Collateralized loan obligations
Accounting. Tax. Regulatory.

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Dear Clients and Friends,

Since the inception of the collateralized loan obligation (CLO) market, this product has provided fixed-income investors with competitive yields, achieved through a highly diversified pool of low-defaulting assets. After some troublesome years faced by investors, the CLO market continues to meet or exceed annual issuance forecasts, all while adapting to a new and highly regulated environment.

With the broadening of the CLO investor base and a continued emergence of new CLO asset managers amongst a tenured competitor base, it is important for such CLO market participants to understand various implications from their participation in the CLO market.

The purpose of this CLO booklet is to provide an overview of the CLO market, its participants, and their roles, as well as discuss the accounting, tax, and regulatory rules and laws impacting their investment and role.

Deloitte[1] is proud of its legacy in the securitization and CLO market and is appreciative of the opportunities provided to participate in different roles over the CLO life cycle.

We look forward to continuing and building upon our CLO relationships and are available to discuss any of these or other topics that are of interest with you.

We hope you find it useful.

Best Regards,

Nathan Abegg
Director
Deloitte & Touche LLP

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CLO overview

The CLO market continues to build upon its post-downturn momentum with year-end forecasts expected to exceed over $100 billion in CLO new issuance, which demands over half of the domestic leveraged loan issuance.

New CLO asset managers continue to enter into the market with a continued investor demand and expanding base. Meanwhile, regulation continues to impact the leverage loan and CLO markets and their participants; the markets have been resilient in adapting to regulatory oversight and rules to date. However, the final risk-retention rules provide a steep hurdle for the CLO market, but with a two-year effective date, the market should be able to assess, adapt, and incorporate the new rules into industry.

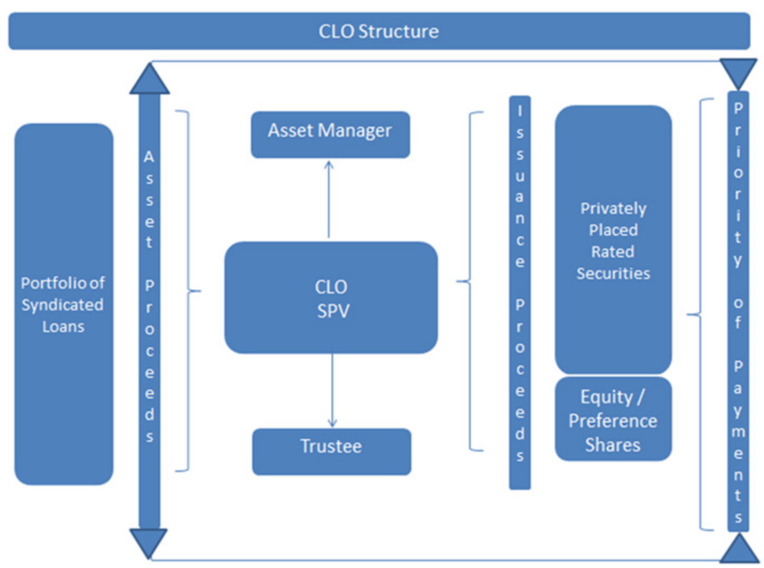
The purpose of this booklet is to provide an overview of a CLO, its market participants, and roles and examine tax, accounting, and regulatory implications to asset managers and investors.

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 to ensure 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, ensuring 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 ensure 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 every subsequent balance sheet, 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[2].

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

[2] 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.

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 has 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 [3] 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[4] 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.

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.

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[3] This present value calculation would be based on the yield currently being used by the investor to recognize interest income on the security.

[4] Section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act.

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 continues to redeliberate its long-anticipated proposed changes to financial instrument impairment. These changes, more commonly referred to as current expected credit losses (CECL), could 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 would be excluded from the model's scope and would 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).
- 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 would 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).

Consolidation

What accounting guidance applies?

For companies applying US GAAP, the consolidation guidance is included in ASC 810, *Consolidation*—in particular, the variable-interest entity (VIE) subsections, otherwise formerly known as Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* ("Statement 167"). Not all special-purpose entities (SPEs) are VIEs, but generally, all CLOs are VIEs. A VIE does not usually issue equity instruments with voting rights (or other interests with similar rights) with the power to direct the activities of the entity, and often the total equity investment at risk is not sufficient to permit the entity to finance its activities without additional forms of credit enhancement or other financial support. If an entity does not issue voting or similar interests, or if the equity investment is insufficient, the decision-making ability is typically determined contractually. Because CLOs are rarely designed to have a voting equity class possessing the power to direct the activities of the entity, they are generally VIEs. The investments or other interests that will absorb portions of a VIE's expected losses or receive portions of its expected residual returns are called variable interests.

After the issuance of Statement 167 in 2009, the FASB deferred the amended consolidation model for certain investment funds—choosing to retain, for these entities, the prior risk and rewards consolidation model, commonly known as FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities* ("FIN 46R"). However, securitization entities and asset-backed financing entities, such as CLOs, were specifically excluded from the scope of the deferral and, therefore, apply the hybrid consolidation model discussed further in this chapter.

Determining who must consolidate the CLO

The first step in determining who should consolidate the CLO is, logically enough, identifying all the parties to the deal and identifying which ones have a variable interest. While there is no requirement for the transaction parties to compare their accounting conclusions (but, theoretically, only one reporting entity should conclude that it controls), each participant needs to understand the various rights and obligations granted to each party in order to conclude as to its own accounting for its interest in the issuer.

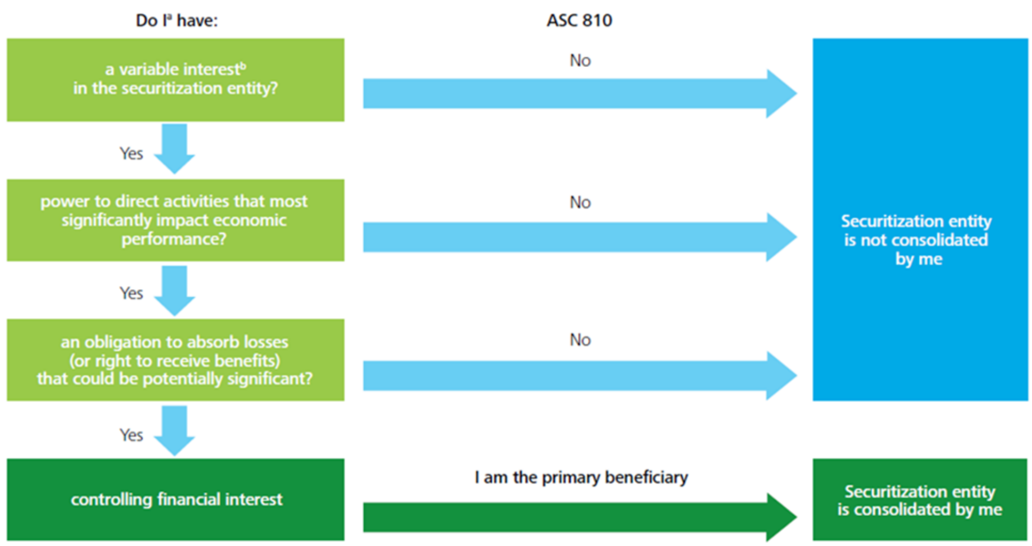
ASC 810 requires identifying "the primary beneficiary," which is the party that has a "controlling financial interest" because it has both (1) the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and (2) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Only one reporting entity is expected to control a CLO. Although several deal participants could have variable interests, typically only one would have the power to direct the activities that most significantly impact the entity's economic performance. Further elaboration on interpreting what it takes to have variable interests that are potentially significant under US GAAP is provided later in this chapter.

The consolidation framework requires consideration of involvements of related parties, or de facto agents, in the consolidation assessment. In short, ASC 810 provides a list of four indicators that must be considered when identifying the existence of a de facto agency relationship. While the nature of the indicators may differ (e.g., transfer restrictions over another party's variable interests or one party financing another party's involvement with a VIE), the intention of the indicators is to identify when one party may be indirectly expanding its interests through another variable-interest holder. When no single party has both the power over the relevant activities and a potentially significant economic interest, but members of a related-party group, as a whole, would meet both of those criteria, then an assessment is performed to determine which party within the related-party group is considered most closely associated with the entity and, therefore, should consolidate. ASC 810 provides the following four criteria to consider in making 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 entity to the various parties within the related-party group
- A party's exposure to the expected losses of the entity
- The design of the entity

US GAAP consolidation decision tree



Note (a): In addition to their own activities and variable interests, reporting entities must also consider the activities and variable interests of both related parties and those parties deemed "de facto agents" in ASC 810.

Note (b): Some servicing fee and decision-making arrangements may not constitute a variable interest in a VIE.

Consolidation is an all-or-nothing proposition. If a CLO must be consolidated, all of its assets and liabilities (to third parties) are included in the consolidated balance sheet of the party that consolidates, and not just their proportionate ownership share. Accounting equity in a consolidated securitization entity held by a third-party investor is generally shown as a noncontrolling interest in the consolidated financial statements. However, SEC filers should be aware that, on the basis of informal discussions with the SEC staff, we understand that the staff would object to the classification of the noncontrolling equity interest in the consolidated entity's balance sheet in instances where an asset-backed financing subsidiary that is not considered a business was created simply to issue beneficial interests in financial assets. Instead, the SEC staff believes that those beneficial interests should be classified as liabilities in the consolidated financial statements of the parent entity regardless of their legal form. [5]

It is important to remember that all intercompany transactions have to be eliminated in consolidation, such as servicing or other fee arrangements between the CLO and the reporting entity that consolidates.

Step 1: Power—identifying the most important activities

In securitizations, the economic performance of the entity is generally most significantly impacted by the performance of the underlying assets. However, in structures like CLOs, management of liabilities will also significantly impact the performance of the entity, but generally not most significantly. Some of the factors that might impact the performance of the underlying assets might be beyond the direct control of any of the parties to the CLOs (like voluntary prepayments) and, therefore, do not enter into the power analysis. The activity that most significantly impacts the performance of the underlying assets in a CLO is typically the management by the collateral manager in selecting, monitoring, and disposing of collateral assets.

When analyzing who has the power to direct those activities, questions that have to be answered include:

- Do I hold the power unilaterally?
- Or 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 CLO? 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 me to take certain actions?
  - Is there another party that can replace me without cause?
  - Is there another party or other parties that direct the same activities as me, but with a different portion of the CLO's assets?
- Is my right to exercise power currently available or contingent on some other event(s) occurring?

When might a collateral manager not have power?

Situation	See related guidance topic below
The manager can be replaced without cause by a single unrelated party.	Kick-out rights
All important manager decisions require the consent of one or more unrelated parties.	Participating rights and shared power
The manager manages less than a majority of the assets in the VIE.	Multiple parties having power

[5] The SEC staff also discussed this issue at the 2009 AICPA Conference on Current SEC and PCAOB Developments in a speech by Brian W. Fields, a Professional Accounting Fellow in the SEC's Office of the Chief Accountant.

Kick-out rights

Although not common for CLOs, substantive kick-out rights (i.e., those that can be exercised at will and not upon a contingent event) held by a single party result in the party performing the relevant activities not having power because it could be removed from that role at the whim of the party holding the removal right. A kick-out right would generally be considered substantive if there are no significant barriers to the exercise. Barriers to exercise include, but are not limited to:

- Conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise.
- Lack of a mechanism for the holder to exercise its kick-out right. For example, the right can be exercised only at an investor meeting, but meetings cannot be initiated by the holder.
- Financial penalties or operational barriers associated with replacing the decision-maker that would act as a significant disincentive for removal.
- The absence of an adequate number of qualified replacement decision-makers or inadequate compensation to attract a qualified replacement.

Participating rights and shared power

Under US GAAP, participating rights are the ability to block actions through which a reporting entity exercises the power to direct the activities of an entity that most significantly impact the entity's economic performance, whereas protective rights are rights designed to protect the interests of the party holding those rights without providing that party with the ability to control directly or to share control.

So what does that mean? If a single participant can veto all important decisions made by the collateral manager, that right, if considered substantive, might cause the collateral manager to not have the "power" and power would be shared between the collateral manager and the participant holding the veto right. If, in addition to being able to veto collateral manager's decisions, a single participant could direct the collateral manager on what actions are needed to manage the assets, the consolidation burden might shift to that single participant. It is unusual in a CLO for any single participant to have the ability to block the collateral manager actions.

The requirement to obtain consent is considered a substantive participating right when the consent is required for all of the activities that most significantly impact the entity's economic performance. When the consent relates only to activities that are unimportant or only to certain of the significant activities, the consent might be considered a protective right; however, power would not be considered shared. In addition, a reporting entity would need to closely analyze the governance provisions of an entity to understand whether the consent requirements are substantive (e.g., the consequences if consent were not given).

Multiple parties having power

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

- Multiple parties performing different activities. It is possible that in certain CLOs, one service provider might be engaged to perform asset management and another service provider to perform funding management. In those situations, one must determine which activity most significantly affects the economic performance of the entity. Judgment will be required based on an analysis of all of the facts and circumstances.
- Multiple parties performing the same activities. If multiple unrelated parties must jointly consent over decisions related to directing the relevant activities of an entity, power is shared and no party would consolidate. However, when multiple parties individually perform

the same activities over separate pools of assets, the party that would consolidate would be the party that has unilateral decision-making over a majority of the assets.

Step 2: Variable interests in an entity

The second step in the consolidation assessment requires consideration of whether a reporting entity is exposed to variable returns, which can include either upside benefit (a performance fee), downside risk (a guarantee), or both (a debt or equity investment). US GAAP simply looks at whether the variable returns absorbed by the reporting entity have the potential to be significant relative to the economic performance of the VIE being evaluated for consolidation. In other words, if the collateral manager (or other party that has the power to direct as determined by Step 1 above) holds a variable interest in the CLO and that variable interest could be more than insignificant under any potential scenario, this second step would be met. However, it is important to note that the FASB provided a list of criteria to consider in determining whether a fee received by a service provider represents a variable interest in an entity.

Fees paid to decision-makers or service providers

It is possible for a servicer or other decision-maker to have the power to direct the activities that most significantly impact the economic performance of a CLO, but without the servicer or decision-maker having a variable interest in the entity. If an asset manager (including consideration of related-party interests) can meet all of the following six conditions, then the arrangement would not be considered a variable interest and the manager would not consolidate. The objective of the tests is to determine whether the service provider is acting in a fiduciary (agency) role as opposed to acting as a principal. If, as is often the case, the collateral manager also owns some of the securities issued by the CLO, it is likely that the collateral manager has a variable interest. The conditions (formerly known as the “B22” criteria) are:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- 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.
- The decision-maker or service provider does not hold other interests in the securitization 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.
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.
- The total amounts of anticipated fees are insignificant relative to the total amount of the entity’s anticipated economic performance.
- The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity’s anticipated economic performance.

If the fees paid to decision-makers or service providers do not meet all of the conditions above (for example, a collateral manager frequently receives a subordinated and/or incentive fee that would not meet criterion b), then those fees are variable interests and the decision-maker or service provider would proceed to the next steps in the ASC 810 consolidation decision tree presented earlier in this chapter. The decision-maker must also determine whether that variable interest is a variable interest in the CLO as a whole, or whether it relates to particular specified assets of the entity. If the variable interest relates to specified assets representing more than half of the total fair value of all of the assets within the CLO, or if the decision-maker holds another variable interest in the entity as a whole, then it would be deemed to be a variable interest in the CLO and the decision-maker or service provider would proceed to the next steps in the same decision tree referenced above.

As a general guideline, we believe that if the variability absorbed through the fee arrangement or other variable interests in the CLO exceeds, either individually or in the aggregate, 10% of the expected losses or expected residual returns of the entity, the conditions in items (c) and (f) above are not met and the decision-maker or service provider fee would therefore be considered a variable interest. The same general guideline can be applied to the evaluation under item (e) above of the total amount of anticipated fees to be received by a decision-maker or service provider compared to the total anticipated economic performance of the securitization entity. However, 10% should not be viewed as a bright-line or safe-harbor definition of “insignificant.”

The analysis performed under items (c), (e), and (f) deal with the expected (or anticipated) outcomes of the entity. Therefore, when analyzing an asset manager fee under these paragraphs, a reporting entity would identify and weigh the probability of the various possible outcomes in determining the expected losses, expected residual returns, and anticipated economic performance of the entity. However, it is not expected that a reporting entity will always need to prepare a detailed quantitative analysis to reach a conclusion as to insignificance.

If a reporting entity determines that a fee paid to an asset manager is a variable interest after considering the conditions above, the asset manager’s interest will usually represent an obligation to absorb losses of the entity or a right to receive benefits from the entity that could potentially be significant to the entity.

Potentially significant variable interest

There may be situations in which a party with a variable interest will not have a right to receive benefits or the obligation to absorb losses of the CLO that could potentially be significant to the CLO. For example, an asset manager’s right to receive a fixed fee may represent a variable interest (because one of the B22 criteria previously discussed were not met), but that variable interest will not always represent a benefit or obligation that could potentially be significant to the entity. While not included in the ASC, this was discussed in the Basis for Conclusions when Statement 167 was issued, which noted that “the servicer may be able to conclude, on the basis of the magnitude of the fixed percentage, that the fee could not ever potentially be significant to the entity because the fee would remain a constant percentage of the entity’s assets.” On the other hand, a fee that was considered insignificant under the criteria discussed above regarding fees paid to service providers and the implicit probability notion might be considered potentially significant, as further discussed below.

The VIE subsection of ASC 810 does not define “economic performance,” but it does indicate that a reporting entity must assess the entity’s purpose and design when evaluating the power to direct the activities of the entity. This assessment includes a consideration of all risks and associated variability that are absorbed by any of the entity’s variable-interest holders. However, the quantitative calculations of expected losses and expected residual returns are not required. A reporting entity should not consider probability when determining whether it has a variable interest that could be potentially significant. Therefore, even a remote possibility (as long as the scenario is consistent with the design of the entity) that a reporting entity could absorb losses or receive benefits that could be significant to the entity causes the reporting entity to meet such condition.

A relatively small first-loss piece might not have the potential to absorb a significant amount of losses, but might have the potential to receive significant benefits. On the other hand, a large senior class might not have the potential to receive significant benefits because the interest is capped, but has the potential to absorb more losses than the smaller subordinated classes.

Reconsideration of who controls

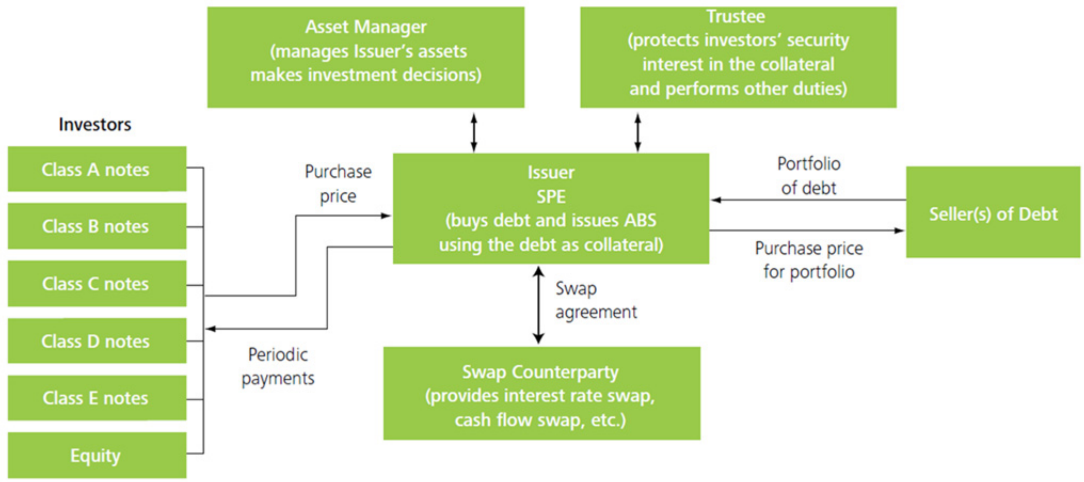
The VIE guidance in ASC 810 requires that a reporting entity continually reconsider its conclusion regarding which interest holder is the entity's primary beneficiary. A change in the determination of whether a reporting entity is required to consolidate could occur as a result of any of the following events or circumstances:

- There is a change in the design of the entity (e.g., a change in the governance structure or management, a change in the activities or purpose of the entity, or a change in the primary risks that the entity was designed to create and pass through to variable-interest holders).
- Issuing additional or retiring or modifying the terms of the variable interests.
- There is a change in the counterparties to the variable interests of the entity (e.g., a reporting entity acquires or disposes of variable interests in a VIE, and the acquired/disposed-of interest, in conjunction with the reporting entity's other involvement with the entity, causes the reporting entity to gain/lose the power to direct the activities that most significantly affect the entity's economic performance).
- A significant change in the anticipated economic performance of an entity (e.g., as a result of losses significantly in excess of those originally expected for the entity) or other events (including the commencement of new activities by the entity) result in a change in the reporting entity that has the power to direct the activities that most significantly affect the entity's economic performance.
- Two or more variable-interest holders become related parties or are no longer considered related parties, and such a related-party group has (had) both the power to direct the activities of the entity and the obligation (right) to absorb losses (benefits) that could potentially be significant to the entity, but neither related party individually possesses (possessed) both characteristics.
- A contingent event occurs that transfers the power to direct the activities of the entity that most significantly impact an entity's economic performance from one reporting entity to another reporting entity.

Because continual reconsideration is required, the CLO participant may need to determine when, during the reporting period, the change in primary beneficiary occurred. If a deal party determines that it is no longer the primary beneficiary of a CLO, it would need to deconsolidate from the date that the circumstances changed and recognize a gain or loss.

CLOs—what is an asset manager to do?

CLOs are unique securitizations in that there is no transferor of assets to the SPE. Instead, the SPE purchases the assets (e.g., senior syndicated loans) from the open market using proceeds first from a warehouse line and then with proceeds from the sale of its securities (which are used to pay off the warehouse line and purchase any remaining assets needed). The CLO SPE issues notes and preferred shares or subordinated notes into the capital markets. The SPE typically employs a trustee to protect the noteholders' interests and a collateral administrator (often the same party as the trustee) to provide back-office support and an independent board of directors. The SPE also employs a collateral manager (typically the bank or asset manager that sponsors the SPE) who performs different functions for a CLO than a servicer does for a typical securitization. Here, the collateral manager is charged with managing the composition of the issuer's collateral, such that specific measures and concentrations of assets are in compliance with the transaction documents. Consequently, the collateral manager determines which assets need to be replaced in a transaction for credit or other reasons, and determines which assets may be purchased to add to the issuer's portfolio. In addition, during the CLO's reinvestment period, the collateral manager invests principal proceeds received from the underlying loans in new loans.



Will the collateral manager consolidate the CLO?

Assume that an asset manager creates a CLO and retains a portion (say, 35%) of the equity tranche of securities. The senior and mezzanine securities are distributed to several investors. The equity class provides credit support to the higher tranches and was sized to absorb a majority of the expected losses of the CLO. For its role as collateral manager, the asset manager receives remuneration, including a senior management fee paid senior to the notes; a subordinate management fee, which is paid senior to the CLO's preferred shares; and an incentive fee (typically, a percentage of residual cash flows after the equity holders have received a specified internal rate of return).

The asset manager will generally be the reporting entity that has the power to direct activities that most significantly impact the CLO's economic performance. Through its ability to determine which assets are acquired and which assets are sold, the asset manager is in a unique position to direct the activities that most significantly impact the economic activities of the CLO.

While only one party will have power over the relevant activities, several of the CLO investors may have investments that create an obligation to absorb potentially significant expected losses or to receive potentially significant expected benefits from the performance of the issuer trust.

The asset manager will need to include the effects of its management, subordinate, and incentive fee arrangements in addition to its exposure through the equity tranche of securities when considering whether it has rights to receive benefits or obligations to absorb losses that could potentially be significant to the issuer trust.

As a result, in this example, the asset manager would have power over the relevant activities of the CLO and a potentially significant variable interest through its fees and 35% equity tranche investment. Therefore, it would be considered the primary beneficiary and need to consolidate the CLO under US GAAP. Accounting for a consolidated CLO has its own complications. See below for a discussion of recent guidance that clarified the accounting for consolidated CLOs when the assets and liabilities are measured at fair value.

Lastly, special care should be paid in determining the primary beneficiary when the asset manager of a CLO receives fees that are more consistent with the service provider model. Typically, the incentive and subordinate fees normally present in CLO deals would result in the fee arrangements being considered a variable interest because of their subordination (and possibly because of the significance of returns they are expected to provide). However, for static deals with only senior fees remaining (in instances in which no other variable interests are held by the asset manager), those senior fees received may not be considered a variable interest in the CLO. Because of ASC 810's continual reconsideration framework, situations might evolve over a deal's life that result in senior fee streams as the sole remaining substantive income to be earned by the asset manager, thus triggering greater scrutiny of whether the asset manager is still the primary beneficiary of the CLO. If the asset manager concludes that its senior fee does not represent a variable interest, the asset manager is not required to further evaluate whether its interest possesses the power to direct the activities of the CLO (i.e., the asset manager would no longer consolidate).

Accounting for consolidated CLOs

Upon the adoption of Statement 167, many entities were required to consolidate CLOs or other collateralized financing entities (CFEs) for the first time and, as a result, were either required or elected to measure the CFE's assets and liabilities at fair value. In many instances, because of market anomalies, the fair value of the assets exceeded the fair value of the liabilities (even though the liabilities are dependent upon performance of the underlying assets). This resulted in diversity in the accounting for the measurement difference between the fair value of the assets and liabilities that arises upon the initial consolidation of a CFE. Specifically, in practice, some entities recorded the initial difference between the fair value of the CFE's assets and liabilities directly to appropriate retained earnings, while others recorded the difference in earnings.

In August 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-13, *Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity*, which provides the following guidance:

- A reporting entity should measure both the fair value of the financial assets and the fair value of the financial liabilities of the CFE using the more observable of the two.
- The objective of this measurement is to reflect in the income statement only those amounts attributable to the consolidating entity (i.e., fair value changes in beneficial interests owned by the consolidating entity and accrual-based compensation for management services).
- A reporting entity that consolidates a CFE and measures its financial assets or financial liabilities using this guidance should disclose all of the information required by ASC 820, ASC 825, and other relevant codification topics, as applicable. However, for the less observable of the financial assets or the financial liabilities, a reporting entity is required only to disclose the method used to determine the less observable fair value. Finally, a reporting entity should also disclose the fair value of its own beneficial interests and should provide relevant disclosures about that fair value measurement.
- A reporting entity may apply ASU 2014-13 using a modified retrospective approach (by recording a cumulative-effect adjustment to equity as of the beginning of the annual period of adoption). However, a reporting entity may also apply the amendments retrospectively to all relevant prior periods beginning with the fiscal year in which the amendments in Statement 167 were initially adopted.

The ASU will be effective for public companies for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public companies, the amendments will be effective for annual periods beginning after December 15, 2015, and interim periods beginning after December 15, 2016. Early adoption of the ASU is permitted.

Consolidation changes on the horizon

The FASB is currently finalizing amendments to the consolidation guidance within ASC 810. The proposed amendments would provide clarifying guidance to assess whether a decision-maker should be determined to have a variable interest when performing a consolidation analysis.

While the initial intent of debating these amendments was to address the issues identified in the investment management industry that resulted in the deferral of Statement 167 for investment funds, these amendments will also likely affect the consolidation conclusions for other structures, including CLOs.

The amended guidance could affect a reporting entity's evaluation of whether (1) limited partnerships and similar entities should be consolidated, (2) variable interests held by the reporting entity's related parties or de facto agents affect its consolidation conclusion, and (3) fees paid to a decision maker or service provider result in the consolidation of a VIE. For additional information on the potential changes, please see our October 2014 Heads Up.

Of these potential amendments, we anticipate that the changes to the decision maker guidance will have the most significant impact on CLOs, which may provide some relief to previous consolidation of these entities by collateral managers.

Potential changes in assessing whether the manager has a variable interest

As discussed earlier in this chapter, under current US GAAP, a collateral manager would be determined to have a variable interest, unless all six of the B22 criteria are met. Frequently, the collateral manager would be deemed to not meet these criteria due to criteria (b), which requires that the fees received are not subordinated. The FASB has tentatively decided to eliminate the criteria related to the fees' priority level and significance (criterion (e) and (f) above). Therefore, under the proposed requirements, the evaluation of whether fees paid to a decision maker or service provider are a variable interest would focus on whether (1) the fees "are commensurate with the level of effort" (previously criteria (a)), (2) the reporting entity has any other direct or indirect interests (including indirect interests through its related parties) that absorb more than an insignificant amount of the CLO's variability (previously criteria (c)), and (3) the arrangement includes only customary terms (previously criteria (d)). Further, in assessing whether the reporting entity has any other indirect interests, and as explained in more detail in our October 2014 Heads Up, a decision maker would generally consider only a proportionate amount of the interests held by its related parties in its evaluation.

The amendments to the B22 criteria, if finalized, would have significant implications to managers of CLOs. We expect that substantially all of the collateral manager contracts in the market will meet (1) and (3) above. Therefore, as long as the collateral manager (including its indirect interests through related parties) does not have other interests that would absorb a more than insignificant amount of the CLO's variability, the collateral manager will not consolidate the CLO. We expect that the result of eliminating three of the B22 criteria and allowing the decision maker to consider only a proportionate amount of the interests held by its related parties in its evaluation, fewer CLOs will be consolidated by its collateral manager.

Potential changes to the related-party guidance

As discussed earlier in this chapter, under current US GAAP, when no single party has both the power over the relevant activities and a potentially significant economic interest, but members of a related-party group would meet both of those criteria, then an assessment is performed to determine which party within the related-party group is considered most closely associated with the entity and, therefore, should consolidate. The amended guidance, if finalized, would also provide some benefits to CLO managers that desire deconsolidation of its consolidated CLOs. Specifically, in situations in which no individual member of the related-party group possesses both the power over the relevant activities of, and a potentially significant economic interest in, the entity (after having considered indirect interests on a proportionate basis), but members of a related-party group (as a whole) meet both of these criteria, the proposed guidance would no longer require that one party within the related-party group consolidate, unless either (1) power is shared by members of the related-party group, (2) the members of the related-party group are under common control, or (3) substantially all of the activities of the CLO are conducted on behalf of a single party within the related-party group.

Illustrative examples of the application of the potential changes

Example 1

Assume that an asset manager creates a CLO and an equity method investee of the asset manager retains 80% of the equity tranche of securities. The equity method investee is a limited partnership in which the asset manager has a 5% limited partnership holding. The senior and mezzanine securities are distributed to several investors. The equity class provides credit support to the higher tranches and was sized to absorb a majority of the expected losses of the CLO. For its role as collateral manager, the asset manager receives market and customary remuneration, including a senior management fee paid senior to the notes; a subordinate management fee, which is paid senior to the CLO's preferred shares; and an incentive fee.

Assume that the asset manager is the reporting entity that has the power to direct activities that most significantly impact the CLO's economic performance. The asset manager would meet the criterion that the fees are commensurate and customary. However, as a related party of the asset manager holds an interest that would absorb more than an insignificant amount of the CLO's variability, the asset manager is determined to hold a variable interest.

Unlike existing US GAAP, although the fee arrangement is considered a variable interest in the CLO, the asset manager will not include the effects of its management, subordinate, and incentive fee arrangements as those are market and customary. Also different from existing US GAAP, because the asset manager has determined that it has the power to direct the activities that most significantly impact the CLO's economic performance, but does not hold any direct interests in the CLO, the asset manager will first assess whether its "indirect" interest (held by its related party), considered on a proportionate basis, provides the asset manager with a potentially significant economic interest in the CLO. In this instance, when considered on a proportionate basis, the asset manager indirectly holds 4% of the CLO's equity tranche, through its related party (i.e., the asset manager's 5% interest in its related party exposes the asset manager to 4% [5% of the related party's 80% interest] of the CLO's equity tranche). Because a 4% holding of equity would not provide a reporting entity with the obligation to absorb losses or the right to receive benefits that could potentially be significant to the CLO, after considering its indirect holdings, the asset manager would conclude that it does not individually have both characteristics necessary to consolidate the CLO. Further, although the related-party group has both characteristics, neither party is required to consolidate the CLO because (1) power over the CLO is not shared, (2) the parties are not under common control, and (3) substantially all of the activities are not conducted on behalf of the asset manager or equity method investee.

This conclusion differs from existing US GAAP for two reasons:

1. The asset manager would likely have been determined to consolidate as it would individually have both characteristics as the fees would have to be considered since they are partially subordinated.
2. Even if the collateral manager did not individually have both characteristics, the related-party determination must be performed under existing US GAAP, regardless of whether the parties are under common control or not. Therefore, the party that was determined to be most closely associated, as discussed early in the chapter, would have to consolidate.

Example 2

Assume the same facts as Example 1, except that the equity method investee holds 95% of all tranches (a larger holding than Example 1) of securities issued by the CLO. When the asset manager and the equity method investee each consider only their own respective interests, neither party would be required to consolidate the CLO. Further, for the same reasons articulated in Example 1 above, after considering its indirect 4.75% holdings [5% of the equity method investee's 95% interest], the asset manager would conclude that it does not individually have both characteristics necessary to consolidate the CLO. However, under the FASB's proposed decisions, the equity method investee would be required to consolidate the CLO because the related-party group possesses the characteristics to consolidate and substantially all of the CLO's activities are conducted on behalf of the equity method investee.

Example 3

Assume that an asset manager creates a CLO and retains a 5% vertical interest (i.e., an interest in each class of asset-backed security interests issued as part of the CLO). The asset manager designed the vertical tranche to be compliant with the risk-retention rules discussed further in the chapter titled Regulatory Impacts for CLOs. For its role as collateral manager, the asset manager receives market and customary remuneration, including a senior management fee paid senior to the notes; a subordinate management fee, which is paid senior to the CLO's preferred shares; and an incentive fee.

Assume that the asset manager is the reporting entity that has the power to direct activities that most significantly impact the CLO's economic performance. The asset manager would meet the criterion that the fees are commensurate and customary. Further, as the vertical interest owned by the asset manager would not absorb more than an insignificant amount of the CLO's variability (due to it owning only 5% of all tranches), the asset management agreement is determined not to be a variable interest.

Under existing US GAAP, the asset management agreement would have been deemed to be a variable interest due to the subordinated fee component. The combination of the 5% vertical interest and the incentive fee component likely would have also caused the asset management agreement to meet conditions (e) and (f), providing two potential other reasons why the asset management agreement would have been deemed a variable interest. However, if the new standard is finalized as expected, the fees received by the asset manager would be excluded from the primary beneficiary assessment because they are at market and customary with terms that are negotiated on an arm's-length basis. Further, because the vertical interest would never absorb more than 5% of the economic performance of the CLO, after appropriately excluding the asset manager's right to receive fees from the primary beneficiary assessment, the asset manager would never possess the right to receive benefits or the obligation to absorb losses that could potentially be significant to the CLO. Thus, the asset manager would not be the primary beneficiary of the CLO.

Summary of impacts on CLOs of the potential amendments and expected timing

If finalized, these amendments are likely to result in deconsolidation by asset managers of certain CLOs. The FASB tentatively decided to require modified retrospective application with an option for full retrospective application. The guidance would be effective for calendar year-end public and private companies in 2016 and 2017, respectively. The FASB tentatively decided to allow early adoption, but if adopted early, would require entities to apply the guidance as of the beginning of the annual period containing the adoption date.

What should companies be thinking about prior to issuance of the guidance? Although the required adoption date is expected to provide over a year to adopt, we believe it would be beneficial for many CLO managers to adopt early if deconsolidation of certain CLOs results occurs. For calendar year companies, that means if the guidance is issued prior to filing their financial statements as of and for the year ending December 31, 2014, a company would be permitted to adopt back to the beginning of 2014. Regardless of the adoption date, the new standard will require companies to assess the impact on the financial statements, consolidation processes, and controls. Involvement in all legal entities will require a technical analysis under the new guidance and revised disclosures and enhanced process to aggregate supporting information.

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 No. 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[6]. 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[7] 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.

[6] 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.

[7] "Tax Rules" refers to the Internal Revenue Code of 1986, as amended, and regulations thereunder as of October 31, 2014.

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[8].
- **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[9]. 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[10].
- **Form 8621**—annual requirement for owners of stock in a PFIC[11].

[8] IRC Section 6038B.

[9] IRC Section 6038D

[10] IRC Section 6501(c).

[11] IRC Section 1298(f)

- **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[12].
- **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.

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.

[12] IRC Section 6501(c)(8).

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 will 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, will be 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 will need to work with the offshore administrator and trustee to determine whether exceptions are met and, if not, to ensure that required reporting occurs beginning in 2015. Guidelines regarding required Cayman Islands reporting may be found here.

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[13]), 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 have issued Interagency Guidance on Leveraged Lending in 2013[14], and more recently, in Nov 2014, issued a report noting that "Leveraged Lending Remains a Concern"[15].

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).

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.

[13] http://www.federalreserve.gov/boarddocs/srletters/2007/SR0705.htm

[14] http://www.federalreserve.gov/bankinforeg/srletters/sr1303.htm

[15] http://www.federalreserve.gov/newsevents/press/bcreg/20141107a.htm

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[16], 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 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%.

[16] 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.

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.

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.

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 recently finalized, and the NSFR regulations have been internationally agreed, and expected to be implemented in the United States. shortly. Both under 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[17] to trust preferred securities collateralized debt obligations (TRUPs CDOs), but such grandfathering relief was not extended to CLO structures. However, regulators have 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[18]. While falling short of industry expectations, it still provides more time to restructure them, instead of fire sale. Therefore, it is anticipated that most existing CLO structures will be amended to exclude any securities in the underlying assets, so that they qualify for Volcker Rule exemption and new issuances are expected to be structured to qualify for Volcker Rule exemption. Failing exemption, banks have to divest their holdings in such Volcker Rule ineligible funds by 2017 and deduct any permissible investments from Tier 1 capital.

Risk retention

The Federal Deposit Insurance Commission (FDIC) passed final risk-retention rules for asset-backed securities on October 21, 2014, which requires a 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. Following the FDIC, other regulators jointly adopted these rules.

These rules significantly impact the CLO market, but provide a two-year effective date window after such rules are published in the Federal Register, exempting CLOs issued prior to the effective date.

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.

[17] http://www.federalreserve.gov/newsevents/press/bcreg/20140114b.htm

[18] http://www.federalreserve.gov/newsevents/press/bcreg/20140407a.htm

- 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.

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 implementation 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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