SEWARD & KISSEL LLP

PRIVATE FUND STRUCTURES AND CLO RISK RETENTION

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The wide range of structures developed by Seward & Kissel to enable CLO managers to comply with Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Retention Rules") share a common characteristic: the need for long-term investor participation. A unique and potentially lucrative opportunity for investment managers to attract such participation is through the establishment of private CLO investment funds ("CLO Investment Funds").

CLO Investment Funds could prove enticing to prospective investors for numerous reasons, including:

- the potential of the related CLO credit risk retention interests ("Retention Interests") to significantly outperform other U.S. private equity returns; and
- the expectation that CLO managers will agree to enhance CLO Investment Fund returns by contributing a portion of their related CLO management fees.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed into law in 2010 in an effort to avoid a recurrence of the consequences experienced by investors, consumers, financial institutions, and the financial system during the recent financial crisis. Section 941 of Dodd-Frank added Section 15G to the Securities and Exchange Act of 1934 and directed six federal regulatory agencies (collectively, the "Agencies")[1] to adopt rules requiring the "securitizer" to retain at least 5 percent of the credit risk of the assets that serve as collateral for asset-backed securities.[2]

The Retention Rules will be effective beginning on December 24, 2016. In general, the Retention Rules require a sponsor or a majority-owned affiliate[3] of the sponsor to retain some credit risk of the securitized assets. In the context of CLOs, risk retention can be accomplished by a

[1] The Agencies are as follows: the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, U.S. Securities and Exchange Commission, Federal Housing Finance Agency, and Department of Housing and Urban Development.

[2] *See* Final Rules at 7.

[3] A majority-owned affiliate is an entity that, directly or indirectly, majority controls, is majority controlled by, or is under common majority control with the sponsor. *See* Final Rule § __.2 at 424. Majority control means owning 50% or more of the equity or maintaining a controlling financial interest (as determined under GAAP). *See id.*

menu of options. The eligible holder of a Retention Interest can hold:

(a) an "Eligible Vertical Interest": an interest in each CLO-issued tranche equivalent to 5% of the face value of each such tranche or a single security representing the same;

(b) an "Eligible Residual Horizontal Interest": an interest in the CLO equity equivalent to least 5% of the fair value of the CLO, determined in accordance with U.S. GAAP;

(c) a cash reserve account in lieu of the Eligible Residual Horizontal Interest; or

(d) any combination of the Eligible Vertical Interest or Eligible Residual Horizontal Interest.[4]

CLO Investment Funds

CLO Investment Funds can be structured to fund the acquisition of Retention Interests by drawing down on investor capital commitments over a multi-year extendible investment period, thereby enabling continual investment in a manager's CLO platform over a significant period of time. Depending on investor appetite, CLO Investment Funds can also be tailored to invest in one or numerous CLO managers, thus affording investors access to a highly diversified—and potentially diversely managed—portfolio of CLO assets.

The acquisition of a Retention Interest can be accomplished in a variety of ways, including by purchasing ownership interests in a CLO manager or its majority owned or controlled affiliates ("MOAs"). Notably, the use of traditional master-feeder or parallel investment fund structures would enable CLO managers or their MOAs to efficiently access both domestic and offshore investors.

It is contemplated that CLO Investment Fund returns would essentially mirror those of the related Retention Interests. As alluded to above, these returns could be enhanced by entitling investors to receive a portion of the senior and/or subordinated management fees payable to the CLO manager or managers in respect of the related CLOs.

Conclusion

The recent adoption of the Retention Rules has created an important opportunity for investment managers. Through the formation of CLO Investment Funds, these managers can create attractive and unique investment opportunities for investors to earn enhanced returns while also providing crucial assistance to the CLO market by enabling CLOs to comply with the Retention Rules on a long-term basis.

[4] *See* Final Rule § __.2 at 423-24; § __.4 at 427.

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