CLIFFORD CHANCE

STRUCTURED CREDIT REGULATORY UPDATE, NOVEMBER 2023

We are publishing a comprehensive regulatory briefing on the issues currently facing structured credit transactions and the CLO industry in particular.

CONTENTS

STRUCTURED CREDIT REGULATORY UPDATE, NOVEMBER 2023

This regulatory update summarizes certain of the many new and proposed regulations that will impact the structured credit industry, including CLOs in particular. The previous issue of our Structured Credit Regulatory Update series can be accessed here.

I. LIBOR Cessation

On July 3, 2023, the UK FCA confirmed that the US dollar LIBOR panel has now ceased and the last published US dollar LIBOR rate was provided on June 30, 2023. The overnight and 12-month US dollar LIBOR settings have now permanently ceased. The UK FCA published an announcement to confirm the implementation of its decisions and reiterate its message that it does not want to see a transition to so-called 'credit sensitive' rates.

The UK FCA will require LIBOR's administrator (ICE) to publish certain US dollar LIBOR settings (1-, 3- and 6-month US dollar LIBOR) from June 30, 2023 to September 30, 2024 using a "synthetic" methodology, which will be calculated using the relevant CME Term SOFR Reference Rate plus the respective ISDA fixed spread adjustment. The UK FCA emphasized in its July 3, 2023 update that synthetic US dollar LIBOR is only a temporary measure to allow firms some extra time to complete their transition. The purpose of this is to assist "tough legacy" contracts that otherwise cannot transition away from LIBOR. For English law-governed contracts, the relevant legislation is the Critical Benchmarks (References and Administrators' Liability) Act 2021 which provides that, unless relevant fallbacks have been agreed, the relevant rate in the contract (or other arrangement) should be read as meaning the adjusted synthetic rate.

Legacy contracts that are governed by US law (e.g. New York law) and reference USD LIBOR may use synthetic USD LIBOR only if the Adjustable Interest Rate (LIBOR) Act does not supply a SOFR-based replacement benchmark by operation of law as of the "LIBOR replacement date" (which occurred on July 3, 2023).

It is also worth noting that on July 3, 2023, the Board of the International Organization of Securities Commissions ("IOSCO") published its "Statement on Alternatives to USD Libor" which assessed four benchmarks (two credit sensitive rates and two Term SOFR rates) developed as potential substitutes for USD LIBOR and discussed the extent to which these benchmarks have implemented IOSCO's 2013 Principles for Financial Benchmarks. IOSCO used SOFR as a comparator and found that Term SOFR rates were "somewhat better placed among the rates reviewed, but still fell short of SOFR. IOSCO believes that the Term SOFR rates are suitable for limited use only." IOSCO believes that Term SOFR rates should be limited to derivative market transactions.[1] The LSTA was not surprised at the IOSCO's findings on Term SOFR rates "as they are consistent with the ARRC's recommendations on the use of Term SOFR."[2]

Finally, CLO portfolios may continue to have small percentages of loans which remain at LIBOR if those loans pay semi-annually or less frequently and their last interest determination date preceded June 30, 2023.

1 IOSCO noted that, "Term SOFR rates are different from SOFR because Term SOFR rates are based on derivative market transactions, and they rely on the continued existence of a deep and liquid derivatives market based on overnight SOFR. The use of Term SOFR rates in derivatives markets should remain limited so that these rates can remain sustainably available for more limited appropriate use cases. If reference to Term SOFR rates were to become too widespread, at the expense of trading in the underlying SOFR derivatives (i.e., futures or swaps) markets, it would undermine the Term SOFR rates themselves."

2 See July 5, 2023 LSTA publication, "And Just Like That… LIBOR Ended." (https://www.lsta.org/news-resources/and-just-like-that-libor-ended/)

II. PRIVATE FUNDS RULE

II. Private Funds Rule

As detailed in our previous briefing available here, on February 9, 2022, the Securities and Exchange Commission ("SEC") proposed new rules and amendments (the "Private Funds Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). We noted this was problematic for CLOs for many reasons. On August 23, 2023, the SEC finalized the Private Funds Rule, and exempted CLOs that are "securitized asset funds" from the quarterly statement rule,[3] private fund audit rule,[4] adviser-led secondaries rule,[5] restricted activities rule,[6] and preferential treatment rule.[7] More specifically, such rules do not apply to investment advisers with respect to "securitized asset funds" ("SAFs").[8] SAFs include "any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt-holders."[9] *It is expected that virtually all CLOs are in fact SAFs and are therefore exempt from the Private Funds Rule with one exception (as detailed below).* The commentary to the final Private Funds Rule states that "advisers will not be required to comply with the requirements of the final rules solely with respect to the securitized asset funds ("SAFs") that they advise."

We provide caution however that CLO managers are not exempt from the compliance rule of the Private Funds Rule.

All registered investment advisers (regardless of whether they manage private funds or not) including those who manage CLOs and any other type of securitized asset fund, "must comply with the compliance rule *and must document* the annual review of their compliance policies and procedures in writing."[10] Previously, there was no such requirement to document that review in writing. So, although the annual compliance review is not a new requirement, the documentation of that review in writing is new, and CLO managers must comply with this.

All SEC-registered advisers, including CLO managers, are required to evaluate periodically whether their compliance policies and procedures continue to work as designed and whether changes are needed to assure their continued effectiveness. The amended rule does not provide for specific elements that advisers need to include but permits advisers to continue to use the review procedures they have already developed and found to be the most effective.

On September 1, 2023, the LSTA announced it has joined five other trade associations in commencing a lawsuit against the SEC for exceeding its statutory authority and acting arbitrarily and capriciously in adopting the Private Funds Rule. Private fund managers that manage hundreds of billions of dollars of loans are still covered and will be negatively impacted once the rule takes effect, including managers of certain rated feeders which do not issue asset-backed securities. The SEC has been criticized for aggressively pushing forward rules without sufficient research and analysis and on a tight timeline for market commentary. In relation to the Private Funds Rule, it is argued that the sophisticated investors involved may not need the protective solutions within the rule which interfere with principles of freedom of contract. Specifically, the SEC is using section 211(h) of the Advisers Act to justify its sweeping rule making (including the Predictive Data Analytics Rule, discussed at section IX of this update), which provides that "*The Commission shall (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and (2) examine and, where appropriate,*

3 Requirements for registered private fund advisers to provide quarterly statements to private fund investors.

4 Requirements for registered private funds to undergo a financial statement audit that meets the requirements of the audit provision in the Advisers Act custody rule (rule 206(4)-2).

5 The reforms require a registered private fund adviser to obtain a fairness opinion or a valuation opinion when offering existing fund investors the option between selling their interests in a private fund and converting or exchanging their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

6 This is a new rule that applies to all private fund investors to address what the SEC perceives as conflicts of interest. Such activities include restrictions on (i) charging or allocating to the private fund fees or expenses associated with an investigation of the adviser without disclosure and consent from fund investors, (ii) charging or allocating to the private fund any regulatory, examination or compliance fees without disclosure to investors, (iii) reducing the amount of an adviser clawback by the amount of certain taxes, unless the adviser discloses the pre- and post-tax amounts to investors, (iv) charging or allocating fees on a non-pro rata basis unless it is fair and equitable with written notice and a description and (v) borrowing or receiving an extension of credit from a private fund client without disclosure and consent from investors.

7 This rule effectively prohibits all private fund advisers from providing certain preferential treatment terms to investors.

8 The commentary to the Private Funds Rule explains that SAFs are special purpose vehicles or other entities that "securitize" assets by pooling and converting them into securities that are offered and sold in the capital markets. However, the definition does not include traditional hedge funds, private equity funds, venture capital funds, real estate funds, and credit funds. See page 54 of the Private Funds Rule. (https://www.sec.gov/files/rules/final/2023/ia-6383.pdf)

9 The final Private Funds Rule is based on the corresponding definition in Form PF and Form ADV.

10 See footnote 153 to the commentary of the Private Funds Rule (https://www.sec.gov/files/rules/final/2023/ia-6383.pdf)

promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

While investment advisers are exempt from the Private Funds Rule with respect to their relationships with SAFs, except as otherwise noted above, we further caution that the SEC will continue to consider whether any additional regulatory action may be necessary with respect to investment advisers of SAFs (which generally include CLOs) in the future.[11] We will continue to monitor this and provide any further updates.

11 See footnote 154 to the commentary of the Private Funds Rule (https://www.sec.gov/files/rules/final/2023/ia-6383.pdf)

III. NAIC DEVELOPMENTS

III. NAIC Developments

The NAIC commenced a review of insurers' investments in structured securities approximately 18 months ago, but rather than following its well-established deliberative approach to evaluating new proposals for insurer capital standards, various NAIC working groups and task forces began a series of seemingly uncoordinated, multi-pronged initiatives that could have resulted in almost immediate negative effects on life insurers and the structured credit market generally. At the NAIC's most recent National Meeting in August, insurance regulators appeared to signal their discomfort with that approach and suggested that it was time to holistically review the processes that were employed. Whether such a review will impact or slow these ongoing initiatives remains to be seen.

CLOs and Regulatory Arbitrage

Starting in the spring of 2022, staff from the NAIC's Securities Valuation Office ("SVO") informed members of the NAIC Valuation of Securities Task Force ("VOSTF") that insurer investments in CLOs had the potential to materially and artificially reduce insurers' capital requirements merely by securitizing a pool of assets. This potential "regulatory arbitrage" was made possible because the current insurer regulatory capital framework, Risk-Based Capital ("RBC"), treats the credit ratings assigned to CLOs (and other structured securities) by commercial credit rating agencies the same as ratings assigned to bonds and equity securities. As a result, a rating assigned to a CLO is mapped directly to the same RBC charge that a bond with the same rating would have. According to the SVO, the capital required for holding all tranches of a structured security should be consistent with the capital required when holding all of the underlying collateral. But in the case of CLOs, there is potential for arbitrage because, for example, securitizing a pool of B-rated corporate loans in a CLO with multiple rated tranches and investing in all tranches could give an insurer a far lower weighted RBC charge than directly investing in such B-rated pool, even though the investment risk for both is arguably the same.

The SVO's proposed solution for this regulatory arbitrage was twofold. First, the SVO requested authority from the VOSTF to begin modelling insurer CLO investments to evaluate tranche level losses across all debt and equity tranches using a series of calibrated and weighted collateral stress scenarios (the "CLO Modeling Project"). The SVO would then use its model (which would first have to be created), instead of the ratings assigned by credit rating agencies, to assign NAIC designations and their associated capital charges.

Second, the SVO noted that because the equity tranches of a CLO absorb losses first, there is naturally a greater risk that a payment default in the underlying collateral could quickly wipe out the equity tranches. Under the current RBC framework, all equity investments – whether common stocks, LP interests or CLO equity tranches – are subject to a maximum capital charge of 30% (although see "Residual Tranche Proposal" below). Without explaining how this relates to the regulatory arbitrage concern or identifying any deficiencies in the existing RBC equity charge, the SVO recommended that appropriate NAIC groups add two new RBC equity charges – of 75% and 100% – to account for the tail risk in any structured security tranche (the "Residual Tranche Proposal"). The SVO proposal did not address which equity tranches should be subject to which of the three equity RBC factors.

These proposals were exposed for public comment, most of which was cautious and expressed concerns over the anticipated timeframe for making significant RBC changes without adequate study. Submissions also pointed out the importance of CLOs to life insurers and the broader capital markets and their favorable historical performance as an asset class. Stakeholders also questioned the SVO's proposed methodology for modeling CLOs.

CLO Modeling Project

In order to enable the SVO to model CLOs, the VOSTF first amended the SVO's procedures to remove CLOs from the category of investments whose RBC charge is derived from the rating assigned by commercial credit rating providers, and instead to subject CLOs to modeling by the SVO (this will become effective on January 1, 2024, but will become operative only when the model has been approved). It also had to develop a CLO model, for which a smaller ad hoc technical group, comprising regulators and industry stakeholders, was formed.

In December 2022, the VOSTF exposed for public comment a draft methodology for modeling all tranches of broadly syndicated loan CLOs (except commercial real estate CLOs) held by U.S. insurance companies. The exposure asked for input on the reasonableness of the assumptions to be used in the model (e.g., cash flow, default and recovery rate assumptions), as well as the mechanics of modeling and assigning ratings. The proposal deferred consideration of stress scenarios and probabilities that would be used in the model. Re-securitizations, (other) asset-backed securities, collateralized debt obligations, and trust preferred securities CDOs were deemed out of scope for the CLO Modeling Project.

During the NAIC's 2023 Spring National Meeting, the VSOTF announced that the starting point for the new CLO model will be several existing CLOs, provided to the ad hoc drafting group by its industry members, that will be used as "dummy" scenarios to test and inform the new CLO model. The ad hoc group ultimately selected six CLOs. At this meeting, the SVO responded to several of the comments on the modeling methodology, primarily the inclusion of prepayment and reinvestment assumptions in the model. According to the SVO, prepayments are not material, but they do influence two other assumptions: (1) using principal to pay down the notes increases the overcollateralization test and (2) building par via trading gains or reinvestment of available proceeds into loans issued at a discount. The SVO suggested that the new CLO model should not include prepayment and purchased discount assumptions and will assume that reinvestment in collateral is purchased at par. The SVO also stated that active management is not unique to CLOs and could apply to any active pool, including loans or bonds, whose RBC charges did not include consideration of active management. Therefore, active management should not be included as an assumption in the CLO model.

In an effort to demonstrate to the CLO modeling ad hoc group the effects of CLO pre-pay and discount assumptions, the SVO tested the six selected proxy CLOs under a model that included modest pre pay and discount assumptions (a 10% constant prepayment rate on the underlying loans and a purchase price discount of 8% on CLO reinvestments). Even though the SVO found that there are significant benefits to the discount purchase assumption, it ultimately concluded that no pre-pay or discount assumptions should be included in the model because (1) the enormous amounts of extra cash generated is a modeling anomaly and without an equivalent assumption in the existing RBC framework; and (2) including pre-pay/discount assumptions would add complexity to the model and potentially result in unintended consequences.

Despite complaints from multiple interested parties, the SVO decided not to include voluntary prepayment and discount purchase assumptions in the CLO modeling framework. The main reason was that any benefit from including them in the methodology would be outweighed by the added uncertainty and cash flow volatility that would result. Additionally, the SVO stated that its review of the methodologies used by the credit rating agencies showed that they do not assume any par-building discount purchases.

The CLO ad hoc group will now move to the development of scenarios and probabilities for the model and has requested feedback from interested parties.

Residual Tranche Proposal

A separate group of regulators – the RBC Investment Risk and Evaluation Working Group ("RBCIRE") – was tasked with evaluating the SVO's proposal to add two new RBC equity charges to account for the tail risk in any structured security tranche. It was unclear why the RBCIRE was moving quickly to add new RBC charges to be effective for 2023 reporting, especially since no reason was provided by the SVO or the RBCIRE for selecting RBC charges of 75% and 100%. Moreover, the proposal to apply the new charges seemed to expand quickly to the residual tranches of all structured securities, rather than just CLOs. Even though the RBCIRE characterized its work as developing an "interim solution," the scope of the proposal would be far-reaching and, with no timeline for developing final RBC charges, the "interim" proposal likely would have resulted in the imposition of significantly higher RBC charges for an indefinite period of time (on all structured securities that have residual or equity tranches).

Early in its deliberations, the RBCIRE heard a presentation from the American Academy of Actuaries (the "Academy"), which regularly advises the NAIC on actuarial issues and the RBC framework. The Academy explained that, although it has been increasing over the last 10 years, the aggregate exposure of the life insurance industry to all tranches of CLOs is currently not material and does not pose a material risk to their capital or solvency (the industry's exposure to below investment grade tranches is approximately 12% of its aggregate exposure to all tranches). The Academy recognized that insurers' exposure to CLOs may of course increase in the future, but it questioned whether there was an immediate need to devote substantial resources to developing new tranche-level capital charges for CLOs. When pressed by members of the RBCIRE to express a preliminary view of using existing RBC factors for CLOs, the Academy responded that senior tranches likely would carry lower capital charges than similarly rated bonds, while equity tranches probably would have higher capital charges than the RBC factor currently applied to equity (i.e., a charge of greater than 30%). Nevertheless, the Academy did not support the proposal to add – as an interim step before CLOs and other structured securities are studied fully – new factors of 75% and 100% for equity tranches.

Despite serious concerns expressed by stakeholders and some insurers, the RBCIRE exposed its interim proposal for public comment. Responses suggested adding a single new RBC charge of 45% for residual tranches (instead of two charges) and adding a sensitivity test or maintaining the existing 30% charge and adding a sensitivity test. Sensitivity tests are part of the RBC process (other assets are also subject to sensitivity tests), but it does not require that insurers actually hold more capital as a result of the test. The sensitivity tests are "what if" scenarios to give regulators a sense of what an increased RBC charge would do to an insurer's overall RBC if the charge were actually applied to the assets under review.

The RBCIRE agreed to expose a single new charge of 45% and a new 45% sensitivity test. In subsequent meetings, stakeholders continued to object to the speed with which the RBCIRE was moving and the potential market disruption it would cause. They also noted the lack of coordination between the RBCIRE's efforts on the interim solution and the NAIC's longer term project to model CLOs and other structured securities. Whereas the NAIC's CLO project was a data-driven, collaborative effort, the RBCIRE seemed intent on imposing a new capital charge immediately, before and without the NAIC's typical deliberative process, especially in light of the low risk residual tranches currently pose to insurer solvency.

Ultimately, the RBCIRE left the current 30% equity charge unchanged for 2023 and adopted a new 45% charge to become effective in 2024. It also added a 15% sensitivity test for 2023.

Structured Equity and Funds

Soon after the SVO alerted regulators to potential regulatory arbitrage in CLO investments, it proposed an amendment to its governing procedures to add a new asset class – "Structured Equity and Funds" – that would no longer rely on commercial credit ratings for determining the appropriate RBC capital charge, and instead such securities would have to be submitted to the SVO for assignment of an NAIC rating and an associated RBC charge. This proposal would require insurers to obtain an SVO rating for investments in certain feeder funds, irrespective of whether the investment already has been rated by an SVO-approved credit rating agency. Insurers holding such investments would have to use the SVO rating in determining the RBC charge associated with such investment.

According to the SVO, using structured equity investments may permit in-substance equity and fund investments to receive improved RBC treatment compared to what they would have received had the insurer held the underlying investments directly. To remedy this and other perceived infirmities with relying on commercial credit ratings for structured equity investments, the SVO staff sought the authority to require that all such investments be submitted to the SVO to conduct a thorough look-through analysis in order to ensure that the overall risk assessment will be RBC neutral when comparing the ultimate underlying assets to the securities issued by the structured equity and fund. The SVO's analysis would include:

- Verifying the type of assets and assessing their credit risk, including performing an independent assessment of credit risk, as necessary.
- Assessing which assets are consistent with a fixed income-like investment and which assets are substantively equity.
- Evaluating the extent to which the composition of a Structured Equity and Fund's underlying investment(s) in a fund(s) can vary under normal market conditions given the underlying fund's policies and investment strategies.
- Evaluating the extent to which the composition of the underlying fund's portfolio may vary under abnormal market conditions and the extent to which changes in composition of the underlying fund's portfolio in abnormal market conditions may persist given the underlying fund's leverage profile or other relevant factors.

Over the ensuing months, this proposal seemed to transform into a proposal that would enable the SVO to challenge existing ratings on insurer investments when the SVO believes that the assigned rating does not accurately reflect the security's risk. At the NAIC's most recent meeting in August, the VOSTF discussed the comments received on this proposal. Not surprisingly, there was significant opposition because of the disruption this may cause to insurer investments and the broader capital markets, and because the SVO's continued expansion of its authority is beginning to look like it wants to be become a rating agency itself. The SVO outlined an appeals process that an insurer may use to challenge the SVO's determination, which could take a year or more to finally settle.

What's Next?

The NAIC Financial Condition (E) Committee, which ultimately governs the SVO, RBCIRE and VOSTF, held a meeting at the NAIC's 2023 Summer National Meeting and exposed for public comment a potential path for slowing (or perhaps halting entirely) the SVO's recent efforts to become more involved in the rating of structured securities and return to its historical role of providing advice and research to insurance regulators. The Committee exposed a document entitled, "Framework for Regulation of Insurer Investments – A Holistic Review" (the "Framework Document"). The Framework Document seemed somewhat unusual in that it appeared on the agenda without any attribution or materials on its background or origin.

The chair of the Committee led a discussion on the Framework Document, stating that the Committee drafted the Framework Document to provide a "holistic overview" of the key work of the various task forces/working groups under the Committee that are focused on insurer investment regulation and to clarify that this work is expressly under the purview of the Committee. The Framework Document acknowledged that insurer investments in recent years have become more complex than traditional bonds and equity, its primary intent is to determine what is the most effective use of regulatory resources in the modern environment of insurance regulation for investments. It stated that the SVO currently lacks the tools to provide due diligence and assessment over the use and effectiveness of credit rating providers, or to conduct enterprise- or industry-wide risk analytics. The Framework Document suggested that instead of a framework that utilizes valuable SVO resources to prioritize synthesizing rating agency functions, a more effective use of those resources would be to prioritize the establishment of a robust and effective governance structure for the due diligence of rating agencies. It also observed that with investment in modern risk analytics tools, the SVO could provide invaluable risk analysis capabilities to better support the risk-focused approach to insurance supervision.

While it is not clear whether any of the existing initiatives (described above) would be delayed or shelved as a result of the Committee's holistic review (some regulators stated that they would not), the Framework Document sets out proposals that focus on modernizing the role and capabilities of the SVO in a way that correlates with the observed shift towards more complex and asset-intensive insurer business strategies.

IV. EU SECURITIZATION REGULATION DEVELOPMENTS

IV. EU Securitization Regulation Developments

Cayman Islands

One area of interest for US CLOs which are marketed to EU investors is eligibility of the Cayman Islands as an SPV jurisdiction under Article 4 of the EU Securitization Regulation. The Cayman Islands were first added to the so called EU AML "blacklist" in March 2022[12], resulting in a migration of US CLOs to Jersey and Bermuda over the course of 2022[13].

Discussions about the Cayman Islands position on the various stop lists have been continuing since then, with the Cayman Islands actively seeking to address the reported deficiencies with the relevant task forces and regulators. As part of these discussions, the Cayman Islands addressed the FATF at the FATF plenary session on June 19-23, 2023, about being removed from the FATF greylist. The FATF confirmed, on June 23, 2023 that the Cayman Islands satisfied all 63 recommended actions and that it could proceed to an on-site assessment, which took place in September and an onsite visit report was presented at the next plenary session of the FATF on October 25-27, 2023. The Cayman Islands were removed from the FATF greylist at that session.

Whilst this development is positive and encouraging, removal of the Cayman Islands from the FATF greylist does not automatically result in them becoming an eligible SPV jurisdiction under Article 4 of the EU Securitization Regulation. Although the FATF stop lists would typically influence composition of the EU AML blacklist, the EU has its own independent process of assessment of risks and updates to the EU AML blacklist (periodic review is typically carried out a couple of times a year and is not linked to updates to the FATF lists) and removal of the Cayman Islands from the FATF greylist does not guarantee its removal from the EU AML blacklist.

Therefore, although we will continue to monitor the status of the Cayman Islands on the EU AML blacklist, it is probably unlikely that, even with the successful removal of the Cayman Islands from the FATF greylist, they would be removed from the EU AML blacklist before the end of the current calendar year.

As we have previously mentioned, the UK Securitization Regulation differs in this regard, referring to the FATF blacklist, which does not include the Cayman Islands at this point in time. On that basis, UK investors are currently not been prohibited from investing in securitization transactions that use SSPEs domiciled in the Cayman Islands.

Final Draft Risk Retention RTS

On October 18, 2023, Commission Delegated Regulation (EU) 2023/2175 of 7 July 2023 (the "2023 Risk Retention RTS") was published in the Official Journal of the European Union, almost five years after the EBA first published a final draft of the risk retention RTS. The 2023 Risk Retention RTS are very similar to the final draft risk retention RTS published by the EBA in April 2022 ("2022 Draft RR RTS"), although there are a number of largely cosmetic and clarificatory changes. One of the more significant changes which is relevant to CLO transactions (and more specifically, originator vehicles that sponsor EU-compliant CLOs and hold their risk retention) relates to the guidance on the "sole purpose" test. The "sole purpose" test set out in article 2(7) of the 2023 Risk Retention RTS has subtly shifted. The familiar tests relating to resources/assets and governance still apply, but while the 2022 Draft RR RTS set them out as a list of factors to be taken into account in order to determine whether an entity has been established or operates for the sole purpose of securitizing exposures, the 2023 Risk Retention RTS now reads "where all of the following applies", such that, where an entity meets all of the criteria set out in Article 2(7), it will not be considered to have been established or to operate for the sole purpose of securitizing exposures. The 2023 Risk Retention RTS are silent as to the treatment of an entity that does not meet all of the criteria.

The 2023 Risk Retention RTS will enter into force on November 7, 2023, i.e., the 20th day after their publication in the Official Journal.

Reporting for third country securitizations

On October 11, 2023, the Joint Committee of the European Supervisory Authorities ("ESAs") published a response to request for Joint Committee guidance to National Competent Authorities on investors' verification duties for third-country securitizations. The ESAs expressed acknowledgement of the importance of the matter for EU investors in third-country securitizations, but communicated that they thought it to be premature to issue enforcement guidance to national competent authorities at this time, pending completion of the review of reporting templates for securitizations which is currently being conducted by ESMA. The position therefore remains subject to further monitoring.

12 Commission Delegated Regulation (EU) 2022/229.
13 See our briefing titled "European Commission to Ban Cayman Securitisation SPVs" and our May 2023 Structured Credit Regulatory Update.

V. UK SECURITIZATION REGULATION DEVELOPMENTS

V. UK Securitization Regulation Developments

In the United Kingdom, as part of the wide-ranging measures introduced by the Edinburgh Reforms and HM Treasury's plan for "Building a smarter financial services framework for the UK", HM Treasury published on July 11, 2023 a near-final version of "The Securitization Regulations 2023" statutory instrument (the "Securitization SI"), which is intended to replace Regulation (EU) 2017/2402 as it forms part of domestic law of the UK by virtue of the European Union (Withdrawal) Act 2018 (the "UKSR").

"The Securitization Regulations 2023" Statutory Instrument

The Securitization SI follows the enactment of the Financial Services and Markets Act 2023, the key piece of legislation which implements the UK's post-Brexit regulatory framework for financial services. It is an updated version of the illustrative draft statutory instrument on securitization regulation published as part of the Edinburgh Reforms package in December 2022.

The changes, as compared to the December 2022 draft, are not significant, though the following key changes are noteworthy in the context of CLO transactions:

- narrowing the scope of the definition of "institutional investor" so that the UK due diligence requirements now only apply to UK AIFMs (instead of also applying to AIFMs with a registered office outside the UK); and
- clarifying the ban on the use of securitization special purpose entities in certain high-risk or non-cooperative jurisdictions, so that it applies to originators and sponsors of securitizations and prospective institutional investors in securitizations with such securitization special purpose entities.

As mentioned above, the Securitization SI retains the overall framework for moving much of the detailed rules regulating the UK's securitization market from primary legislation to the rulebooks of the regulators, i.e., the Financial Conduct Authority (the "FCA") and the Prudential Regulation Authority (the "PRA"), while requiring them to have regard to the "coherence of the overall framework for the regulation of securitization" when making the relevant rules.

In connection with such move from primary legislation to the rulebooks of the regulators, both the PRA and FCA launched separate (but related) consultations on the proposed rules: the PRA consultation was published on July 27, 2023 (the "PRA Consultation"), and the FCA consultation was published on August 7, 2023 (the "FCA Consultation"). We consider these in more detail below.

PRA Consultation

The PRA's proposals relate to the provisions of the UKSR for which the PRA has supervisory responsibility and largely look to preserve the current requirements under the UKSR with some targeted adjustments, including the below:

- **Clarification of the person scope of requirements on manufacturers:** With respect to the rules which will replace Articles 6-9 of the UKSR, the PRA proposes to make clear that, alongside the application to PRA authorized CRR firms (broadly, banks and investment banks) and Solvency II firms (broadly, insurers and reinsurers), the scope of the rules also captures other PRA-authorized firms that manufacture securitizations.
- **Adjustments to diligence requirements:** In a helpful shift to a more principles-based approach, the proposed new rules would require UK institutional investors to verify that they have sufficient information to independently assess the risks of the investment (as opposed to locking them up into the strict confines of the prescribed templated reporting, which would be a very welcome shift particularly for third country securitizations such as US CLOs). That requirement goes on to specify certain categories of information institutional investors must receive. Those categories broadly mirror the disclosure requirements on manufacturers, but without the accompanying detailed templates. We expect that this should facilitate investment by UK investors in non-UK securitizations as compared to the present approach.
- **Delegation of due diligence:** The PRA is proposing to clarify in its rules replacing Article 5(5) UKSR that if a delegating party instructs a managing party to fulfil any of its due diligence obligations, then the delegating party would not bear responsibility for a failure to comply with the delegated obligations. The rules are also being changed so that only FCA or PRA supervised institutional investors be a managing party for the purposes of these rules.
- **Clarification of timelines for manufacturers making available certain information:** There is various information which the UKSR requires to be provided prior to pricing but which is impractical or impossible to provide at that time, such as the final prospectus or final deal documents (both of which contain pricing information). In practice, these documents are only ever provided in

draft form prior to pricing and the proposed new rules would acknowledge this reality. Final versions of this information will be required at the latest 15 days after closing.

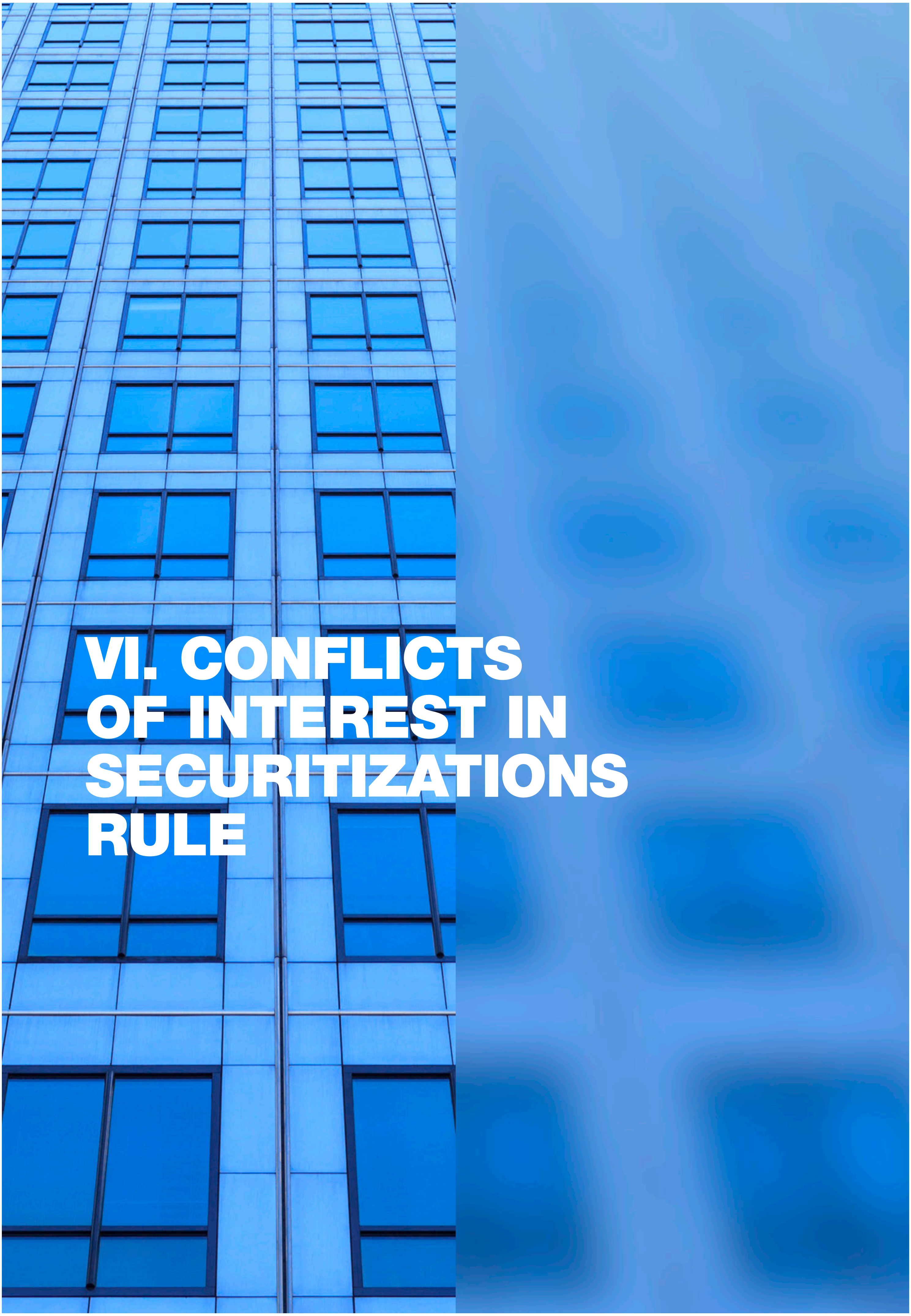
- **Replacing relevant provisions in the Risk Retention Technical Standards with PRA rules:** The PRA proposes to replace the relevant provisions in the currently applicable risk retention technical standards (still the old 2014 ones made under the CRR) with PRA Rules. In the process, the PRA proposes to make some changes to align with the EU Risk Retention Regulatory Technical Standards adopted by the EU Commission in July 2023 (but not yet in force).
- **Replacing the relevant provisions in the Disclosure Technical Standards with PRA rules:** The PRA proposes to preserve the requirements in the existing disclosure technical standards under the UKSR and provide further details on some of the transparency requirements.

FCA Consultation

The FCA proposals largely mirror the PRA proposals as far as shared areas are concerned, with the same adjustments to due diligence requirements and delegation, risk retention, disclosure timelines, risk retention technical standards, etc. being mirrored (albeit sometimes in different form) in the proposed FCA rules.

Next steps

Industry feedback on the Securitization SI has been submitted to HM Treasury on September 10, 2023, and that consultation has now been closed. A number of European market associations are currently in the process of consolidating industry feedback on the PRA Consultation and the FCA Consultation, which are open for comments until October 30, 2023. When finalized, these three instruments will together replace the UKSR, which is currently retained EU law. This is not however expected before the end of 2023.



VI. CONFLICTS OF INTEREST IN SECURITIZATIONS RULE

VI. Conflicts of Interest in Securitizations Rule

As detailed in our previous briefing available here, the SEC's Proposed Rule on the "Prohibition Against Conflicts of Interest in Certain Securitizations" ("Proposed Conflicts Rule") poses many potential problems for the CLO industry but also applies to all asset-backed securities. Since then, the Structured Finance Association ("SFA") sent a follow-up letter to the SEC on July 13, 2023 with recommended amendments to the Proposed Conflicts Rule. They urged the SEC to make several changes, as the current Proposed Conflicts Rule is critically flawed and unworkable. Their suggested changes include: (i) narrowing the definition of "conflicted transaction" to remove an "unworkably broad approach," (ii) refining and clarifying the commencement date of the prohibition on a securitization participant's entry into a transaction that would involve a material conflict of interest, (iii) clarifying and narrowing the definition of "sponsor" including exceptions for (a) persons that perform routine securitization activities and (b) long investors and (iv) providing a definition for the term "synthetic asset-backed security" as there is no commonly understood meaning among market participants.

As a reminder, the Proposed Conflicts Rule would prohibit a material conflict of interest between a securitization participant and an investor. The definition of "securitization participant" is extremely broad, capturing an arranger and sponsor's affiliates. The conflicted transaction definition includes an unclear general catch-all which could have the result of one short position on one asset in a CLO being deemed a conflict. Finally, securitization participants could not cure any such conflicts through disclosure or traditional information barriers (and a proposal for use of information barriers pursuant to certain conditions has been called unworkable by many market participants).

We also note that the SEC has proposed new conflicts of interest rules regulating the use of predictive data analytics in "investor interactions" by broker-dealers and investment advisers. That is described in more detail in section IX of this update.

VII. SAFEGUARDING RULE

VII. Safeguarding Rule

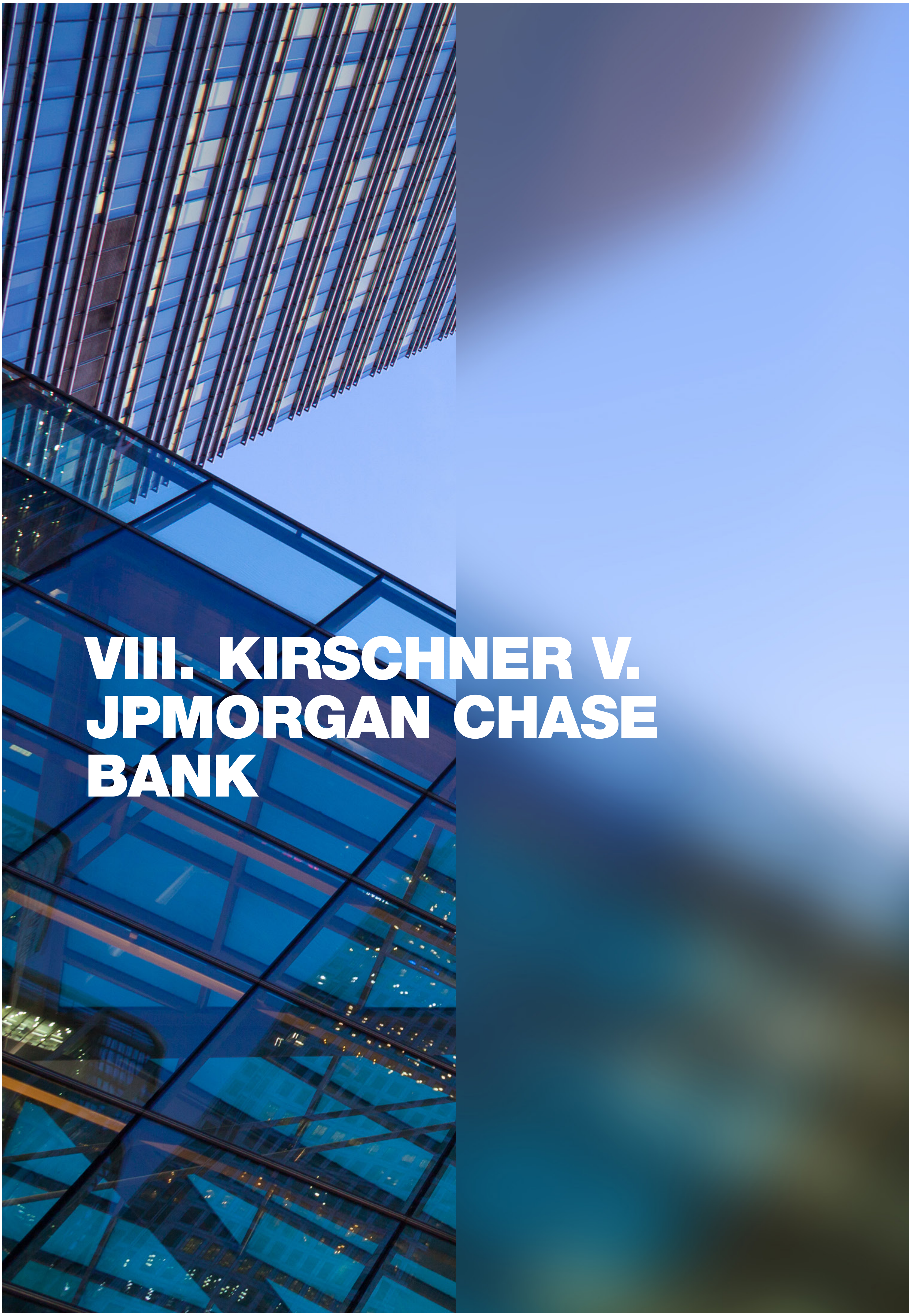
The proposed "safeguarding rule" under the Advisers Act would apply to all registered investment advisers (RIAs). The proposed rule would deem RIAs with discretion over client assets to have custody and require the RIA to comply with the limitations and requirements imposed by the Rule. The proposed rule applies not just to securities, but to all client "assets" which significantly expands the scope of this rule from the current Custody Rule and would include loans in a CLO, which collateral managers have the ability to trade on behalf of the issuer.

If this rule ultimately applies to CLOs, the loan assets would need to be held with a qualified custodian who has possession and control of the assets. The current agent banks involved in CLO transactions may not fulfil all of the requirements to be considered a qualified custodian under the amended definition thereof (in particular, it's unlikely such counterparties will agree to indemnify CLOs for the bank's negligence given the low cost business model) and there are concerns about how loan participation arrangements would work. Given settlement times, many deals utilize master participation agreements, particularly if purchasing from another managed CLO. Further, the collateral manager itself would have significant obligations to maintain an ongoing reasonable belief that the custodian is complying with the client protection requirements, beyond simply ensuring a written agreement covers the custodian's obligations, which would increase compliance costs for the manager.

Related to this, the proposed rule requires independent verification of the client assets by an independent public accountant. If certain assets are unable to be maintained with a qualified custodian (or the manager seeks to use the privately offered securities exemption), the adviser must engage an independent public accountant to verify every purchase, sale or transfer of beneficial ownership of such assets and notify the SEC within one business day upon finding any material discrepancies. That's in addition to the annual audit or surprise examination procedures already required. Further, the manager "must ensure that the independent public accountant's involvement in the verification and notification requirements in the proposed rule are implemented effectively so as to ensure the reliability and integrity of the surprise exam." [14] The requirement for trade-by-trade verification by an accounting firm would be both uneconomical from a cost perspective but likely unworkable from a resource standpoint given the trading volume in the CLO market.

14 See the commentary to the proposed rule at p177 (https://www.sec.gov/files/rules/proposed/2023/ia-6240.pdf)

VIII. KIRSCHNER V. JPMORGAN CHASE BANK



VIII. Kirschner v. JPMorgan Chase Bank

On March 16, 2023, the Court of Appeals asked the SEC for "any views it wishes to share" on the central question of whether the Term Loan B at issue in *Kirschner v. JPMorgan Chase Bank, N.A. et al*.[15] is in fact a security under the *Reves*[16] "family resemblance" test. After the Court granted multiple extensions of time to the SEC, the SEC filed a response on July 18, 2023 stating that "[d]espite diligent efforts to respond to the Court's order and provide the Commission's views, the staff is unfortunately not in a position to file a brief on behalf of the Commission in this matter."

JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC filed their own request, on May 26, 2023, for the Court to solicit the views of the primary federal agencies that oversee the syndicated loan market (the Office of the Comptroller of the Currency, the Department of the Treasury, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System. They submitted that given the Court solicited the views of the SEC, the views of the loan market regulators should equally be relevant. There would seem to be some logic to that view, both on the face of it and because an element of the *Reves* test is to consider whether there are risk reducing factors such as another regulatory scheme. The Court did not agree, however, and denied the request.

On August 24, 2023, the long awaited Kirschner decision was handed down and affirmed the District Court's order dismissing the plaintiff's state law securities claims. The Court of Appeals held that the District Court did not erroneously dismiss Kirschner's state-law securities claims because Kirschner failed to plausibly suggest that the Term Loan Bs (the "notes" in question) are securities under *Reves*.

The Court takes a fresh look at the Reves test and sets the context for the test that *"only "notes issued in an investment context" are "securities." By contrast, notes "issued in a commercial or consumer context" are not."*

The motivations that would prompt a reasonable seller and buyer to enter into the transaction

The considerations under this limb perhaps draw to attention a particular difficulty with the *Reves* test which requires an analysis of whether the motivations of the parties are for investment purposes or commercial/consumer purposes. On the one hand, it seems plausible to argue that any lending has an investment purpose as generally lenders expect to profit from the transaction. However, the purpose for which the company seeks the additional capital and the factors in this case suggest that Millennium's motivation was commercial – to redeem outstanding warrants, debentures and stock options. Oddly, the Court both acknowledges that the motivations of the parties were mixed but seems to also see this as tilting in favor of the notes being securities.

The plan of distribution of the instrument

In considering this factor, a note is likely to be a security if it's offered and sold to a broad segment of the public and not considered a security if there are limitations, such as transfer restrictions, preventing such note being broadly sold. Here, the Court was satisfied that the notes were sold only to sophisticated institutional entities and, despite receiving a document that may resemble a securities-style offering document, such document explicitly said it was not "all-inclusive" and such sophisticated investors were required to perform their own independent investigation and analysis of the lending transaction. Additionally, the market-standard assignment restrictions weighed against the conclusion that the notes are securities.

The reasonable expectations of the investing public

This factor shows that terminology matters. The Court was persuaded that the sophisticated institutional investors involved here were given ample warning that the notes were loans and not securities. The investors were required to certify their independent assessment of the transaction, without reliance on the arranging banks, and the documentation more consistently used the term "lenders". The Court did consider the isolated references to "investors" but didn't find it reasonable that this was sufficient for a conclusion that the loan was in fact a security. Given some of this focus, we expect loan syndication documentation to be more careful going forward to use loan-like terminology.

Whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities laws unnecessary

Finally, the Court was not persuaded that the application of the securities laws were necessary for two reasons. First, the loan was secured by a perfected first priority security interest, which reduces the risk associated with the notes. Second, "*the Office of the Comptroller of the Currency, the Board of Governors of the Federal*

15 Kirschner, v. JP Morgan Chase Bank, N.A. et al, 17 Civ. 6334 (PGG) (S.D.N.Y. Sep. 30, 2021)
16 See Reves v. Ernst & Young, 494 U.S. 56 (1990).

Reserve System, and the Federal Deposit Insurance Corporation (jointly, the "Bank Regulators") issued "specific policy guidelines" addressing syndicated term loans."

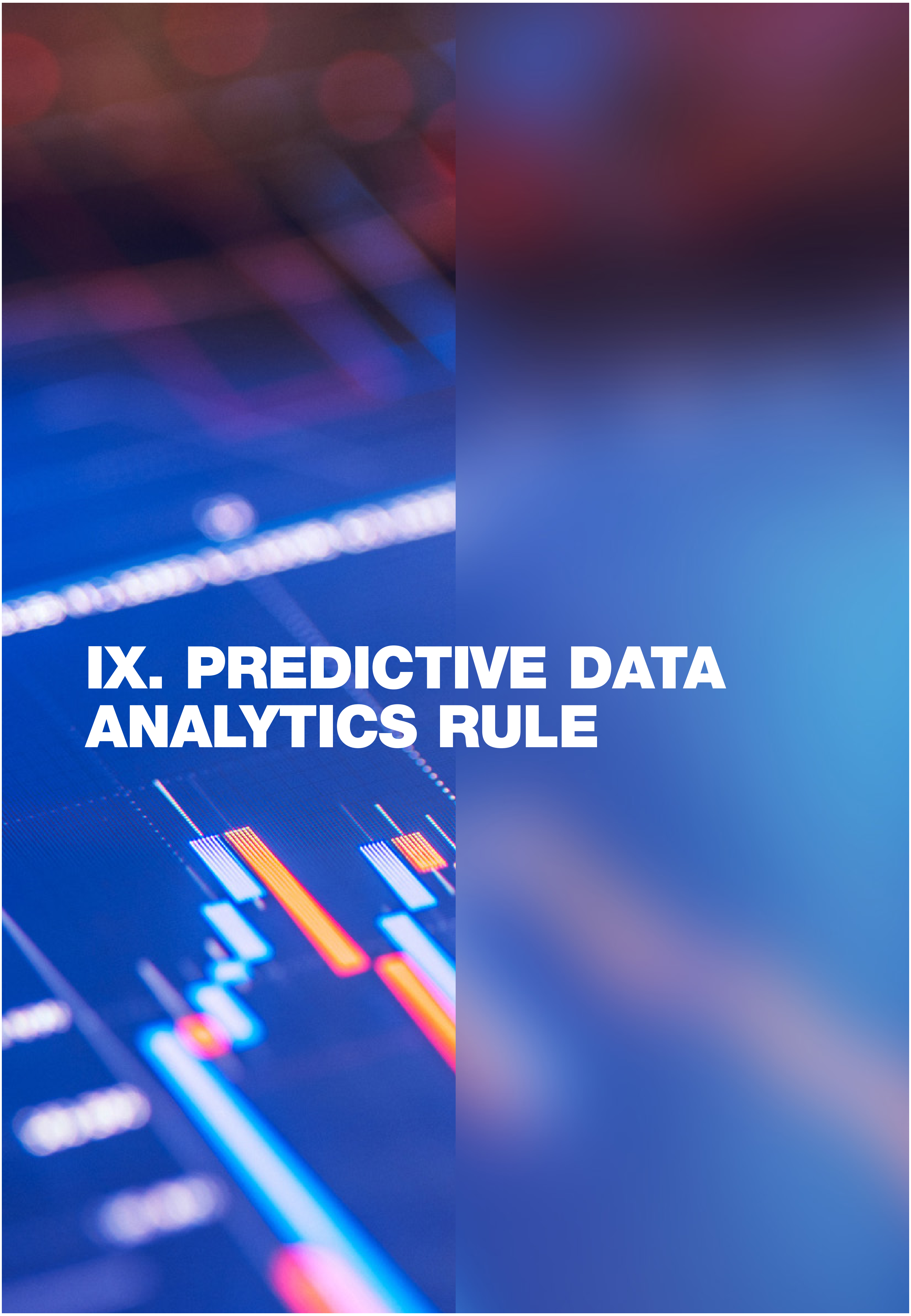
Although favorably decided for the CLO market for now, if an appeal were to ultimately be successful and a court subsequently finds that Term Loan Bs are in fact securities, the consequences would be wide ranging and unpredictable. Loan syndication and trading activity would need to change in order to comply with securities laws (state and federal), such activity would need to be conducted through registered broker-dealers and practices with respect to "material non-public information" would need to change. Overall, this could lead to a period of little to no loan origination while the market adjusts and the whole syndicated loan market would essentially need to be recreated. The loan market could potentially shift to a 144A market, a 4(a)(2) market or a new market entirely. It's also possible that a future Term Loan B market would fragment in part into the bond, 4(a)(2) and private credit market, as well as new formats. Any of these options would be dramatic changes to the current market.

Additionally, and as we have previously pointed out, for purposes of the Volcker Rule, CLO collateral managers would no longer be able to use the loan securitization exclusion and thus would be considered "covered funds". This could be particularly concerning for managers that are part of a banking entity. The US CLOs that rely on the loan securitization exclusion would no longer be able to do this since, the Volcker Rule excludes "securities," as defined in the Exchange Act, from qualifying as "loans" for purposes of the loan securitization exclusion. If a CLO is a covered fund, the manager's ability to own "ownership interests" in such CLO would be constrained by the Volcker Rule, and its ability to enter into trading or financing transactions with the CLO would be restricted by Super 23A.

However, closing that exemption would seemingly violate the BHCA. Section 13 of the BHCA, the authority under which the Volcker Rule was promulgated, contains this within its rules of constructions - Section 13(g)(2): "*Nothing in this section shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law.*"

Despite the SEC's reluctance to formally comment in the Kirschner case, in a recent speech available here, Commissioner Caroline A. Crenshaw expressed her concern "*with "loans" that look less and less like loans*". She continued, "*The syndicated loan market has grown vastly larger in recent years and the loans themselves are far different from traditional loans. Many are sold to hundreds of "passive" investors. They trade frequently and on standardized documentation. And they are used to conduct activities far beyond traditional borrowing to buy a piece of machinery or a new building. Despite this significant growth, much of this market is not subject to meaningful regulation and investors are being put at risk. In addition, I am concerned that systemic financial issues are lurking in the market, and that if these instruments are not monitored more closely, the risk to the financial system itself will continue to grow.*" Commissioner Crenshaw went on to reference the CLO market specifically and the symbiotic relationship between banks arranging loans that they sell to institutional purchasers.

Commissioner Crenshaw specifically addressed the *Reves* test as applied in *Banco Espanol* and *Kirschner* and expressed concern about the risk that has accumulated in the broadly syndicated loan ("BSL") market, highlighting the recent focus on "snooze drag" provisions. Some may take issue with her claim that "*Retail investors have enormous exposure to* [the BSL] *market*." Data from LPC Collateral, Refinitiv Lipper and Morningstar LSTA Leveraged Loan Index shared at the LSTA Annual Conference this month suggests that loan funds (including mutual funds and ETFs) have a less than 10% share of the BSL market. This recent speech makes clear that certain of the Commissioners may not consider the *Kirschner* decision the end of this debate and could seek to regulate BSLs on financial stability grounds.



IX. PREDICTIVE DATA ANALYTICS RULE

IX. Predictive Data Analytics Rule

On July 26, 2023, the SEC proposed new conflicts of interest rules (the "Proposed PDA Rule") under the Securities Exchange Act of 1934 (the "Exchange Act") and the Investment Advisers Act of 1940 (the "Advisers Act"), available here, to address conflicts of interest from the use of artificial intelligence ("AI") and "predictive data analytics" ("PDA") and similar technology by both broker-dealers and also investment advisers to interact with investors to prevent firms from placing their interests ahead of investors' interests. The purpose of the proposed rule is to "eliminate, or neutralize the effect of conflicts of interest associated with the firm's use of covered technologies" that optimize for, predict, guide, forecast or direct investment-related behaviors or outcomes. The comment period ended on October 10, 2023. We also note that several trade associations, including the LSTA, the Securities Industry and Financial Markets Association, the Investment Adviser Association and many others, sent a letter to the SEC asking for an extension of the comment period. The letter emphasized that the Proposed PDA Rule may implicate other rules, including the Marketing Rule. That there isn't sufficient time to consider the proposed rules on their own but also in terms of how they interact with other proposed rulemaking has been a longstanding criticism of the SEC's current rulemaking agenda, both within the industry and with certain members of the Commission itself. The LSTA and the American Investment Council jointly submitted a comment letter (the "Joint Comment Letter") to the SEC on October 10, 2023, which focused on the SEC's lack of authority[17], short comment period and impact on the SEC's recently adopted Marketing Rule.

The proposed rules would apply when a broker-dealer or an investment adviser (whether registered or required to be registered under section 203 of the Investment Advisers Act of 1940) (or, in each case, its associated persons) uses or reasonably foreseeably may use "covered technology" (as defined below) in an "investor interaction" (as defined below).

"Covered technology" is defined in the Proposed PDA Rule as an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes.

"Investor interaction" is defined in the Proposed PDA Rule as engaging or communicating with an investor, including by exercising discretion with respect to an investor's account; providing information to an investor; or soliciting an investor; except that the term does not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support.

A "conflict of interest" exists when an investment adviser or a broker-dealer, respectively, uses a covered technology that takes into consideration an interest of the firm, or a natural person who is a person associated with the firm.

The Proposed PDA Rule would require investment advisers and broker-dealers to do the following:

- **Evaluation/Identification:** Evaluate the use or reasonably foreseeable use of a covered technology in an investor interaction to identify any potential conflict of interest, and determine whether any identified conflict of interest places or results in placing the firm's or its associated person's interest ahead of investors' interests.
- **Eliminate/Neutralize:** Eliminate, or neutralize the effect of, any conflict of interest.
- **Policies & Procedures:** Investment advisers and broker-dealers would be required to adopt and implement (and, solely in the case of broker-dealers to also maintain) written policies and procedures reasonably designed to, with respect to investment advisers, prevent violations of the proposed rules, and with respect to broker-dealers, achieve compliance with the proposed rules. The Proposed PDA Rule requires:
  - a written description of the process for evaluating any potential conflicts of interest before implementing any covered technology.
  - a written description of the process for determining whether any conflict of interest identified by this evaluation results in an investor interaction that places the firm's or its associated persons' interests ahead of any of its investors'.
  - a written description of the process for determining how to eliminate, or neutralize the effect of, any such conflicts of interest.
  - a review and written documentation of that review, at least annually, of

17 The comment letter states Section 211(h) of the Advisers Act does not provide the SEC with such authority to adopt the Proposed PDA Rule, and it does not have a "blank check [from Congress] to adopt rules regarding any sales practice, conflict of interest, or compensation practice of an investment adviser."

the adequacy of the policies, procedures and written descriptions, and the effectiveness of their implementation.

- **Books/Records:** Maintain detailed records, including written documentation of the evaluation of any potential conflict of interest, a list of all covered technologies, the date on which a covered technology is first implemented and the dates when materially modified as well, an evaluation of the intended use compared to the outcome in investor interactions, documentation describing the testing of the covered technology (including dates, methods, potential conflicts of interest), a description of any changes to the covered technology, restrictions as a result of the testing, written documentation of the elimination or neutralization for potential conflicts of interest, and records of disclosure provided to investors regarding use of covered technology.

The Proposed PDA Rule generally would apply to a firm's use of a covered technology to the extent it is used in connection with the firm's engagement or communication with an investor, including by exercising discretion with respect to an investor's account, providing information to an investor, or soliciting an investor.[18]

We expect there to be significant comments and debate on the Proposed PDA Rule as it is overly broad, difficult to comply with and can be costly and burdensome. The SEC commissioners themselves were split in voting for the Proposed PDA Rule (in a 3 to 2 vote). Commissioner Hester Peirce notes in her strong dissenting statement available here that the Proposed PDA Rule reflects the SEC's "distorted thinking" and is "hostile" towards the use of technology. The LSTA also views the Proposed PDA Rule as "astonishingly broad in its scope, imposes incredibly prescriptive requirements, abandons long-held SEC principles and seems to be wholly unnecessary…"[19]

The proposed definition of "covered technology" for example can potentially capture any form of analytics not necessarily limited to sophisticated artificial intelligence. Industry standard software, math formulas, statistical tools, and other tools commonly used in the market (perhaps even including excel spreadsheets) may possibly be captured as "covered technology." The Joint Comment Letter noted that even a telephone may be considered to be a covered technology, The proposed rule is also difficult to comply with; how can a broker-dealer and/or investment adviser be able to determine that the covered technology does not advance its own interests over the investors? (As the saying goes, it is difficult to know what you don't know). Not only does the Proposed PDA Rule attempt to prevent violations, but in the case of broker-dealers, it must actually *achieve compliance*. That can be difficult when it is not entirely clear how to "test" for potential conflicts of interests to begin with, or to know once compliance is "achieved." There may also be significant costs associated with the ongoing compliance requirements, which may squeeze out smaller investment advisers. Finally, we note that disclosure is often the "cure" for any conflicts of interest (or potential conflicts of interest). The SEC is attempting to expand their reach and their overuse of strict regulations when simple disclosure and consent should suffice. Commissioner Peirce even noted in her dissenting statement that the Proposed PDA Rule reflects the SEC's "loss of faith in one of the pillars of our regulatory infrastructure: the power of disclosure and the corresponding belief that informed investors are able to think for themselves."

The Joint Comment Letter also urged the SEC to exclude from the scope of the Proposed PDA Rule all advertisements and endorsements subject to the Marketing Rule as the Proposed PDA Rule does not address or explain its impact on the Marketing Rule. Both the Marketing Rule and the Proposed PDA Rule "will affect investment advisers' use of technology when communicating with investors."[20] The Joint Comment Letter also cautioned the SEC that the Proposed PDA Rule does not address whether compliance with the Marketing Rule would "neutralize' a conflict of interest under the Proposed PDA Rule.

We will continue to monitor this and provide any further updates.

18 See page 2 of SEC fact sheet (https://www.sec.gov/files/34-97990-fact-sheet.pdf)
19 See August 15, 2023 LSTA publication, "CONFLICTS IN THE USE OF PREDICTIVE DATA ANALYTICS: ANOTHER MYSTIFYING SEC RULE PROPOSAL" (https://www.lsta.org/news-resources/conflicts-in-the-use-of-predictive-data-analytics-another-mystifying-sec-rule-proposal/).
20 See Joint Comment Letter, page 4.

X. BASEL "ENDGAME" PACKAGE

X. Basel "Endgame" Package

On July 27, 2023, the U.S. federal banking agencies – the Board of Governors of the Federal Reserve, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation – released their long-awaited proposal implementing the final set of capital reforms under the Basel III accord, colloquially known as the Basel "Endgame" package. The controversial 1089-page rule proposal, which was released despite notable dissents from board members of the agencies, will markedly increase regulatory capital requirements for all banking organizations with over $100 billion in total assets.

The proposed capital framework replaces entirely the "advanced approach" or internal ratings-based approach (IRBA) currently applicable to the largest and most complex U.S. banks with a new expanded risk-based approach (ERBA), which is based off of the "standardized approach" but with more granular and expanded risk weights. The ERBA largely does away with models for sizing risk-weighted assets, which the agencies found to be not transparent, susceptible to gaming and based on overly rosy historical data.

Despite broad recognition that the regional banking crisis earlier this year was driven by runs on uninsured deposits (liquidity risk) and asset / liability mismanagement (duration risk), the agencies elected to apply the new ERBA to a much wider swath of banking organizations than the original IRBA, scoping in many large regional banks and other special purpose banks with over $100 billion in total assets.

The ERBA also forces banks to apply deductions to regulatory capital on par with those applicable to the U.S. G-SIBs, the most notable of which is a recognition of Accumulated Other Comprehensive Income (AOCI). AOCI would result in losses on securities held in the banking book flowing through to a bank's total equity. This stance was clearly informed by the banking crisis earlier this year, when losses on fixed rate, long-dated instruments raised serious questions about the solvency of some regional banks.

One of the more controversial aspects of the proposed rule is the extent to which it continues the U.S.'s "gold-plating" of internationally agreed-upon standards. Despite the intent of central bankers under the Basel III Accord for the Endgame package be net "capital neutral", the proposed U.S. framework will significantly increase capital requirements for all U.S. banks and IHCs subject to the ERBA by imposing more punitive risk weights relative to their non-U.S. counterparts.

As an example of the increased granularity of the ERBA, under the current standardized approach, residential mortgages are typically subject to a 50% or 100% risk weight depending on whether they are first-lien mortgages or more than 90 days past due. Under the ERBA, risk weightings will fluctuate depending on the LTV ratio and whether the underwriting of the mortgage is dependent on the cash flows generated by the property, with risk weights ranging from 40% to 125%.

The ERBA will also significantly impact the securitization market by doubling the supervisory parameter – *p* factor – used to calculate the risk weightings for securitization exposures. If adopted as proposed, the revised securitization standardized approach (SEC-SA) is expected to have a significant negative impact on the market for credit risk transfer (CRT) trades, in which banks purchase protection on underlying credit exposures to release capital savings.

XI. MARKETING RULE

XI. Marketing Rule

On October 16, 2023, the SEC's Division of Examinations announced its 2024 Examination Priorities, which will include a focus on marketing practice assessments to test if investment advisers have "(1) adopted and implemented reasonably designed written policies and procedures to prevent violations of the Advisers Act and the rules thereunder including reforms to the Marketing Rule; (2) appropriately disclosed their marketing related information on Form ADV; and (3) maintained substantiation of their processes and other required books and records." This follows a June 8, 2023 risk alert, which warned advisers to "review their marketing practices and advertisements to ensure compliance" with the SEC's recently amended Marketing Rule. In that risk alert, the Division of Examinations identified several areas of the Marketing Rule whicĥ will be scrutinized during upcoming SEC examinations.

In particular, during SEC examinations, the staff are reviewing (i) an adviser's policies and procedures, such as whether advisers have adopted and implemented written policies and procedures that are reasonably designed to prevent violations by the advisers and their supervised persons of the Advisers Act and the rules thereunder, including the Marketing Rule; (ii) the substantiation requirement, such as whether advisers have a reasonable basis for believing they will be able to substantiate material statements of fact in advertisements; (iii) performance advertising requirements, including whether advisers are in compliance with performance advertising requirements in the Marketing Rule; and (iv) books and records, such as whether advisers are in compliance with Advisers Act Rule 204-2, as amended, that requires advisers to make and keep certain records, such as records of all advertisements they disseminate, including certain internal working papers, performance related information, and documentation for oral advertisements, testimonials, and endorsements.

The staff are reviewing whether advisers are including clear and prominent disclosure of whether the person giving the testimonial or endorsement (the "promoter") is a client or investor, that the promoter is compensated, if applicable, and of material conflicts of interest. The staff is also reviewing whether (i) oversight conditions are met, such as whether advisers have a reasonable basis for believing that the testimonials or endorsements disseminated comply with the requirements of the Marketing Rule, (ii) written agreements are entered into where required, (iii) ineligible persons have been compensated for testimonials or endorsements and (iv) advisers are in compliance with the Marketing Rule requirements regarding the use of third-party ratings in advertisements.

Additionally, because the SEC amended Form ADV in conjunction with the Marketing Rule to require advisers to provide additional information regarding their marketing practices, the SEC risk alert stated that staff will review whether advisers accurately completed these questions. In short, the SEC will review to ensure that all Marketing Rule requirements are being complied with.

It is recommended that managers continue to assess their marketing materials and websites to determine whether certain statements may be considered "testimonials" under the Marketing Rule. Advisers should also consider whether certain arrangements are "endorsements" and are in compliance with the Marketing Rule. A Manager should also obtain assurances at the time it enters into an engagement with a CLO arranger (typically, in an engagement letter), and have those assurances brought down in connection with the closing of the transaction, that the arranger is an SEC-registered broker-dealer and is not subject to statutory disqualification under the Exchange Act. And finally, advisers should review their Form ADV responses under the new subsection 5.L under Item 5 and ensure such responses to these questions accurately reflect their marketing activities.

Please refer to our briefing, available here for further information, best practices and recommendations.

XII. RULE 15C2-11

XII. Rule 15c2-11

On October 30, 2023, the SEC granted exemptive relief to brokers and dealers from the requirements of Rule 15c2-11 with respect to fixed-income securities that are sold in compliance with Rule 144A.

As discussed in the previous issue of our Structured Credit Regulatory Update series, available here, Rule 15c2-11, without this exemptive relief, would have prohibited broker-dealers from publishing quotations on CLO securities and therefore would have significantly affected trading of CLO securities without changes to current market practice.

This exemptive relief follows from a petition from the National Association of Manufacturers and the Kentucky Association of Manufacturers, and in limiting this relief to Rule 144A fixed-income securities, "*it is limited to resales of securities to an investor base that "can be conclusively assumed to be sophisticated," is able to obtain certain basic financial information concerning the issuers' business, and has extensive experience in the private resale market for restricted securities.*"[21]

SIFMA has issued the following statement from its President and CEO Kenneth E. Bentsen, Jr. regarding this development: "We believe the exemptive order issued today by the SEC is the right outcome on Rule 15c2-11, and we applaud the Commission for taking this action. SIFMA and others warned of the potential harm that applying the public disclosure requirements of the Rule to the 144A market would have caused to U.S. companies and investors. The 144A market is currently relied upon by thousands of corporate and asset-backed securities issuers to raise capital and fund consumer lending, and the exemptive order preserves the ability of issuers to access this important market."

Rule 15c2-11 will continue to apply to any equity securities that are sold pursuant to Rule 144A.

21 See SEC Release No. 34-98819; File No. 4-795 at page 4.

CONTACTS

CLO/Structured Credit

Jessica Littlewood
Global Operations & Business Transformation
Partner
London
T: +44 207006 2692
E: jessica.littlewood@cliffordchance.com

Rebecca O'Brien
Partner
New York
T: +1 212 878 8263
E: rebecca.obrien@cliffordchance.com

Gareth Old
Partner
New York
T: +1 212 878 8539
E: gareth.old@cliffordchance.com

Julia Tsybina
Partner
London
T: +44 207006 4368
E: julia.tsybina@cliffordchance.com

Robert Villani
Partner
New York
T: +1 212 878 8214
E: robert.villani@cliffordchance.com

Marcie Kowlowitz
Counsel
New York
T: +1 212 878 3234
E: marcie.kowlowitz@cliffordchance.com

Brittany Binderoff
Associate
New York
T: +1 212 878 8024
E: brittany.binderoff@cliffordchance.com

Sarah Holm
Associate
New York
T: +1 212 878 8053
E: sarah.holm@cliffordchance.com

Arshak Mkrtchyan
Senior Associate
London
T: +44 20 7006 2512
E: arshak.mkrtchyan@cliffordchance.com

Tracy Poon
Senior Associate
London
T: +44 20 7006 1506
E: tracy.poon@cliffordchance.com

Phil Sandu
Senior Associate
London
T: +44 20 7006 2267
E: phil.sandu@cliffordchance.com

Konstantinos Voulgarakis
Senior Associate
London
T: +44 20 7006 4671
E: konstantinos.voulgarakis@cliffordchance.com

Tanner Schenewark
Associate
New York
T: +1 212 880 5691
E: tanner.schenewark@cliffordchance.com

Joanna Rymarowicz
Associate
New York
T: +1 212 878 8291
E: joanna.rymarowicz@cliffordchance.com

Regulatory

Jeff Berman
Partner
New York
T: +1 212 878 3460
E: jeffrey.berman@cliffordchance.com

CONTACTS

Regulatory

Cliff Cone
Partner
New York
T: +1 212 878 3180
E: clifford.cone@cliffordchance.com

Young Kim
Counsel
New York
T: +1 212 878 4902
E: young.kim@cliffordchance.com

Andrew Nelson
Associate
New York
T: +1 212 878 8284
E: andrew.nelson@cliffordchance.com

Daniel Drabkin
Partner
New York
T: +1 212 878 8255
E: daniel.drabkin@cliffordchance.com

Michael Sabin
Partner
New York
T: +1 212 878 3289
E: michael.sabin@cliffordchance.com

Private Funds

Vadim Avdeychik
Partner
New York
T: +1 212 878 3055
E: vadim.avdeychik@cliffordchance.com

Susan Burkhardt
Partner
New York
T: +1 212 878 3279
E: susan.burkhardt@cliffordchance.com

Insurance

Dennis Manfredi
Partner
New York
T: +1 212 878 3226
E: dennis.manfredi@cliffordchance.com

Joseph Cosentino
Partner
New York
T: +1 212 878 3149
E: joseph.cosentino@cliffordchance.com

Eugene Benger
Counsel
New York
T: +1 212 878 8033
E: eugene.benger@cliffordchance.com

ERISA

Paul Koppel
Partner
New York
T: +1 212 878 8269
E: paul.koppel@cliffordchance.com

Tax

James Gouwar
Partner
New York
T: +1 212 878 3388
E: james.gouwar@cliffordchance.com

Avrohom Gelber
Partner
New York
T: +1 212 878 3108
E: avrohom.gelber@cliffordchance.com

Rebecca Pereira
Partner
New York
T: +1 212 878 3392
E: rebecca.pereira@cliffordchance.com

Michaela Morr
Associate
New York
T: +1 212 878 8156
E: michaela.morr@cliffordchance.com

CLIFFORD
CHANCE

2310-008422