CLIFFORD CHANCE

STRUCTURED CREDIT REGULATORY UPDATE, MAY 2023

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

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STRUCTURED CREDIT REGULATORY UPDATE, MAY 2023

This regulatory update summarizes certain of the many new and proposed regulations that will impact the structured credit industry, including CLOs in particular.

I. Transition from LIBOR to Term SOFR

June 30, 2023 will be the last day on which USD LIBOR will be published on a representative basis. For US law governed contracts that reference commonly used tenors of USD LIBOR and lack adequate fallback provisions, the Board of Governors of the Federal Reserve System (the "**Federal Reserve Board**") has adopted regulations that will supply a Board-selected benchmark replacement pursuant to the Adjustable Interest Rate (LIBOR) Act (the "**LIBOR Act**"). In December 2022, the Federal Reserve Board adopted Regulation ZZ (available here) to implement the LIBOR Act. As discussed below, certain CLOs may replace USD LIBOR with the applicable tenor of Term SOFR plus a spread adjustment pursuant to the LIBOR Act and Regulation ZZ.

Background

For over five years, market participants have been expecting a transition away from LIBOR, a set of benchmark rates that had been widely used in variable rate financial contracts. In June 2017, shortly after the United Kingdom Financial Conduct Authority (the "**FCA**") announced that it planned to no longer compel or persuade certain banks to provide LIBOR submissions after 2021, the Alternative Reference Rates Committee (convened by the Federal Reserve Board and the Federal Reserve Bank of New York, the "**ARRC**") announced that it had selected the Secured Overnight Financing Rate[1] ("**SOFR**") as its recommended replacement rate for USD LIBOR settings. In 2021, the ARRC also formally recommended the forward-looking SOFR term rate administered by CME Group Benchmark Administration, Ltd. ("**Term SOFR**") for use in business loans and in securities backed by such loans.

On March 5, 2021, the FCA issued an announcement (the "**FCA Announcement**") that all LIBOR settings will either cease to be provided by any administrator or no longer be representative immediately after:

- December 31, 2021 for all GBP, EUR, CHF and JPY LIBOR settings and one-week and two-month USD LIBOR settings; and
- June 30, 2023 for the remaining USD LIBOR settings.

The FCA Announcement constituted an "Index Cessation Event" under the ISDA 2020 IBOR Fallbacks Protocol and resulted in fixing the fallback spread adjustments[2] for all LIBOR benchmark settings. Similarly, the FCA Announcement constituted a "Benchmark Transition Event" with respect to all USD LIBOR settings for purposes of the model fallback provisions that the ARRC had recommended. In addition, for cash products (other than loans to consumer borrowers) the ARRC's recommended spread adjustments match the values of ISDA's spread adjustments.

On April 3, 2023, the FCA announced its decision to require continued publication of one-, three- and six-month settings of USD LIBOR using a synthetic methodology. The FCA intends for the publication of synthetic USD LIBOR settings to continue through September 30, 2024. Synthetic USD LIBOR is not intended for use with new contracts and will not be representative of the underlying market and economic reality that USD LIBOR had been intended to measure. Legacy contracts that are governed by US law may use synthetic USD LIBOR only if the LIBOR Act does not supply the benchmark replacement by operation of law as of the "LIBOR replacement date" (currently expected to be July 3, 2023).

Application of the LIBOR Act to CLOs

The LIBOR Act and Regulation ZZ will supply a benchmark replacement for USD LIBOR by operation of law for a CLO indenture (and for any loan held by a CLO) when it:

- is governed by US law (e.g., New York law);

1 SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities in the repurchase agreement (repo) market. This rate is produced by the Federal Reserve Bank of New York, which publishes SOFR each business day at approximately 8:00 a.m Eastern Time.

2 Spread adjustments are intended to address certain differences between SOFR and USD LIBOR, including the fact that USD LIBOR is unsecured and therefore includes an element of bank credit risk that may cause it to be higher than SOFR.

- references specified tenors of USD LIBOR (including one-month and three-month USD LIBOR); and
- any one of the following applies: (1) the contract neither includes a determining person (one with sole authority to select a benchmark replacement rate) nor specifies a clearly defined replacement benchmark rate or (2) the contract names a determining person but such person fails to select a benchmark replacement in a timely manner.

In addition, the LIBOR Act overrides fallback language that is based in any way on any LIBOR value or requires a person to conduct a poll, survey, or inquiries for quotes or information concerning interbank lending or deposit rates. These types of provisions are deemed to be null and void.

For in-scope contracts, the LIBOR Act provides that the Board-selected benchmark replacement will be the benchmark replacement for that contract on the LIBOR replacement date (currently expected to be July 3, 2023).

Pursuant to Regulation ZZ, the Federal Reserve Board has selected Term SOFR plus the spread adjustment specified in the LIBOR Act to replace LIBOR for all "cash transactions" that are not either consumer loans or loans involving specified government-sponsored enterprises. ***CLOs fall within the category of "cash transactions", and the Board-selected benchmark replacement for this category is Term SOFR plus the statutorily specified credit spread adjustment.*** The LIBOR Act's spread adjustment to be used when replacing:

- one-month USD LIBOR is 11.448 bps (0.11448%); and
- three-month USD LIBOR is 26.161 basis points (0.26161%).

To avoid disrupting the derivatives market, where there has been significant adherence to the ISDA 2020 IBOR Fallbacks Protocol, the Federal Reserve Board has selected SOFR compounded in arrears plus the statutorily specified spread adjustment to replace USD LIBOR for in-scope derivative transactions. The use of compounded SOFR to replace USD LIBOR in derivative transactions is consistent with ISDA's fallback approach and the ARRC's recommended limitations on the use of Term SOFR (available here). This transition approach presents hedging mismatch risk and the possibility of cash shortfalls for legacy CLOs that have entered into derivative transactions meant to hedge their USD LIBOR exposures.

The LIBOR Act provides litigation safe harbor protections in connection with:

- the selection or use of the applicable Board-selected benchmark replacement (which includes the specified spread adjustment); and
- the determination and implementation of certain conforming changes.

CLOs that transition from USD LIBOR to Term SOFR plus the statutorily specified spread adjustment (e.g., 26.161 basis points when replacing three-month USD LIBOR) will benefit from the LIBOR Act's safe harbor provisions, regardless of whether they transition via an active amendment process or by operation of law pursuant to the LIBOR Act. This protection promises to insulate market participants from liability for any alleged damages arising from selection or use of the Board-selected benchmark replacement rate and in-scope conforming changes that are made when implementing the benchmark replacement.

Next steps and implementation considerations

If CLO managers have not done so already, they should review the indentures for all of their CLOs that reference USD LIBOR to identify any action items and deadlines related to replacing USD LIBOR and implementing conforming changes. This would be especially important for CLO indentures that authorize a determining person to select a benchmark replacement if the determining person intends to select a benchmark replacement different from the one specified in Regulation ZZ. ***If a determining person does not select the benchmark replacement by July 3, 2023, the LIBOR Act as implemented by Regulation ZZ will provide the applicable Board-selected benchmark replacement with the statutorily specified spread adjustment by operation of law.***

Other recent CLO indentures include the ARRC's recommended hardwired fallback language, available here, (or similar language) for replacing USD LIBOR. For these, a "Benchmark Transition Event" has already occurred and the "Benchmark Replacement Date" is still ahead. ***In practice, this means that a CLO indenture that includes the ARRC's recommended hardwired language has not yet switched to a replacement rate***. These indentures are generally expected to transition in accordance with their terms and not pursuant to the LIBOR Act. To avoid administrative bottlenecks in connection with amending indentures to implement customized conforming changes, it is advisable to begin the amendment process well in advance of June 30, 2023.

As a matter of best practice, CLO managers will want to identify the first interest determination date on which reference will be made to the benchmark replacement instead of USD LIBOR for each indenture under which CLO notes are outstanding. Managers will want to coordinate with indenture trustees and any calculation agents to confirm these dates. In addition, they will want to consider how the transition to a replacement benchmark will affect the portfolio assets and, in particular, how to calculate the weighted average spread test after the transition of both the assets and the liabilities.

The following are some examples of questions that have arisen as CLO managers have begun to take steps to replace USD LIBOR:

- For CLOs expecting to transition pursuant to the LIBOR Act because the indenture lacks adequate fallback provisions, what process needs to be followed to reflect appropriate conforming changes in the Indenture?
- For CLOs that have been partially refinanced so that effective fallback provisions apply to only some (but not all) of the notes under an indenture, how should the changes be implemented in the indenture with respect to the original notes?
- What process should be followed to make benchmark-related adjustments to indenture provisions concerning underlying assets and related tests, and would these types of changes qualify for the conforming changes safe harbor protections provided by the LIBOR Act?
- What provisions should be included in an amended indenture to address potential cash shortfalls or payment mismatches resulting from a related interest rate derivative transaction that will transition to compounded SOFR (as opposed to Term SOFR)?

Since the adoption of Regulation ZZ is fairly recent, market participants have not yet had a chance to develop consistent responses to these questions. In addition, it remains to be seen how many CLOs that have "determining person" provisions in their indentures will actively transition from USD LIBOR to Term SOFR plus the statutorily specified spread adjustment.

Please see our briefing, available here for further information.

II. PRIVATE FUNDS RULE

II. Private Funds Rule

On February 9, 2022, the Securities and Exchange Commission ("**SEC**") proposed new rules and amendments (the "**Proposed Rules**") under the Investment Advisers Act of 1940 (the "**Adviser's Act**"). The Proposed Rules do not specifically reference CLOs, however, since most CLOs rely on Section 3(c)7 for their exemption from registration under the Investment Company Act of 1940, they would be considered "private funds" and thus covered under the scope of the Proposed Rules. Though the goal of the SEC was to provide for more transparency and to prohibit private fund advisers from engaging in certain sales practices, conflicts of interest, and compensation schemes, the consequences of the Proposed Rules would be to drive up compliance costs in addition to burdensome reporting requirements for CLOs. On April 25, 2022, the LSTA sent the SEC a comment letter (the "**LSTA Comment Letter**") outlining their concerns over the Proposed Rules, as they relate to CLOs.

A quick summary of the Proposed Rules includes the following: (i) newly prohibited activities, such as prohibitions on charging fees or expenses associated with a governmental examination or investigation of the adviser, a prohibition against fees or expenses for other regulatory or compliance measures and a prohibition on fees for unperformed services; (ii) a prohibition on seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, simple negligence, or recklessness in providing services to the private fund; (iii) mandatory detailed quarterly statements, including a fund table (disclosing compensation, fees, rebates and other amounts allocated or paid to the investment adviser) and performance information for "liquid funds" (relating to net performance of the fund); (iv) a requirement for an annual financial statement and an annual audit by an independent public account for each CLO, a third-party fairness opinion from an "independent opinion provider" for an advisor led secondary transaction and consolidated reporting for substantially similar pools of assets; and (v) a prohibition against certain preferential treatment, including preferential access to portfolio information for certain investors if that would have a material negative effect on other investors, granting an investor the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors and prohibiting advisers from providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors.

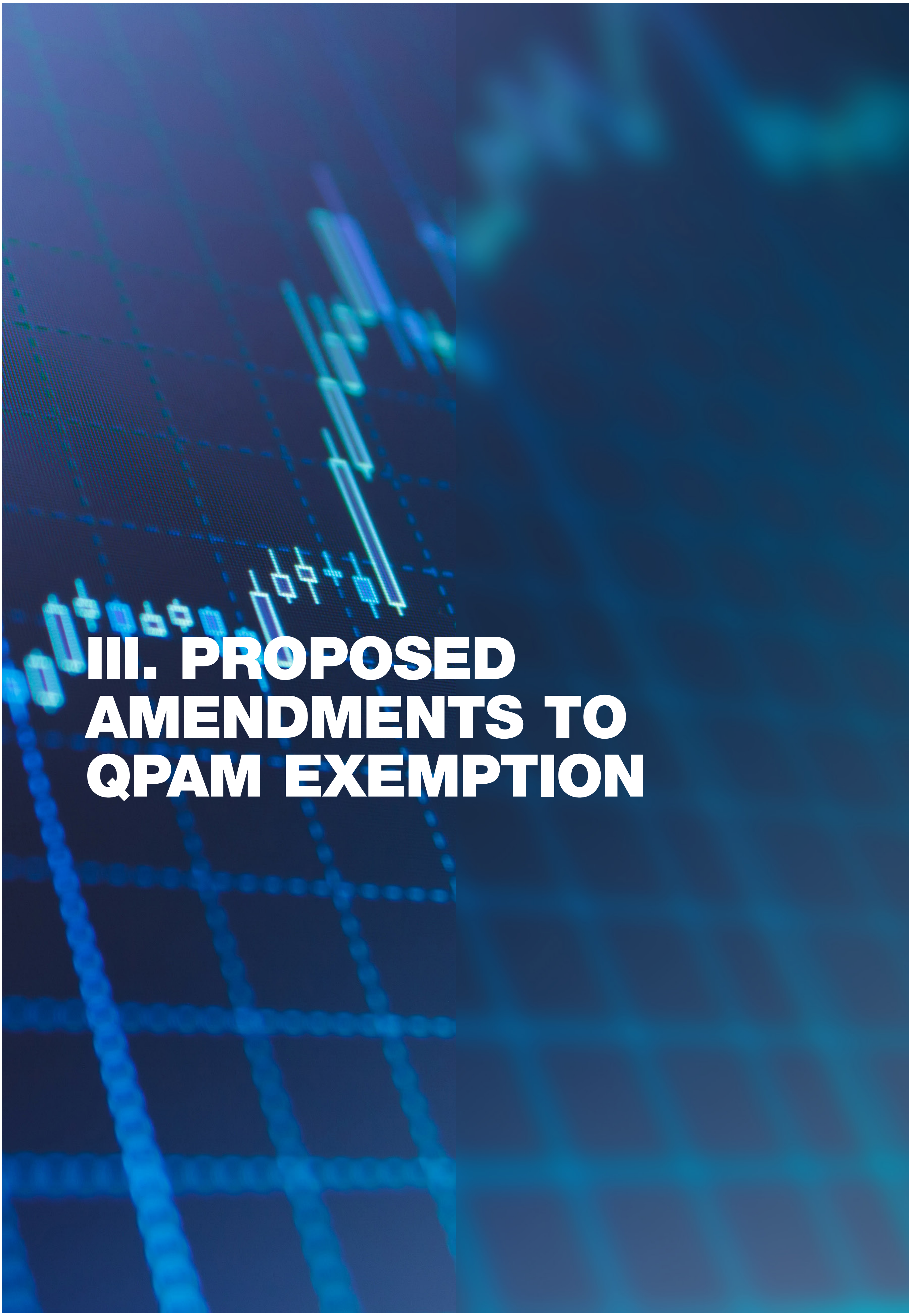
This is problematic for CLOs for many reasons: CLOs already provide full and fair disclosure in not only the offering circular, but also in monthly and quarterly reports, all of which are accessible to investors. Requiring CLOs to provide detailed quarterly and annual financial statements would not develop more meaningful transparency; it will only generate more costs and expenses. Furthermore, CLO collateral managers typically disclose all such limitations on liability and indemnification, as well as all of their fees and expenses, in an offering circular and collateral management agreement that investors have the opportunity to both review and negotiate prior to committing to purchase any CLO securities. Given the robust nature of the disclosure already provided in CLOs, the proposed SEC rules do little in terms of transparency (as was also pointed out in the LSTA Comment Letter).

Second, it is questionable how the consolidated reporting for "substantially similar pools of assets" would affect CLO managers who manage more than one CLO. Consolidated reporting of several CLOs by the same collateral manager would be impractical, confusing and unhelpful for investors.

Third, the preferential treatment prohibitions are not particularly helpful or meaningful for a CLO. For example, it is common for the equity holders to negotiate arrangements (such as fee rebates) with the CLO manager set out in a side letter. Though granular details of side letters are not usually disclosed to other investors, the existence of such an arrangement is usually provided in the offering circular as a means of transparency. This practice may be prohibited if the Proposed Rules apply to CLOs. Another concern is whether CLO collateral managers would be prohibited from discussing the underlying assets of the CLO with certain investors if not all investors are privy to the same information. But more important is the application of the preferential redemption to CLOs—would optional redemptions directed by the equity tranche now be prohibited? Will repayment of principal constitute a "redemption" that falls within the prohibited redemption category? These are questions that, as of current date, remain open and potentially problematic in a CLO context.

The Proposed Rules do not contain a grandfather clause, meaning they would apply retroactively once codified into law. The SEC did, however, provide for a one-year transition period to provide time for advisers to comply with the Proposed Rules if they are adopted. It is not practical for CLO managers to amend all of the indentures to bring the deals into compliance. Though there is a supplemental indenture section in CLO indentures allowing for future amendments, it is deal-specific as these sections are highly negotiated by investors. There could be consent hurdles standing in the way of such amendments, and the level of consent will vary by deal. Keeping in mind that compliance will be costly (especially given the detailed reporting) and that equity tranches are particularly vulnerable to increased costs given the waterfall structure, it is debatable whether existing CLOs can realistically be amended in order to comply. If CLO investors do not consent to such amendments, this may ultimately lead to termination of the CLO.

In conclusion, though the SEC has good intentions in improving transparency for investors, the Proposed Rules potentially do more harm than good in the CLO context and do not seem originally intended to apply to CLOs. We will continue to monitor for any further developments. The SEC's regulatory agenda for 2023 originally anticipated that the final version of this rule would be adopted by the end of April, so it is expected that there will be some movement on this proposal in the near future.



III. PROPOSED AMENDMENTS TO QPAM EXEMPTION

III. Proposed Amendments to QPAM Exemption

On July 27, 2022, the Department of Labor (the "**DOL**") proposed an amendment to Prohibited Transaction Class Exemption 84–14 (which relates to transactions effected by independent "qualified professional asset managers," or "**QPAMs**," and which is called the "**QPAM Exemption**") that, if adopted as proposed, could limit not only the transactions for which the QPAM Exemption may be relied on, but could also limit who may rely on such exemption (the "**DOL Proposal**"). Many transactions between a retirement plan and a "party in interests"[3] would be prohibited absent an exemption. The QPAM Exemption, which is commonly used, permits qualifying registered investment advisers, banks, savings and loan associations, and insurance companies to engage in certain transactions that would otherwise be prohibited by the U.S. Employee Retirement Income Security Act of 1974, as amended ("**ERISA**"). Investment advisers that satisfy the QPAM requirements have typically relied on the QPAM Exemption to engage in transactions on behalf of a benefit plan, and such exemption is often relied on by benefit plan investors who participate in CLOs. The DOL Proposal could have a major impact on the CLO industry because the QPAM Exemption has historically been the primary prohibited transaction exemption and the most widely recognized and readily accepted prohibited transaction exemption in the market that is used by benefit plan investors to invest in CLOs.

While we are still waiting for the final amended QPAM Exemption, at the time of writing, the DOL Proposal would (i) require a one-time notice to the DOL that a QPAM will be relying on the QPAM Exemption, (ii) require increased capitalization requirements and assets under management thresholds for financial institutions to qualify as a QPAM, (iii) require that each QPAM maintains records for six years to demonstrate their compliance with the exemption, (iv) require a written management agreement (or an amendment to the existing management agreement) that applies in the event of ineligibility[4] and that must include indemnification from the QPAM to the benefit plan to cover any losses, (v) update the list of crimes in Section I(g)[5] to explicitly add foreign crimes that are substantially equivalent to the listed crimes, (vi) expand the circumstances that may lead to ineligibility for the QPAM Exemption for ten years (including engaging in a systematic pattern or practice of violating conditions of the exemption, intentionally violating the conditions of the exemption and providing materially misleading information to the DOL in connection with the exemption) and (vii) provide a one-year winding-down period to help plans and Individual Retirement Arrangements avoid or minimize possible negative impacts of terminating or switching QPAMs or adjusting asset management arrangements when a QPAM becomes ineligible.

> Benefit plan investors that are subject to ERISA, such as pension plans and funds with significant pension participation, are frequent investors in CLO debt, equity and junior debt tranches, and the fiduciaries of such benefit plan investors often rely on the QPAM Exemption when participating in CLOs. The DOL Proposal would significantly impact managers with foreign affiliates.[6] The DOL notes that:
>
> "[g]iven that financial services institutions increasingly have a global reach, both in their affiliations and in their investment strategies, transactions involving Plan assets are increasingly likely to involve entities that reside and operate in foreign jurisdictions. An ineligibility provision that is limited to U.S. federal and state convictions would ignore these realities…"
>
> Furthermore, entering into non-prosecution and deferred prosecution agreements (including foreign prosecution) with prosecutors to side-step or mitigate the consequences of a criminal conviction would be considered "prohibited misconduct" that could lead to ineligibility under Section I(g).

QPAMs with foreign affiliates would thus fall within the scope of the DOL Proposal relating to an expansion of prohibited misconduct and additional crimes as they relate to foreign affiliates. Foreign criminal convictions (or non-prosecution agreements) would make a QPAM unable to rely on the QPAM Exemption for a period of ten years. What is more troubling is that since there is no grandfathering clause, the DOL Proposal

3 ERISA broadly defines "party in interest" to include any fiduciary of the plan, any person providing services to the plan, any employer whose employees are covered by the plan and certain affiliates.

4 Section I(g) provides for ineligibility under the QPAM Exemption if the QPAM, certain of its affiliates or five percent or more owners are convicted of certain crimes. (See DOL Proposal page 3, citing to 75 FR 38837 (July 6, 2010)).

5 Id.

6 The DOL Proposal would also affect fund managers who have agreed in fund documents with investors to act as QPAMs if their funds ever fail the so-called 25% "significant participation" test.

(if implemented as drafted) would apply to benefit plan investor participation in existing CLOs. The absence of any grandfathering may create additional risks for CLO managers, especially those who have accepted benefit plan investors managed by QPAMs with foreign affiliates, as those QPAMs may be held liable for crimes encompassed by the DOL Proposal committed by their foreign affiliates, regardless of whether they have any involvement in the commission. Additionally, if the DOL Proposal is finalized as currently drafted, then investment advisers relying on the QPAM Exemption will need to amend their management agreements with plans in order for the manager to comply with the new rules (especially for the expanded indemnity).

Not only will the DOL Proposal create additional liability for QPAMs with foreign affiliates, but even those QPAMs without foreign affiliates will incur increased costs as a result of the new recordkeeping requirements. Moreover, the DOL Proposal may cause smaller asset managers to leave the retirement advisory business due to the increased capitalization and assets under management requirements. The expanded indemnity provision will increase expenses and business risk as managers may have extraordinary indemnity costs if they fail to qualify for the QPAM Exemption.

An unintended consequence of the DOL Proposal may be that fewer benefit plans would be able to invest in CLOs if the proposed amendments are finalized as drafted, because they would not be able to confirm that a sophisticated independent fiduciary was acting to neutralize possible prohibited transaction risk. It would be unfortunate if CLOs fell out of favor with plans who otherwise consider CLO securities to be attractive investments.

Clifford Chance will continue to monitor the DOL Proposal for any future developments.

IV. NAIC PROPOSED AMENDMENTS

IV. NAIC Proposed Amendments

On June 9, 2022, the National Association of Insurance Commissioners (the "**NAIC**") revealed a proposal that would shift the risk assessment of U.S. insurers' CLO investments from rating agencies to its in-house team at the Investment Analysis Office (the "**NAIC Proposal**"). Rather than relying on traditional credit ratings, the NAIC would use its own internal modeling to determine the risk-based capital (RBC) factors, suggesting that the process would be similar to the one it currently employs for Residential and Commercial Mortgage Backed Securities ("**RMBS/ CMBS**"). The NAIC is considering changing the RBC framework so that capital required for holding all tranches of a CLO should be consistent with the capital required when directly holding all the underlying collateral and is part of the NAIC's broader focus on preventing and eliminating so-called RBC arbitrage. The LSTA in particular has been vocal in opposing the proposal in a comment letter that it sent to the NAIC on July 15, 2022 ("**LSTA Comment Letter**").

On April 20, 2023, the NAIC's risk-based capital working group proposed increasing the capital charge for residual tranches of structured-finance transactions (which would include CLO equity tranches) to 45% from 30% as an interim measure while the NAIC continues to develop its internal model referenced above. Residual tranches are described as follows: "*Residual tranches or interests captures securitization tranches and beneficial interests as well as other structures captured in scope of SSAP No. 43R – Loan-Backed and Structured Securities, that reflect loss layers without any contractual payments, whether interest or principal, or both. Payments to holders of these investments occur after contractual interest and principal payments have been made to other tranches or interests and are based on the remaining available funds.*"[7] This proposal was exposed for comment for 21 days (until May 12, 2023) and a meeting was held on May 17, 2023 to discuss the comments. No decisions were made at that meeting and the comment period was reopened until June 9, 2023. In order to have this new charge be effective for year-end 2023 reporting, the NAIC has to adopt the change by June 30, 2023.

We agree with the LSTA Comment Letter that the risk profile of CLOs does not match the risks of their underlying collateral because of structural protections and active collateral management of CLOs. For example, there are various tests, such as the overcollateralization test, interest diversions and interest coverages tests, that are designed to protect the CLO if such test falls out of compliance by diverting cash to pay down CLO debt tranches in order of seniority until the test is cured. These tests are key features that ultimately lead to better investment outcomes and a less-risky product and serve to mitigate risks on the underlying loans. CLOs are also actively managed by a collateral manager, who can purchase and sell the underlying loans (including selling underperforming loans), with some restrictions, including limits on the types of loans the CLO can acquire, which ensures diversification of assets, and collateral quality tests to safeguard the quality of the CLO portfolio. Because CLOs are actively managed and have various safeguards in place, the risks of a CLO are not identical to its underlying collateral, and insurance companies' investment in CLOs are not an "RBC arbitrage."

If the NAIC Proposal is ultimately implemented, an important source of CLO investment could dry up quickly. Life insurance companies invest heavily in CLOs, holding over half of BBB-rated CLO notes, and the consequences of the NAIC Proposal, if implemented, could be material for insurance companies and the CLO market in general.[8] The NAIC Proposal may drive insurance companies away from investment in future issuances of CLO notes. This could also lead to a major disruption in the loan market and the secondary market for CLOs. Additionally, significantly increased capital charges for junior tranches would reduce a critical flow of capital into the deal, pushing costs up for the CLO equity and potentially destroying the incentives for the transaction altogether.

Furthermore, CLOs are not the only product with the potential to be targeted by an NAIC crackdown on RBC arbitrage. The NAIC believes certain collateralized fund obligation ("**CFO**") transactions may be inconsistent with typical bond reporting and accounting treatment. CFOs have similar—if not more dramatic—RBC arbitrage benefits for insurance companies as those targeted in CLOs. CFOs give insurance companies (the primary investors in these vehicles) exposure to private equity or hedge fund investments without the 30% RBC charge associated with investing directly in equity. By investing through a

7 NAIC Life Insurer 2022 Annual Statement Instructions, Schedule BA General Instructions, at 529.
8 See LSTA Comment Letter, page 3.

CFO, the insurance company can instead take the RBC charge for bonds, which is about 0.4%. Private funds commonly use these "feeder" arrangements to meet the specific tax, ERISA or other needs of their investors, and, in the case of CFOs, are widely used to cater to insurance companies. The NAIC Proposal could change the reporting of certain types of loan-backed and structured securities that are currently afforded bond accounting treatment (using regular amortized cost accounting) from Schedule D to Schedule BA of an insurer's Annual Statement.[9] There is also a proposed principles-based bond definition, which has yet to be finalized.

Moving forward, the LSTA and other groups have continued to push for a more robust approach to modeling the risks and benefits presented to insurance company investors by CLOs. Following the NAIC's Valuation of Securities Task Force ("**VOSTF**") meeting on October 20, 2022, the group released a mark-up of its "Purposes and Procedures" manual that seemed to simply add CLOs to the sections covering RMBS/CMBS. At its December 14th meeting, the VOSTF proposed additional amendments to the manual that built on the approach of adding CLOs to the existing methodology for RMBS/CMBS and discussed the group's proposed CLO modeling methodology. With these developments, the ultimate shape of the NAIC's involvement with these vehicles remains less clear than ever. What *is* clear is that now that it has reared its head, this is only the beginning of the discussion on this topic across the industry.

9 NAIC Statutory Accounting Principles Working Group (SAPWG) Issue Paper, Reference #2019-21 –SSAP No. 43R, Loan-Backed and Structured Securities.

V. EU AML LIST – CAYMAN ISLANDS

V. EU AML List – Cayman Islands

In March 2022, the Cayman Islands were added to the EU's list of jurisdictions which the EU has identified as having strategic deficiencies in their Anti-Money Laundering/Counter Terrorist Financing (AML/CFT) regimes that pose significant threats to the financial system of the EU[10]. As we noted previously, that resulted in a number of consequences for CLOs and the securitization industry in general.

One significant consequence of the Cayman Islands being placed on the EU AML blacklist is that EU financial institutions are now prohibited from establishing securitization special purpose entities ("**SSPEs**") in the Cayman Islands[11] under the EU Securitization Regulation[12]. We do note, however, that the UK Securitization Regulation[13] differs from the EU securitization regime; the UK references the FATF blacklist jurisdictions, which does not include the Cayman Islands.

In practical terms, EU investors cannot invest in instruments issued by a Cayman SSPE. This also means that EU sponsors and originators would also be prohibited from issuing securitizations that are established in the Cayman Islands. Therefore, any CLOs (and other securitizations) that have closed since March 13, 2022, and which intend to be compliant with the EU Securitization Regulation, should be established outside of the Cayman Islands. This includes any US CLOs complying with the European risk retention rules that are marketed to in-scope investors in the EU and these deals have generally been using foreign issuers based in Jersey or Bermuda or domestic issuers based in Delaware. It should be noted that offshore vehicles are generally treated as foreign corporations for US tax purposes, however, issuers based in Delaware would be treated as a US partnership to avoid entity level tax.

The addition of the Cayman Islands to the EU AML blacklist has presented EU investors with certain compliance challenges, for example, as to whether divestment of legacy positions is required. Though a reasonable approach would be to continue to hold these securities rather than require a forced sale, there is no definitive answer and investors may take guidance from their local regulators on their approach here. US CLOs based in the Cayman Islands may use a refinancing as an opportunity to redomicile the issuer, particularly if the indenture provides that broad changes can be made with only majority equity consent and if the indenture otherwise has a streamlined process for such a move.

Although some market participants expressed hope that the Cayman Islands would be quickly removed from the FATF grey list, as of the most recent review (in February 2023), the FATF declined to remove the Cayman Islands from the list. Until it does so, the EU will likewise not remove the jurisdiction from its AML blacklist.

10 Commission Delegated Regulation (EU) 2022/229
11 Article 4 of the EU Securitization Regulation states that SSPEs "shall not be established" in a non-EU jurisdiction which is on the EU AML List by an EU financial institution.
12 Regulation (EU) 2017/2402 (such regulation, as amended, including any implementing regulation, technical standards and official guidelines related thereto, the "EU Securitization Regulation").
13 Regulation (EU) 2017/2402 which forms part of UK domestic law by virtue of the European Union (Withdrawal) Act 2018, as amended by the Securitisation (Amendment) (EU Exit) Regulations 2019 of the United Kingdom (such regulation, as amended, including any implementing regulation, technical standards and official guidelines related thereto, the "UK Securitization Regulation").

VI. EU SECURITIZATION REGULATION – TRANSPARENCY REPORTING

VI. EU Securitization Regulation – Transparency Reporting

On October 10, 2022, the European Commission (the "**Commission**") published its review report on the EU Securitization Regulation (the "**Report**"). The most significant portion of the Report related to the Commission's interpretation of Article 5(1)(e) of the EU Securitization Regulation which deals with the obligation of EU institutional investors to ensure they are receiving certain information and reporting in respect of the securitizations they invest in and, specifically, templated loan-level and investor reports pursuant to Article 7 of the EU Securitization Regulation.

In the Report, the Commission made a pretty clear statement that EU institutional investors are required to get all the same information in respect of third country securitizations as they would get from EU securitizations, and that it should not be left to the discretion of the investors to decide whether they are in receipt of "materially comparable information". The Commission has acknowledged that such an interpretation of Article 5(1)(e) "de facto excludes EU institutional investors from investing in certain third-country securitizations".

Where does that leave US CLOs, which generally don't comply with Article 7 transparency reporting, marketed to European investors?

Publication of the Report has drawn a line under the ability of EU institutional investors to invest in third country securitizations, including US CLOs, which do not provide EU templated reporting (technically, UK institutional investors should still be able to rely on the somewhat more flexible "substantially the same" standard for reports under the UK Securitization Regulation subject to satisfactory "gap" analysis). Those US CLO managers who continue to target EU investors have, by and large, managed to set up templated reporting to accommodate the EU requirements with the help of third-party service providers. However, this has led to increased compliance costs (which can eat into equity returns) and additional administrative burden. US CLO managers are also faced with questions around potentially repapering transactions issued prior to October 10, 2022, to accommodate the continued holding by EU investors of their legacy positions.

The Commission acknowledged in the Report that there was a general feeling that the transparency and due diligence requirements are disproportionate and invited the European Securities and Markets Authority ("**ESMA**") to review the disclosure templates generally with a view to streamlining the provision of information and, in the case of private securitizations (which would include US CLOs), setting up simplified template(s) for such private transactions. Although private consultations with the market have already commenced, a final solution for reporting on third country securitizations may still be some time away.

Please refer to our briefings, available here and here for further information.

VII. MARKETING RULE

VII. Marketing Rule

From November 4, 2022 onwards, all investment advisers registered with the SEC must comply with Rule 206(4)-1 (the "**Marketing Rule**"). The new rule (and its subsequent interpretative guidance) addresses the ability of registered investment advisers to advertise and solicit cash within Rule 206(4)-1 and 206(4)-3 under the Investment Advisers Act of 1940 (the "**Advisers Act**"). Any communications that are considered "advertisements" under the Marketing Rule will need to comply with the Marketing Rule. Under the rule, "advertisements" fall into two categories: (i) communications to more than one person by the investment adviser (or communications to one or more persons if such communication contains "hypothetical performance," including targeted returns) and (ii) any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly. This second prong captures communications and solicitation activities from the CLO arrangers engaged by a CLO portfolio manager.

Any form of statement by an arranger to a prospective investor, including oral statements made in person or in a call or email, may potentially be an endorsement, if it is considered a solicitation or referral to invest in CLO securities or indicates the approval, support, or recommendation of the collateral manager or its personnel. The Marketing Rule requires disclosure for advertisements that are or include endorsements, but more importantly, the CLO manager must "reasonably believe" that the person giving the endorsement (i.e., the arranger) is disclosing certain information, including that the endorsement is given by a person other than a current investor, compensation is being provided for the endorsement and a statement about any material conflicts of interest (collectively, the "**Required Disclosures**").[14]

Furthermore, the CLO manager must have a reasonable basis for believing that the endorsement complies with the requirements of the Marketing Rule, and there must be a written agreement with any person giving an endorsement that describes the scope of the agreed-upon activities and the terms of compensation for those activities.[15] CLO managers are also prohibited from compensating a person for an endorsement if the CLO manager knows, or in the exercise of reasonable care should know, such person is an "ineligible person" at the time the endorsement is disseminated. If the CLO arranger (or other endorsement provider) is an SEC-registered broker-dealer, there is an exemption from this prohibition where the broker-dealer is not subject to "statutory disqualification" as defined in Section 3(a)(39) of the Exchange Act.[16]

To best comply with the Marketing Rule, CLO managers should assess current practices and work with CLO arrangers to ensure ongoing marketing activities satisfy the requirements of the Marketing Rule. Practically speaking, the engagement letter between the CLO manager and arranger must include provisions ensuring compliance with the Marketing Rule, including the scope of the Required Disclosure that will accompany communications to prospective investors. The market appears to have gotten comfortable with a "cleansing" notice, such as through email blast or Bloomberg, with prospective investors at the time of any initial oral communications. A cleansing email would then cover any subsequent oral communications. This appears to be the direction where the market is heading. Any subsequent written endorsements should also include the Required Disclosures, which should also be in any offering memoranda or written marketing materials distributed by an arranger. The trend has been to include the Marketing Rule disclosure on the front cover of any offering circular that is sent to potential investors.

The engagement letter should also require representations from the arranger as to its broker-dealer status or that it is otherwise not an "ineligible person," which would alleviate the risk that a CLO manager would violate the Advisers Act by compensating their arranger. Best practice is a continuing representation from the arranger (such as, if the broker-dealer status ceases to be true, the arranger must notify the CLO manager) and, for particularly long-lasting offerings, bring-down representations.

The SEC's Division of Examinations has indicated in its Marketing Rule Risk Alert

14 Advisers Act Rule 206(4)-1(b)(1)(i).
15 Advisers Act Rule 206(4)-1(b)(2).
16 Note that continued registration as a broker-dealer is not sufficient evidence that the counterparty has not suffered a statutory disqualification – the Financial Industry Regulatory Authority, Inc., the self-regulatory organization responsible for overseeing the broker-dealer industry, and the SEC have procedures in place to waive statutory disqualification and allow these statutorily disqualified persons to continue operating a securities business.

that it will check for compliance with the new recordkeeping requirements under the Marketing Rule, so it is especially important that the CLO manager maintain books and records of endorsements (and any required disclosures thereto) in connection with the marketing of the CLO transaction. This requires the cooperation of the arranger. Unfortunately, the market is less settled with respect to this area of the Marketing Rule. At a minimum, the engagement letter should address how the CLO manager can maintain documentation substantiating its reasonable basis for believing that an endorsement is compliant with the Marketing Rule and we recommend that the pre-pricing and pre-closing due diligence procedures should include bring-down representations as to eligibility from the CLO arranger.

Other recommendations include implementing updated written policies and procedures to prevent violations of the Marketing Rule and reviewing all existing and new engagement letters.

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

VIII. CONFLICTS OF INTEREST IN SECURITIZATIONS RULE

VIII. Conflicts of Interest in Securitizations Rule

On January 25, 2023 the SEC proposed the Prohibitions Against Conflicts of Interest in Certain Securitizations Rule which would prohibit a "securitization participant" from directly or indirectly engaging in any transaction that would result in a material conflict of interest between the securitization participant and an investor. This rule was first proposed in 2011 to implement the prohibition under Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The aim of the re-proposed rule is to target transactions "that effectively represent a bet against a securitization" and are essentially what were deemed to be "ABS-related misconduct" during the financial crisis of 2007-2009. The rule defines asset-backed securities based on the Section 3 definition in the Exchange Act. As has been pointed out already by industry participants, CLOs are not structured to fail and many of the SEC's concerns, as such relate to CLOs, appear to be misplaced in the same way such "originate to distribute" concerns missed the mark with respect to risk retention in CLOs (see below re definition of "sponsor"). In fact, CLOs create an alignment of interest between the portfolio manager and equity investors who would bear the first losses on the transaction through incentive management fees and provide detailed reporting providing all investors with transparency on the underlying assets.

The rule captures "securitization participants" who are defined as underwriters, placement agents, initial purchasers and sponsors, together with their affiliates and subsidiaries. Importantly, the defined term "sponsor", being a person who organizes and initiates an asset-backed security ("ABS") transaction, or who directs or causes the direction of the structure, design or assembly of an ABS or the composition of the pool of assets underlying the ABS (or who has the contractual right to do so), would include a collateral manager for a CLO transaction with the contractual right to direct asset purchases or sales on behalf of the CLO. This definition of sponsor does not align with the Regulation AB definition of sponsor and broadly syndicated loan CLO managers are generally not considered "sponsors" for the purposes of the U.S. Risk Retention Regulations.[17] The broad range of market participants captured also necessitates a clarification in the release that an investor with detailed stipulations as to the asset selection criteria would not be captured as a securitization participant.

The wide range of securitization participants captured by the rule poses many potential problems for the CLO industry, particularly in relation to a participant's knowledge of the activities carried out by its affiliates or subsidiaries and, further, the SEC does not permit the use of traditional information barriers as an exception for affiliates or subsidiaries due to concerns these would be used to evade the rule. Given the nature of CLO portfolios, constituting institutional corporate loans, and the role of arrangers and bank-affiliated (or other large) portfolio managers in CLO transactions, there is wide scope for overlap between institutions that hold, trade and hedge both the CLO assets and the CLO liabilities. In relation to CLOs, the size and revolving nature of the portfolio is also of concern as to how securitization participants can effectively comply with this prohibition. While there is a materiality element to the rule, the general prohibition of betting against the pool of assets could easily lead to uncertainty as to what type of transaction is caught by the rule and whether a credit default swap referencing one asset, or a subset of the pool, would be prohibited.

The proposed rule prohibits a securitization participant from engaging in any conflicted transaction, being a transaction where there's a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision in the ABS. A conflicted transaction includes short sales of the relevant ABS, the purchase of a credit default swap or other credit derivative with respect to the ABS or the purchase or sale of any other financial instrument or entry into a transaction the terms of which are substantially the economic equivalent of a direct bet against the relevant ABS. This last limb appears to be a broad catch-all, in part due to "the potential ability of market participants to craft novel financial structures that can replicated the economic mechanics" of prohibited conflicted transactions. Further, it is not necessary for the securitization participant to actually benefit from a conflicted transaction, rather it's sufficient that the transaction creates an opportunity for such benefit, e.g., a decline in the market value of the ABS, even absent such a decline. The problem with such a broad definition, however, is that it may capture new and complex transactions, with a legitimate business purpose, which even the participants do not intend or reasonably foresee to fall within the rule.

As mentioned, general reliance on traditional information barriers will not prevent the affiliate or subsidiary of a market participant from being caught by the rule. The rule proposes five detailed

17 See *Loan Syndications & Trading Ass'n v. SEC et al.*, No. 17-5004, 17 (D.C. Cir. Feb. 9, 2018), available here.

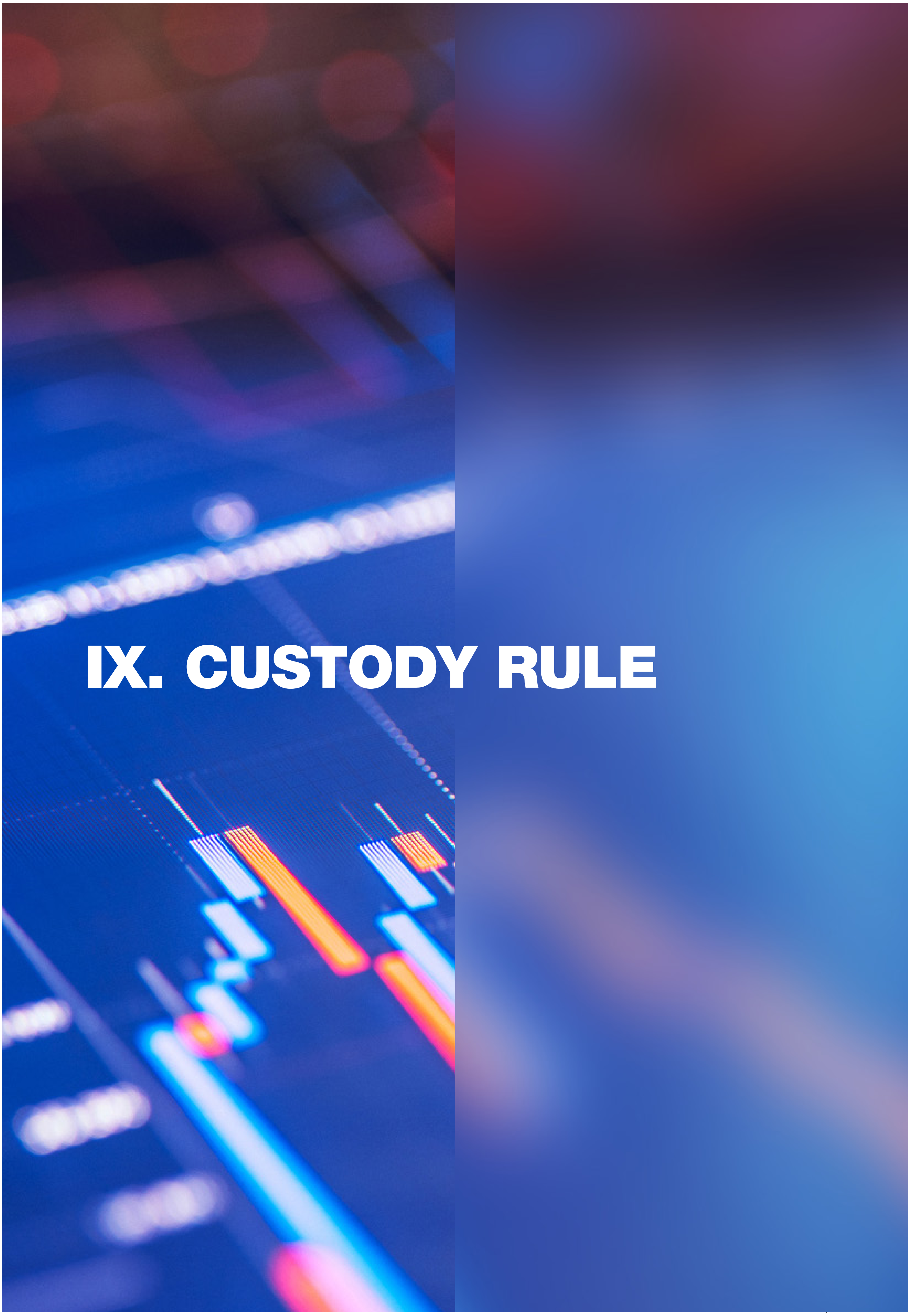
criteria in order to rely on an information barriers exception as follows: (1) the implementation, maintenance, enforcement and documentation of written policies and procedures to prevent the flow of information between the relevant parties, (2) the implementation, maintenance, enforcement and documentation of a written internal control structure governing the implementation and adherence to such policies and procedures, (3) procuring an annual, independent assessment of the operation of such policies and procedures and the internal control structure referenced above, (4) that the affiliate or subsidiary has no officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) in common with the securitization participant and was not involved in the creation, distribution, origination of the assets, or otherwise providing services with respect to the related ABS and (5) the exception would not be available if, in the case of any specific securitization, the securitization participant knows or reasonably should know that, notwithstanding meeting the conditions described above, the transaction would involve or result in a material conflict of interest. Compliance with these will likely add significant cost for CLO participants.

The timeframe for compliance with the proposed rule could also lead to some uncertainty in relation to CLO transactions. The prohibition commences on the date on which a person has reached, or has taken substantial steps to reach, an agreement that such person will become a securitization participant (the “commencement point”) and would end one year after the date of the first closing of the sale of the relevant ABS. It would seem then that this covers not only the warehouse period but also the negotiation period prior to the opening of the warehouse. The release mentions that for arrangers this is likely when there are substantive engagement letter negotiations. The prohibition then is essentially backwards looking as a conflicted transaction cannot occur if no ABS is issued but, once issued, the rule covers that prior period from the commencement point.

Parties used to dealing with conflicts have, in the past, viewed disclosure to investors as a permissible means for complying with various rules and regulations, however, this would not be permitted here. The release expresses a concern that the investor’s consent could be somehow coerced and invalid which seems an odd result for professional investors used to evaluating the risks of such transactions.

The proposed rule includes certain exceptions for risk-mitigating hedging activities, bona fide market-making activities and liquidity commitments. However, this does not include a requested exception for synthetic CLOs used as a risk management tool because the securitization participant could structure synthetic ABS products entitling it to receive payments in the event the referenced ABS fails. Additionally, the rule includes an anti-circumvention clause which states that a transaction that circumvents the prohibition is a conflicted transaction even if the definitions do not address the form, label, or documentation of the transaction in question. The proposed rule discusses a concern that securitization participants may route payments through multiple transactions or recharacterize payments to obscure the economics of a conflicted transaction. On the whole, the proposed rule as it would apply to CLOs, appears to be solving a conflicts problem that doesn’t currently exist and, at best, would impose burdensome requirements and costs on the relevant market participants which ultimately will be negative for investors.

IX. CUSTODY RULE



IX. Custody Rule

On February 15, 2023, the SEC proposed sweeping revisions to the Custody Rule,[18] redesignating it as the safeguarding rule, which would impose additional costs on CLO managers and CLO vehicles. The Custody Rule is intended to protect client assets from misappropriation and other unlawful activities by an adviser or its personnel.

The proposed rule would expand the types of assets subject to the rule from "funds and securities" to the broader "funds, securities, or other positions held in a client's account." This appears at least in part to futureproof the rule in relation to new or innovative asset types, such as crypto assets specifically addressed by the rule. The proposed rule also includes discretionary authority to trade within the definition of custody, which is generally how CLOs will be caught as the portfolio manager is able to trade the loan assets of the CLO vehicle pursuant to the indenture and power of attorney in the management agreement.

Advisers would be required to maintain client assets with a "qualified custodian" and that qualified custodian must have "possession or control" of client assets. "Possession or control" is defined to more broadly cover any participation in the change in beneficial ownership of such client assets. Qualified custodians will be required to enter into a specific form of written agreement with the relevant adviser to implement the required safeguards and advisers must obtain reasonable assurances that the qualified custodian will: (1) exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation or similar loss, (2) indemnify the client against losses caused by the custodian's negligence, recklessness or willful misconduct, (3) not be excused from its obligations as a result of sub-custodial or other arrangements, (4) clearly identify and segregate client assets from the custodian's assets and liabilities and (5) not subject client assets to any right, charge, security interest, lien or claim in favor of the custodian or its related persons or creditors, unless authorized in writing by the client. This change of agreement form would likely result in additional costs for the CLO vehicle.

The proposed rule also requires that managers with discretion over client assets that are maintained by a qualified custodian, but which do not settle "delivery vs. payment" (DVP) (like broadly syndicated loans), engage an auditor to verify the client's assets by undertaking a surprise annual examination. The implication is that assets that do not settle DVP are inherently risky because there can be a transfer of assets out of the client account without a corresponding transfer of payment into the account. The LSTA and other trade organizations have previously undertaken unsuccessful efforts to obtain "no-action" relief with respect to loans that do not settle DVP. CLOs provide investors with detailed reporting in relation to the assets, including trading reporting, and arguably the time and expense which goes into such reports should be sufficient to safeguard the relevant client assets.

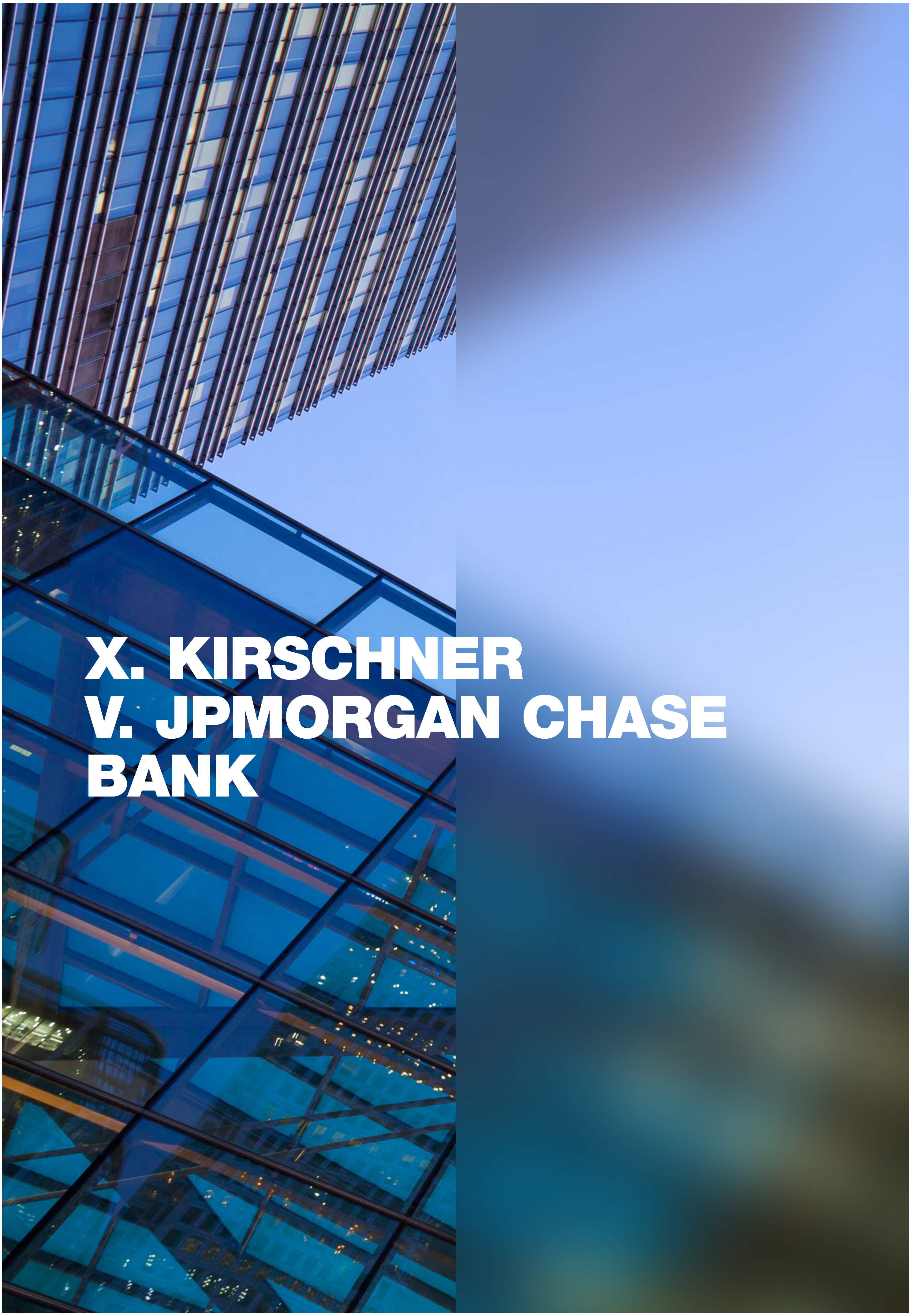
The SEC's primary concern in this new proposed rulemaking seems to be to target crypto assets (and other innovative asset classes) but the rule is so broad that it captures any other client asset, position or investment, creating an uncertain regulatory framework for advisers. In relation to CLOs, it should be noted that an adviser is already prohibited from misdirecting customer assets into its own account and the rule seems to add no material benefit to the CLO that would justify the new costs related to the annual audit, new form of qualified custodian contract, recordkeeping and other administrative costs for the adviser. Further, there are no grandfathering provisions and the proposed rule also has a short one year compliance period.

Depending on the outcome of the Kirschner case (see below), the changes to the "privately offered securities" exception may also have implications for CLO structures. The proposed rule requires that the following conditions are met for an adviser to avail itself of the exception: (1) the adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained by a qualified custodian, (2) the adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation or the adviser's insolvency, (3) an independent public accountant (pursuant to a written agreement) verifies any purchase, sale or transfer of beneficial ownership of the assets promptly and notifies the Commission within one business day upon finding any material discrepancies, (4) the adviser notifies the independent public accountant of any purchase, sale or transfer of beneficial ownership within one business day and (5) the existence and ownership of such privately offered securities or physical assets not maintained with a qualified custodian are verified during the annual surprise examination.

18 17 C.F.R. § 275.206(4)-2.

The SEC is concerned that the volume of privately offered securities has vastly expanded from the time the original exception was envisioned. Additionally, the SEC states that the amendments to the privately offered securities exception are to address the concern that a loss of these assets could be undetected for an indeterminate amount of time. As mentioned, this does not account for the detailed reporting which investors receive on a CLO transaction. Further, the above requirements are extremely burdensome and costly, if not practically impossible to comply with given the volume of loan trading across CLO platforms.

X. KIRSCHNER V. JPMORGAN CHASE BANK



X. Kirschner v. JPMorgan Chase Bank

In *Kirschner v. JPMorgan Chase Bank, N.A. et al*.,[19] a federal case related to the bankruptcy of Millennium Health LLC, the plaintiffs alleged that Millennium's broadly syndicated Term Loan B is in fact a security (and not a loan) and therefore the arranging banks have liability under the applicable securities laws. This case is significant for the CLO market as the term loan in question closely resembles the loans which constitute the portfolio assets in a typical broadly syndicated CLO transaction.

On May 22, 2020, the US District Court for the Southern District of New York (SDNY) granted a motion to dismiss the securities law claims on the ground that the underlying Term Loan B was not a security.[20] In October 2021, Kirschner filed an appeal to the United States Court of Appeals for the 2nd Circuit and the Court of Appeals heard oral arguments in March 2023. 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 loans in this case are securities under the Reves[21] "family resemblance" test which considers (1) the motivation of the parties (a reasonable seller and buyer), (2) the plan of distribution of the instrument to determine whether there is common trading for speculation or investment, (3) the reasonable expectations of the investing public and (4) whether there are risk reducing factors such as another regulatory scheme.

If Term Loan Bs are held to be securities, this would have huge and unexpected consequences for the loan market. Such loans would need to be structured to comply with securities laws (both state and federal), loan syndication and trading activity would need to be conducted through registered broker-dealers and current material non-public information (MNPI) practices would need to change to prevent asymmetry of confidential information. Generally, it is expected that the origination and syndication process would become slower and more expensive.

CLOs that currently comply with the "loan securitization" exclusion of the Volcker Rule[22] would no longer be able to rely on that exclusion and would be covered funds[23].This is perhaps less of a concern to some managers after the amendments to the Volcker Rule published on June 25, 2020[24] which, among other things, (i) permit covered funds relying on the loan securitization exclusion to acquire debt securities in an amount up to 5% of the aggregate value of the issuing entity's assets, (ii) exclude from the definition of "ownership interest" certain "senior loans" or "senior debt interests" issued by a covered fund and (iii) clarify that the right to participate in the removal or replacement of the collateral manager would not be a feature that results in a banking entity having an ownership interest in a covered fund. However, this would still be a concern for banking entities who have invested in the deal on the basis of the loan securitization exclusion and would have practical and contractual consequences for the affected CLO transactions.

CLO managers would need to carefully consider required changes to their deal documentation and structures, as a result of the recharacterization of the CLO assets, and there could be a material period of time where active trading and new loan origination is suppressed while the market reestablishes itself in a new form. This in turn would impact new CLO issuance as well as secondary trading of CLO securities. Further, if loans are recharacterized as securities, this would impact the ability of both the CLO assets and liabilities to be able to use Term SOFR following the publication of the Summary and Update of the ARRC's Term SOFR Scope of Use Best Practice Recommendations on April 21, 2023.

The Court of Appeals granted an extension of time, until July 27, 2023, for the SEC to file a response to the court.

19 Kirschner, v. JP Morgan Chase Bank, N.A. et al, 17 Civ. 6334 (PGG) (S.D.N.Y. Sep. 30, 2021).
20 Pl. Memo. of Law in Op. to Defs.' Mot. to Dismiss, *Kirschner, v. JP Morgan Chase Bank, N.A. et al,* 17 Civ. 6334 (PGG) (S.D.N.Y. May 22, 2020), at 23.
21 See *Reves v. Ernst & Young,* 494 U.S. 56 (1990).
22 12 C.F.R. § 248.10(c)(8).
23 The loan securitization exemption defines "loans" as loans, extensions of credit or secured or unsecured receivables that are not derivatives or "securities" as defined under the Exchange Act. Accordingly, redefining broadly syndicated loans as securities for Exchange Act purposes would have the effect of making them ineligible for use in a loan securitization vehicle under the Volcker Rule.
24 *See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Final Rule* (June 25, 2020), available here as well as our briefing on the topic available here.

XI. RULE 15C2-11

XI. Rule 15c2-11

Rule 15c2-11 implements Section 15(c)(2) of the Exchange Act and generally prohibits a broker-dealer from publishing quotations for an unlisted security when specified current information about the issuer is not publicly available, which would include the ability of brokers and dealers to publish quotations on CLO securities and therefore could significantly affect trading of CLO securities without changes to current market practice. Since at least September 2021, the SEC staff has taken the view that Rule 15c2-11 applies to unlisted fixed income securities (including Rule 144A fixed income securities, "**Rule 144A Securities**") as well as OTC equity securities.

On December 16, 2021, the staff of the SEC's Division of Trading and Markets (the "**Division**") issued a no-action letter (the "**December 2021 Letter**", available here) indicating that the staff would not recommend enforcement action under Rule 15c2-11 for brokers or dealers that publish or submit quotations for unlisted fixed income securities in a quotation medium and providing for phased compliance for such securities, the first of which was set to expire on January 3, 2023.

However, on November 30, 2022, pursuant to a no-action letter (the "**November 2022 Letter**", available here) the Division withdrew the December 2021 Letter and delayed the timeline for compliance for Rule 144A Securities, which the applicable broker-dealer reasonably believes satisfy the information requirements of Rule 144A(d)(4), until January 4, 2025.

While the delay in required compliance has generally been positively received by the CLO market, many had hoped that Rule 144A Securities would be excluded from the rule altogether. The rule had historically only been applied to equity securities and many market participants were surprised by the SEC's decision to apply the rule to fixed income securities generally. In November 2022, the National Association of Manufacturers and the Kentucky Association of Manufacturers submitted a petition to the SEC to amend Rule 15c2-11 to exempt Rule 144A Securities or otherwise provide exemptive relief.

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C L I F F O R D

C H A N C E

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