respond to concerns of the EU as to the absence of ES requirements for entities carrying on business through these jurisdictions, the *Cayman Islands International Tax Co-operation* (*Economic Substance*) *Law, 2018* and *The International Tax Co-Operation* (*Economic Substance*) *Regulations, 2018* came into force on 1 January 2019. As it stands it seems unlikely that CLO SPVs incorporated in Cayman will fall within the scope of ES (based on current guidance as to what activities constitute a "relevant entity" for the purpose of the ES legislation) and thus the hope is that SPVs are not impacted. We do note however that there are still a lot of unknowns when it comes to ES and its application more generally. If nothing else there will be at least one additional burden on SPVs as of January 2020 when <u>all entities</u> (which will include the CLO SPVs) registered or formed in the Cayman Islands will be required to include a statement in its annual return with the Registrar of Companies confirming as to whether or not they are carrying on a "relevant activity" that brings them within the scope of ES.

Reasons for Optimism

Concerns about the ballooning market for leveraged loans, a perceived deterioration of underwriting standards and 80% of the leveraged loan pool being categorised as "covenant-lite" has naturally given global regulators reason to express their concerns about CLO exposures. Whilst these concerns have been circulating for the last couple of years (and have not seemed to have impacted either deal volume or returns) there is some recent evidence that some of these fears may be overstated. The Bank of England issued its 2019 July Financial Stability Report and whilst remaining coy on the overall risk of CLO exposures, they reported that investors holding investment grade CLO paper would not suffer losses in a market stressed to the same extent as the last financial crisis. In fact it estimates that it would take a loss rate more than twice as severe as the last financial crisis for Triple A tranches to incur losses.

All of the above paints a picture of how CLOs have consistently waded through the muddy regulatory waters and adapted admirably with respect to both the ever expanding role of the SPV and the related market challenges arising from the incremental layering of regulation over CLOs as a product.

The latter half of 2019 predicts a number of resets and refinancings with the possibility of some investors pulling back from the new issue market for the time being, but there is nothing to suggest anything other than the normal cyclical levels of deal flow between now and the end of the year.

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