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The Foreign Transaction Safe Harbour for U.S. Risk Retention on European CLOs

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With the U.S. Risk Retention Rules becoming effective for CLO transactions on 24 December 2016, the CLO market has worked hard to develop acceptable methods of compliance. With respect to European CLOs, several transactions have already sought to rely on the Foreign Transaction Safe Harbour. But this has presented a number of logistical and ideological challenges. Will the market settle on a standard method of relying on the Foreign Transaction Safe Harbour?

The credit risk retention regulations (the "U.S. Risk Retention Rules") issued under Section 15G of the U.S. Securities Exchange Act of 1934, as amended, became effective with respect to CLO transactions on 24 December 2016. Pursuant to the U.S. Risk Retention Rules, the "sponsor" of a securitisation transaction (or majority-owned affiliate of the sponsor) is required, absent an available exemption, to retain at least 5% of the credit risk to the assets collateralising the asset-backed securities issued in such transaction. Under the U.S. Risk Retention Rules, the collateral manager will generally be considered to be the "sponsor" and is thus, absent an available exemption, subject to the retention rule.

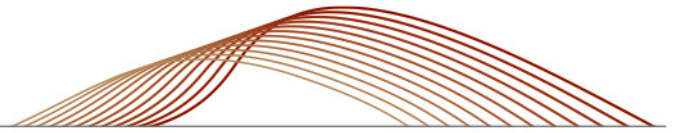
In addition to the new U.S. Risk Retention Rules, pursuant to the existing EU risk retention rules under various regulations including Article 405 of EU Regulation 2013/575/EU (the "EU Risk Retention Rules"), various types of EU regulated investors including institutions for occupational retirement, credit institutions, investment firms, authorised alternative investment fund managers, insurance and reinsurance undertakings and UCITS funds are prohibited from investing in securitisations (including CLOs) unless an eligible retainer undertakes to retain a material net economic interest of not less than 5% in the securitisation.

For most European CLO transactions, the EU Risk Retention Rules will be satisfied by the collateral manager undertaking to retain the material net economic interest. Thus, in most cases and subject to the disclosure requirements of the U.S. Risk Retention Rules, compliance by the collateral manager with the EU Risk Retention Rules will allow compliance with the U.S. Risk Retention Rules.

Dual Compliance?

However, there are a number of situations where the collateral manager of a European CLO may find it burdensome or impossible to satisfy the U.S. Risk Retention Rules, even where the EU Risk Retention Rules will be satisfied. This may be the case in any of the following situations:

1. **Horizontal Retention, Fair Value Determination** – both the U.S. Risk Retention Rules and the European Risk Retention Rules allow compliance by retaining a first loss position. However, the U.S. Risk Retention Rules require the sponsor to retain 5% of the fair value



of all notes then outstanding determined using a fair value measurement framework under U.S. generally accepted accounting principles. The fair value determination needs to be disclosed a reasonable time prior to sale of the notes and again after closing. European CLO managers may view the process of preparing and disclosing the fair value determination and having it confirmed by an accounting firm as a costly and time consuming burden.

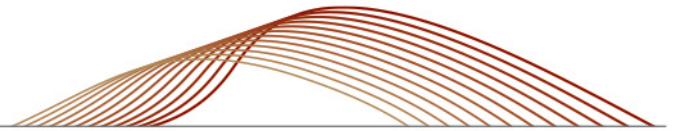
2. **Horizontal Retention, Refinancings** – as described above, the U.S. Risk Retention Rules require the sponsor to retain 5% of the fair value of all notes then outstanding. For horizontal retention, the EU Risk Retention Rules require retention in an amount equal to no less than 5% of the nominal value of the securitised exposures. It is possible that the collateral manager would satisfy the EU Risk Retention Rules but not the U.S. Risk Retention Rules on the basis of the differing retention calculations. This would be fine in the context of a new issue transaction, as the collateral manager would ensure it would retain the higher of the two. However, in the context of refinancings and resets of existing transactions, this may not be possible as the manager would either have to purchase additional equity from existing investors or direct a tap issuance for additional equity. As both require additional cash from the collateral manager and in the case of a tap issue, the consent of the existing noteholders, this may not be a palatable solution.
3. **Ineligible Retainer** – The EU Risk Retention Rules allow retention by the sponsor, originator or original lender, whereas the U.S. Risk Retention Rules require retention by the sponsor or its majority owned affiliate. European CLO transactions that are structured with a third party originator as the eligible retainer would generally not be compliant with the U.S. Risk Retention Rules as the originator would be unlikely to be the sponsor or a majority owned affiliate of the sponsor. In this situation, compliance with the U.S. Risk Retention Rules would not be possible.

If any of the above situations are present, the collateral manager of a European CLO can seek to rely on the Foreign Transaction Safe Harbour. Alternatively (and solely with respect to refinancings), it may be possible for the collateral manager to avoid retention under the U.S. Risk Retention Rules if a proposed refinancing meets the requirements of an SEC no-action request letter from Crescent Capital Group LP, in which the SEC indicated that it would not seek enforcement of the U.S. Risk Retention Rules in connection with a refinancing of CLOs that priced prior to 24 December 2014 and where the refinancing meets certain requirements including, in particular, that the only material changes to the transaction is the reduction of the interest rate of the original notes.

The Foreign Transaction Safe Harbour

To rely on the Foreign Transaction Safe Harbour, a securitisation transaction must meet certain conditions, including that (1) the transaction is not required to be and is not registered under the Securities Act of 1933, as amended (the “Securities Act”); (2) no more than 10 per cent. of the dollar value (based on the fair value of the securities) of all classes of securities issued in the securitisation transaction are sold or transferred to U.S. persons or for the account or benefit of U.S. persons (as defined in the U.S. Risk Retention Rules); (3) neither the sponsor nor the issuer is organized under U.S. law or is a branch located in the United States of a non-U.S. entity; and (4) no more than 25 per cent. of the underlying collateral was acquired from a majority-owned affiliate or branch of the sponsor or issuer organised or located in the United States.

Managers that have sought to rely on the Foreign Transaction Safe Harbour have focused principally on the challenges of ensuring compliance with condition (2) above. Compliance with



conditions (1), (3) and (4) has proved sufficiently straightforward in the context of a CLO transaction.

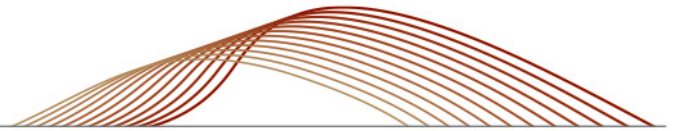
The 10 per cent. U.S. Person Definition

The market has found compliance with requirement (2) more challenging. First, it should be noted that the safe harbour applies if no more than 10 per cent. of the notes are sold or transferred to U.S. persons in the initial distribution of the notes and does not apply to secondary sales of the notes. If secondary sales into the U.S. were contemplated at the time of issue, this might be viewed as part of a plan or scheme to evade the rule.

Under the U.S. Risk Retention Rules "U.S. person" means any of the following:

1. Any natural person resident in the United States;
2. Any partnership, corporation, limited liability company, or other organisation or entity organised or incorporated under the laws of any State or of the United States;
3. Any estate of which any executor or administrator is a U.S. person (as defined under any other clause of this definition);
4. Any trust of which any trustee is a U.S. person (as defined under any other clause of this definition);
5. Any agency or branch of a foreign entity located in the United States;
6. Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person (as defined under any other clause of this definition);
7. Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organised, incorporated, or (if an individual) resident in the United States; and
8. Any partnership, corporation, limited liability company, or other organisation or entity if:
 - a. Organised or incorporated under the laws of any foreign jurisdiction; and
 - b. Formed by a U.S. person (as defined under any other clause of this definition) principally for the purpose of investing in securities not registered under the Securities Act.

It has been noted that the definition of "U.S. person" in the U.S. Risk Retention Rules is substantially similar to, but not identical to, the definition of "U.S. person" under Regulation S. The material difference between such definitions is that (1) a "U.S. person" under Regulation S includes any partnership, corporation, limited liability company or other organization or entity that is organized under the laws of any foreign jurisdiction formed by one or more "U.S. persons" (as defined in Regulation S) principally for the purpose of investing in securities that are otherwise offered within the United States pursuant to an applicable exemption under the Securities Act unless such organization or entity is organized and owned by accredited investors (as defined in Rule 502 of Regulation D under the Securities Act) who are not natural persons, estates or trusts (emphasis added). The accredited investor exclusion does not feature in the definition of U.S. Person in the U.S. Risk Retention Rules.



This divergence means that collateral managers that seek to rely on the Foreign Transaction Safe Harbour will need to take additional steps from those taken under Regulation S in order to determine that the offering of the notes complies with the 10 per cent. limit.

Compliance

The Paul Hastings team has advised both collateral managers and arrangers on a number of European CLO transactions that have successfully closed in reliance on the Foreign Transaction Safe Harbour, including some of the first such transactions in January 2017.

To avoid a retention obligation under the U.S. Risk Retention Rules, the collateral manager must determine whether the requirements of the Foreign Transaction Safe Harbour are satisfied. Failure to comply with the retention obligations imposed by the U.S. Risk Retention Rules may result in enforcement or other regulatory action against the collateral manager by U.S. regulators.

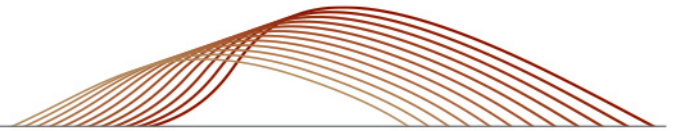
Collateral Managers have adopted various approaches to determining whether the requirements are satisfied, as follows:

1. **Deemed Representations** – the notes include a representation that any purchaser that acquires notes in the initial syndication is not a U.S. Person (as defined in the U.S. Risk Retention Rules) (a “Risk Retention U.S. Person”) or if it is, it has obtained a waiver from the collateral manager. This latter provision allows the collateral manager to control the percentage of Risk Retention U.S. Persons that are initial noteholders. In addition, the notes include a representation that the purchaser is not acquiring the notes as part of a scheme to evade the U.S. Risk Retention Rules.
2. **Forced Transfer** – if it is discovered that a purchaser acquired notes in breach of one of the above deemed representations, the terms and conditions of the notes include an obligation on the issuer to force such purchaser to sell its notes to an investor that is not a Risk Retention U.S. Person.
3. **Certification** – in addition to the above, some transactions have contemplated either a requirement that all initial investors provide separate written certifications that they are not a Risk Retention U.S. Person or, alternatively, a clearly disclosed ability for the collateral manager to require any initial investor to certify whether it is Risk Retention U.S. Person. This latter right, while not limited, would be used only where the manager considers there is a risk that the investor is a Risk Retention U.S. Person.

In addition, some collateral managers have sought to impose a lock up period that restricts transfer for 40 days post-closing. This borrows the equivalent concept from the distribution compliance period requirements pursuant to Regulation S that restrict flow back of debt securities into the U.S. after a qualifying Regulation S offering. This has been included to provide the collateral manager with additional comfort that the Foreign Transaction Safe Harbour has been complied with because it would restrict secondary transfers into the US during a 40 day lock up period. However, we do not consider it a necessary restriction on the liquidity of the notes. The deemed representations regarding evasion and the forced sale provisions should be sufficient.

It is clear that the European CLO market has yet to reach a standard method of ensuring reliance on the Foreign Transaction Safe Harbour and each of the above solutions presents its own practical challenges. We expect a standard to develop, in the context of European CLOs but also with respect to other securitisation asset classes.

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