

CLOs in the Heartland

Opening Remarks

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REUTERS/Regis Duvignau

FITCH/MAYER BROWN CLOs IN THE HEARTLAND MIDDLE MARKET LENDING UPDATE

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BIGGEST THEMES FACING MIDDLE MARKET LENDERS

Supply

3

- Leveraged lending hit record levels in 2013, driven by 3Rs (refi, recap, repricing)
- M&A is picking up in 2014, but still not robust

Demand

8

- Money flows into the leveraged loan market from everywhere!
- Investor base is evolving: institutional interest rises, yields grind lower

Structures

13

- Second liens take the lead, unitranche is gaining, mezz loses steam
- Leverage levels: How high will they go? Covenant lite: how low will it go?

Leveraged Lending Guidance

17

- Banks lower their leverage tolerance
- Will non-bank lenders pick up the slack?

2013 WAS A YEAR OF RECORDS: DRIVEN BY TOO MUCH MONEY CHASING TOO FEW DEALS

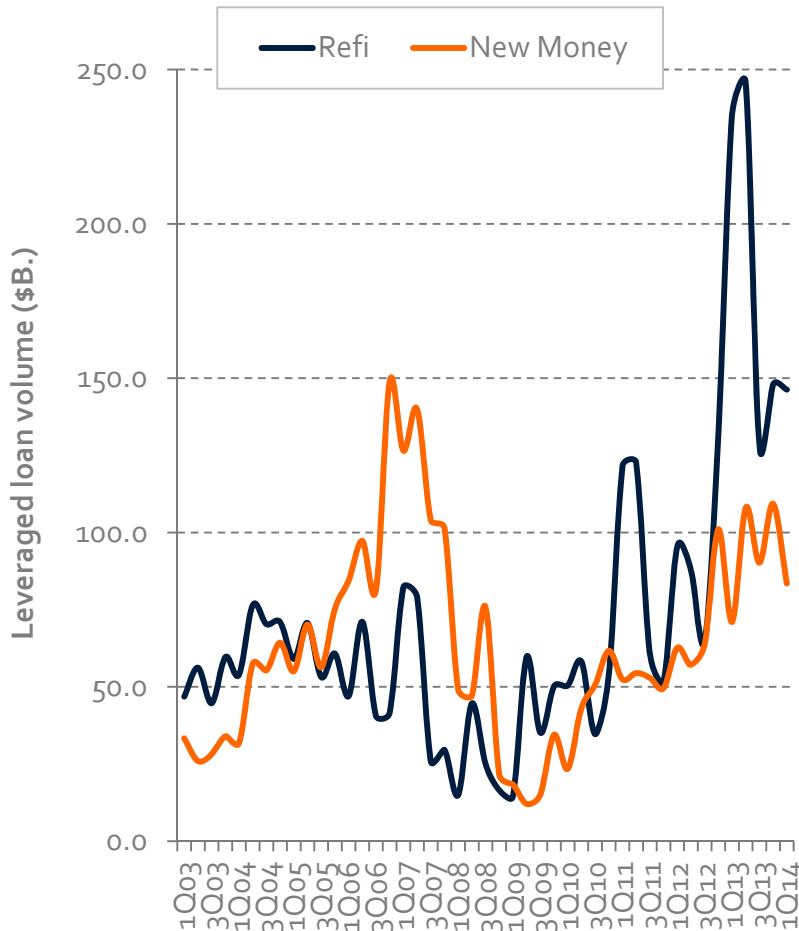
2013: A YEAR OF NEW RECORD HIGHS

(\$ in billions)	2007	2012	2013	2014E*
Global loan volume	3980.4	3121.0	4029.8	
U.S. Overall	1686.8	1575.7	2138.5	
Asia Pacific, excl. Japan	288.4	308.5	461.9	
U.S Issuance				
Leveraged loans	688.5	664.4	1135.2	1015.0
Leveraged - Refinancings	216.7	380.0	756.8	500.0
Leveraged - Institutional	425.8	335.2	625.4	565.0
Leveraged - Pro Rata	262.7	329.2	509.8	450.0
Leveraged - Sponsored	366.3	352.2	530.2	
Dividend Recapitalization	20.8	47.1	49.8	
Covenant-Lite	108.2	83.9	381.4	
HY Bonds	136.3	326.7	332.4	283.0
Loan Retail Fund Flows	-0.9	12.2	62.6	
Investment Grade bonds	993.2	1011.0	1016.7	
Investment Grade - M&A loans	70.9	79.1	133.0	160.0
Middle Market loan volume	183.2	180.3	203.6	
Middle Market - Refinancings	75.7	102.1	129.9	
Middle Market - Non-sponsored	112.3	110.7	131.0	
Middle Market - Sponsored	71.0	69.6	72.5	
Middle Market - Dividend Recap	7.2	9.1	13.8	10.0
Middle Market - Covenant-Lite	7.5	4.8	16.7	

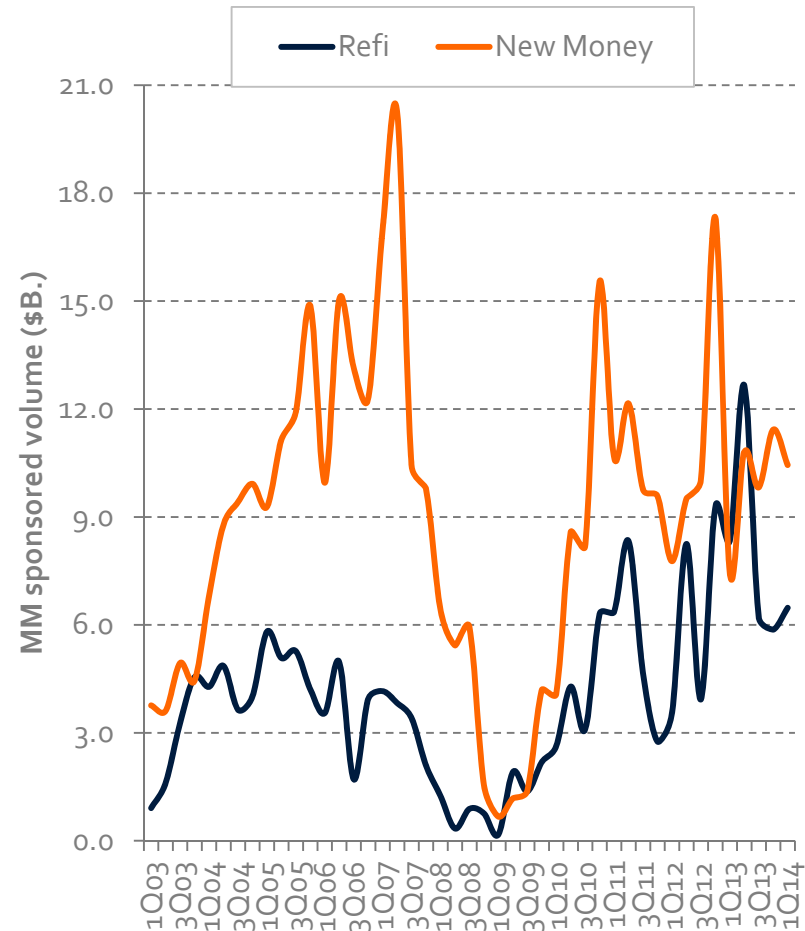
*2014 forecast is generated from Thomson Reuters LPC's Quarterly Lender Survey

NEW MONEY DEALFLOW IS BUILDING BUT STILL NOT BACK TO PRE-CRISIS LEVELS

LEVERAGED LOAN VOLUME



MIDDLE MARKET SPONSORED LOAN VOLUME

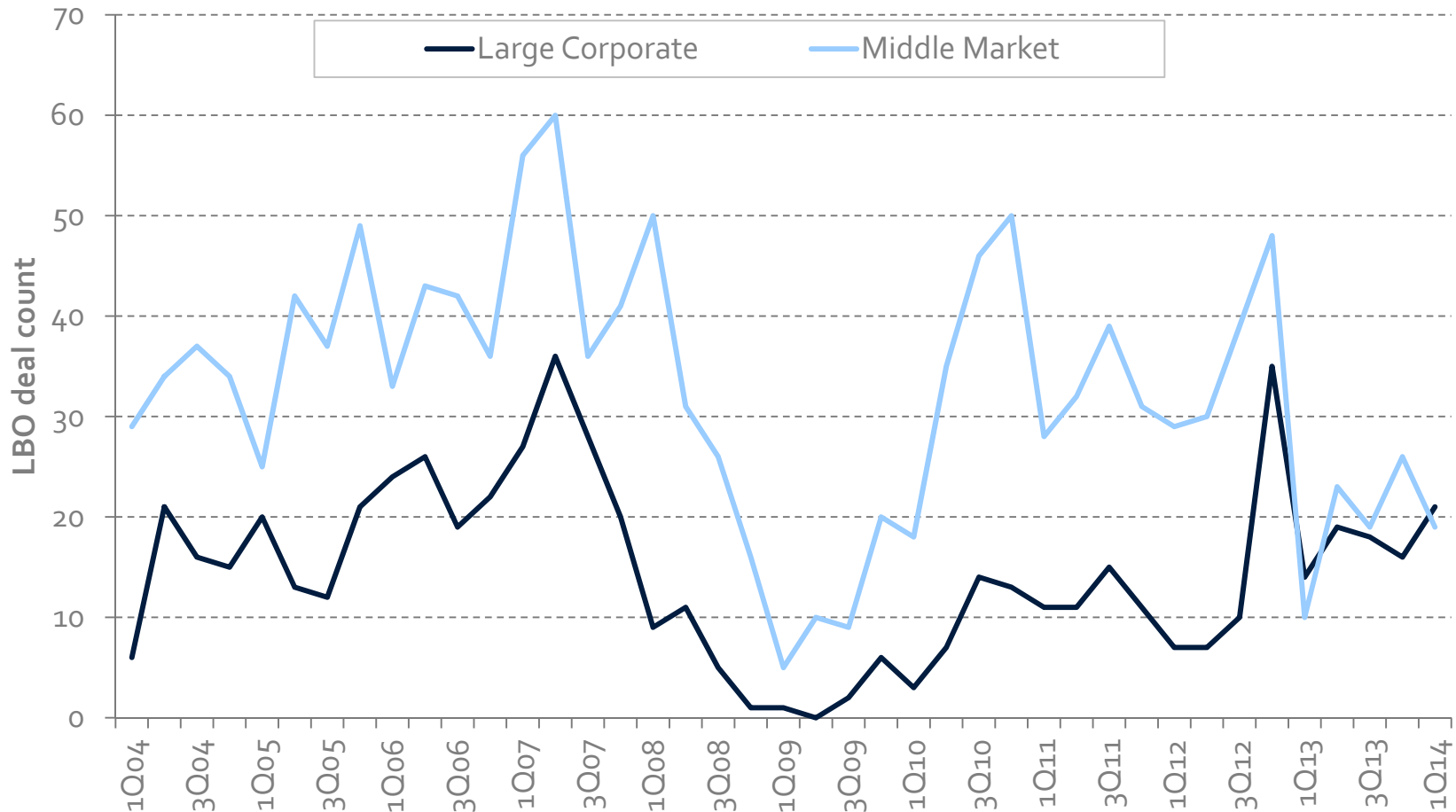


Note: Data current as of 3/06/14, includes completed and in process deals
 Middle market defined as issuers having revenue and a total loan deal size of \$500 million and below

SOURCE: THOMSON REUTERS LPC

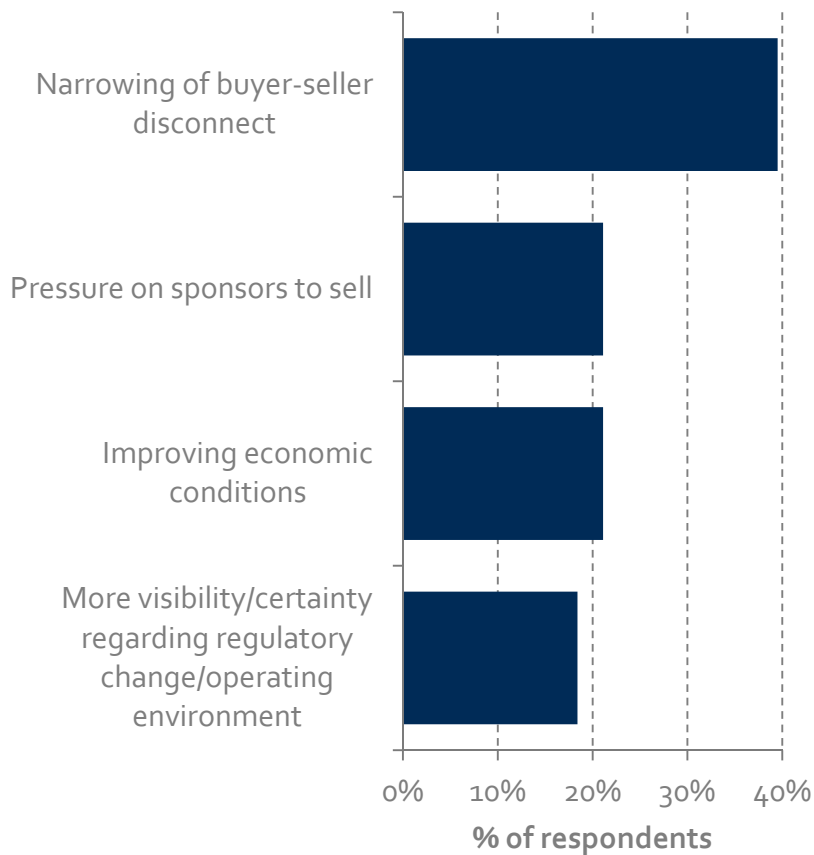
LARGE CORPORATE LBOs ARE OUTPACING MIDDLE MARKET BUYOUTS SO FAR IN 1Q14

LBO DEAL COUNT

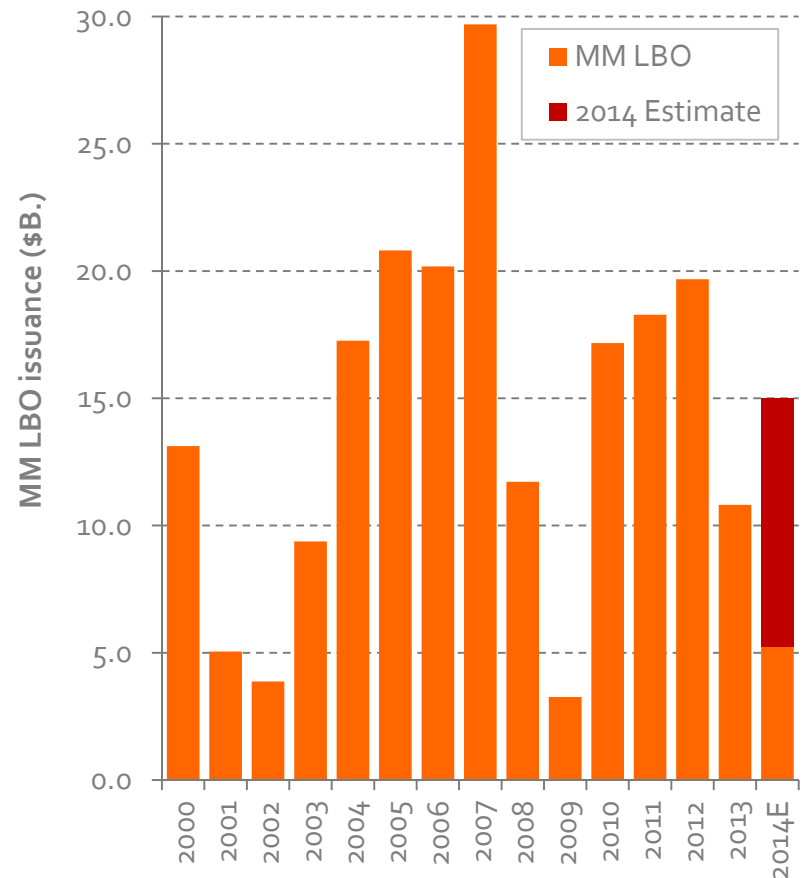


LENDERS PREDICT MIDDLE MARKET LBO VOLUME WILL INCREASE MODERATELY IN 2014

WHAT DO YOU SEE AS THE KEY DRIVER OF SPONSORED M&A DEALFLOW IN 2014?



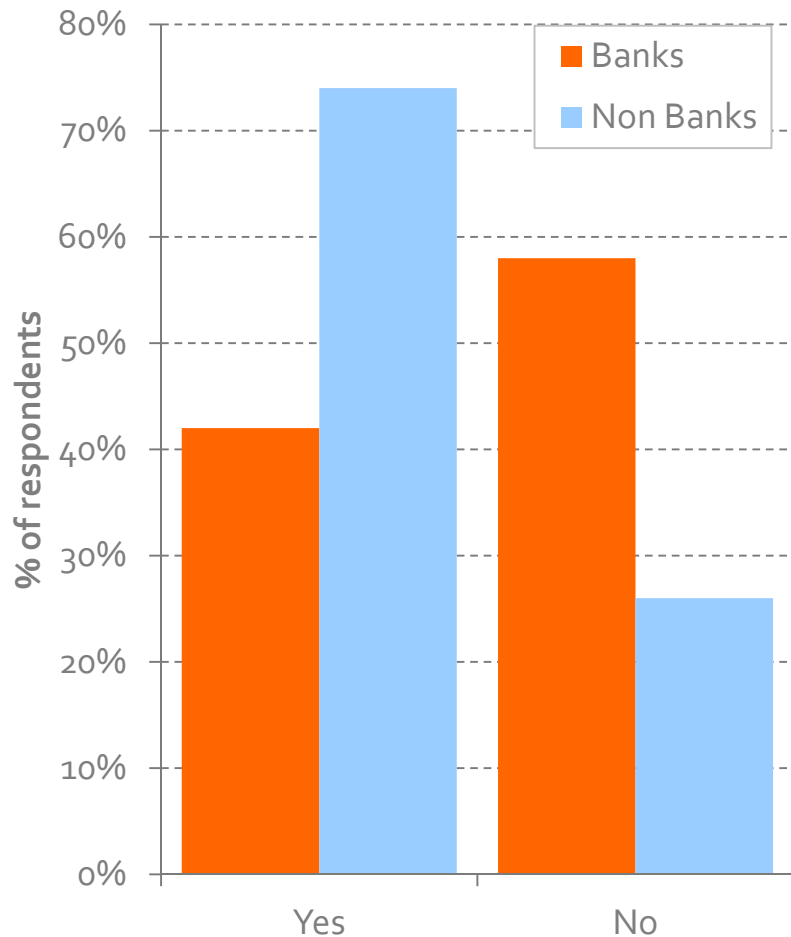
MIDDLE MARKET LBO ISSUANCE



2014 forecast is generated from Thomson Reuters LPC's Quarterly Lender Survey

WILL MIDDLE MARKET LENDERS HIT THEIR BUDGET THIS YEAR?

DO YOU EXPECT TO HIT YOUR LENDING GOAL?

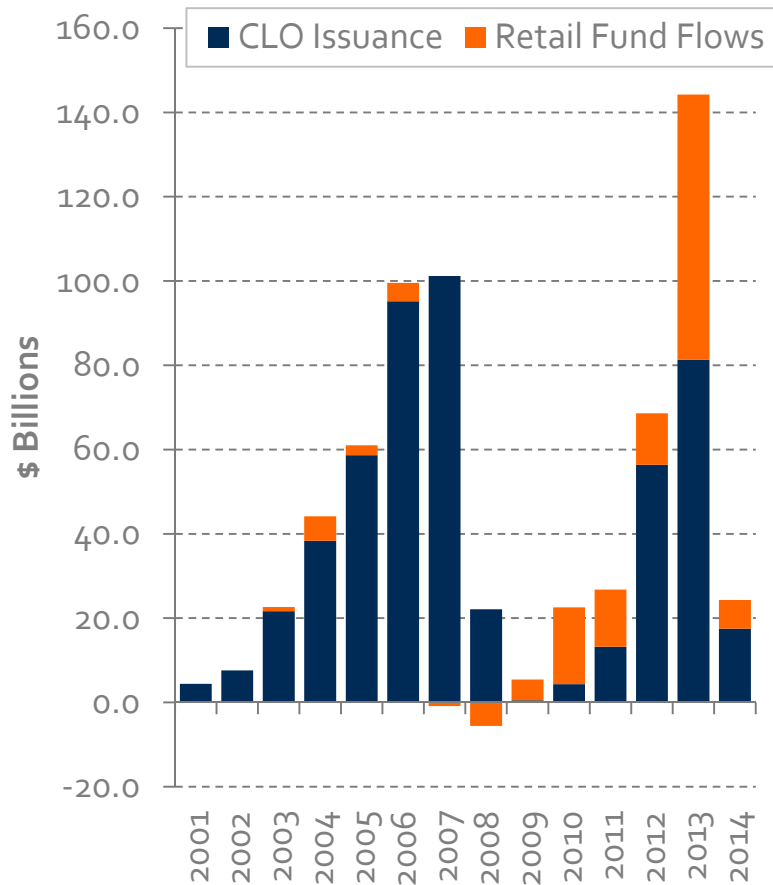


WHY OR WHY NOT?

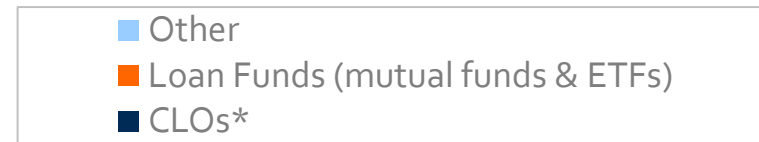
- **YES!** 😊
 - Seeing (hoping for) better volume
 - More M&A discussions
 - Built out origination platform
 - Taking bigger hold sizes
 - Strong technicals
 - More focused on lower middle market
 - Bigger product offering
- **NO!** ☹️
 - Lack of M&A
 - Too much competition
 - High credit hurdles
 - Leveraged Lending Guidance
 - Structures are too weak
 - Covenant lite pushing down market
 - Pass rate is high
 - Portfolio churn is a big issue

THE LEVERAGED LOAN ASSET CLASS HAS SEEN UNPRECEDENTED DEMAND IN THE LAST YEAR

CLO ISSUANCE & LOAN MUTUAL FUND FLOWS



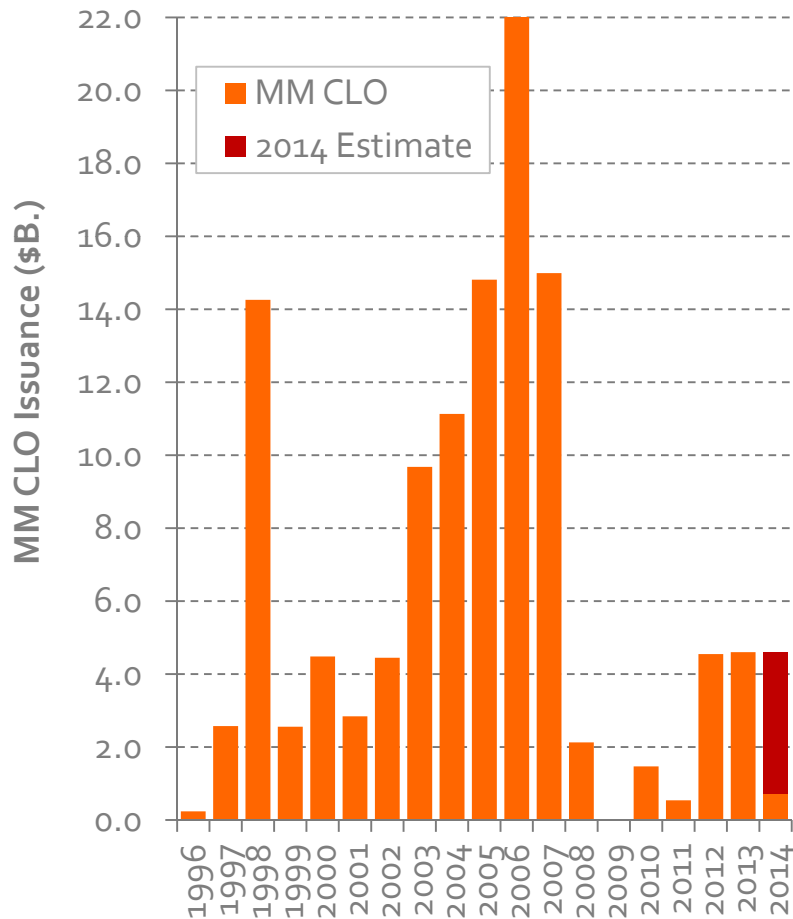
SHARE OF U.S. INSTITUTIONAL LEVERAGED LOAN MARKET OUTSTANDINGS**



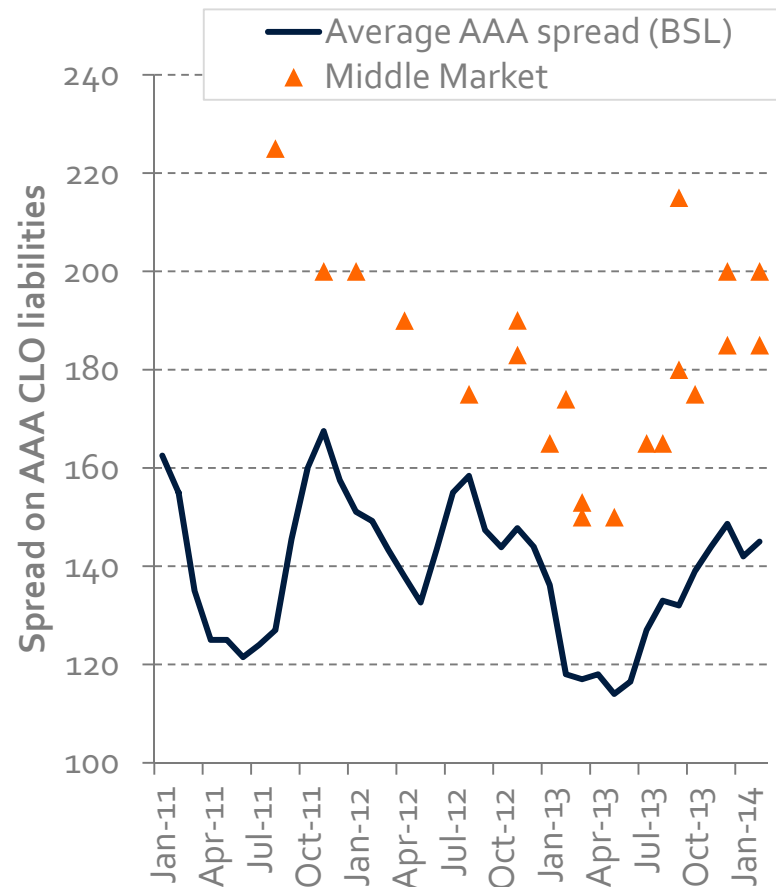
*Based on LPC Collateral's universe of 769 U.S. CLOs
 **Based on S&P/LSTA Leveraged Loan Index outstandings

MIDDLE MARKET CLOs USED AS A FINANCING VEHICLE; 2014 VOLUME EXPECTED TO RESEMBLE 2013

MM CLO ISSUANCE

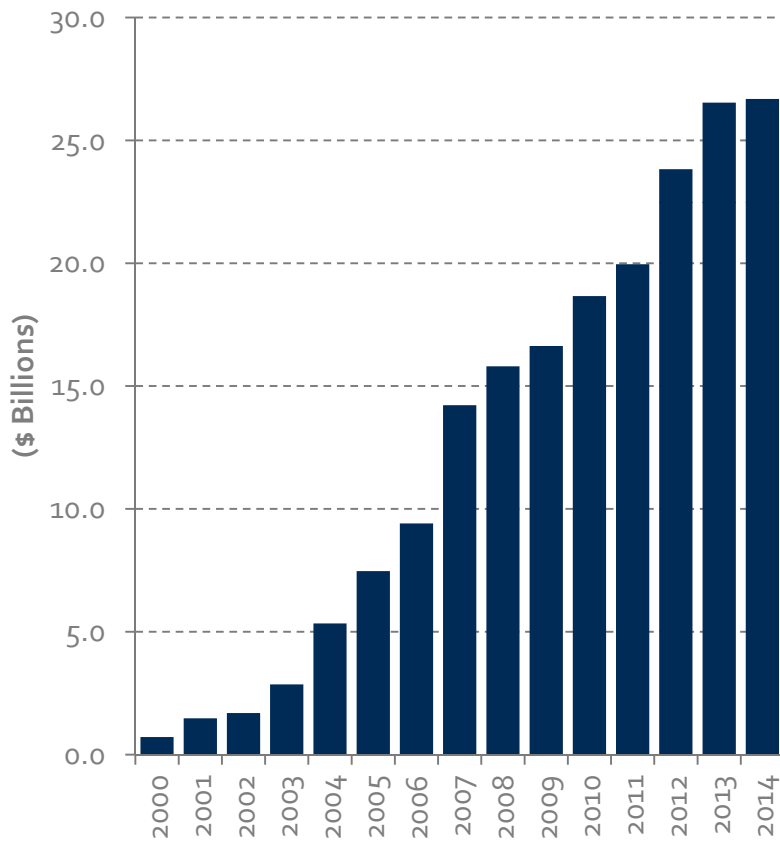


AAA SPREADS REMAIN HIGHER ON MM CLOS

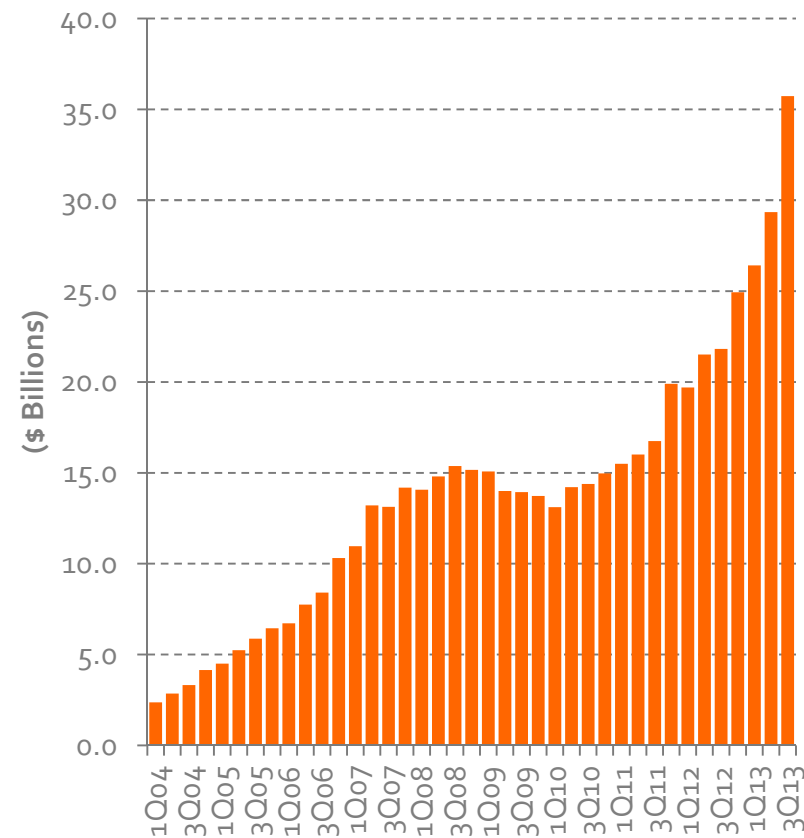


CLOSE TO \$27 BILLION IN CUMULATIVE EQUITY CAPITAL RAISED BY BDCs SINCE 2000; BDC ORIGINATIONS PEAK

BDC CUMULATIVE EQUITY CAPITAL RAISED (THROUGH 1/14/14)

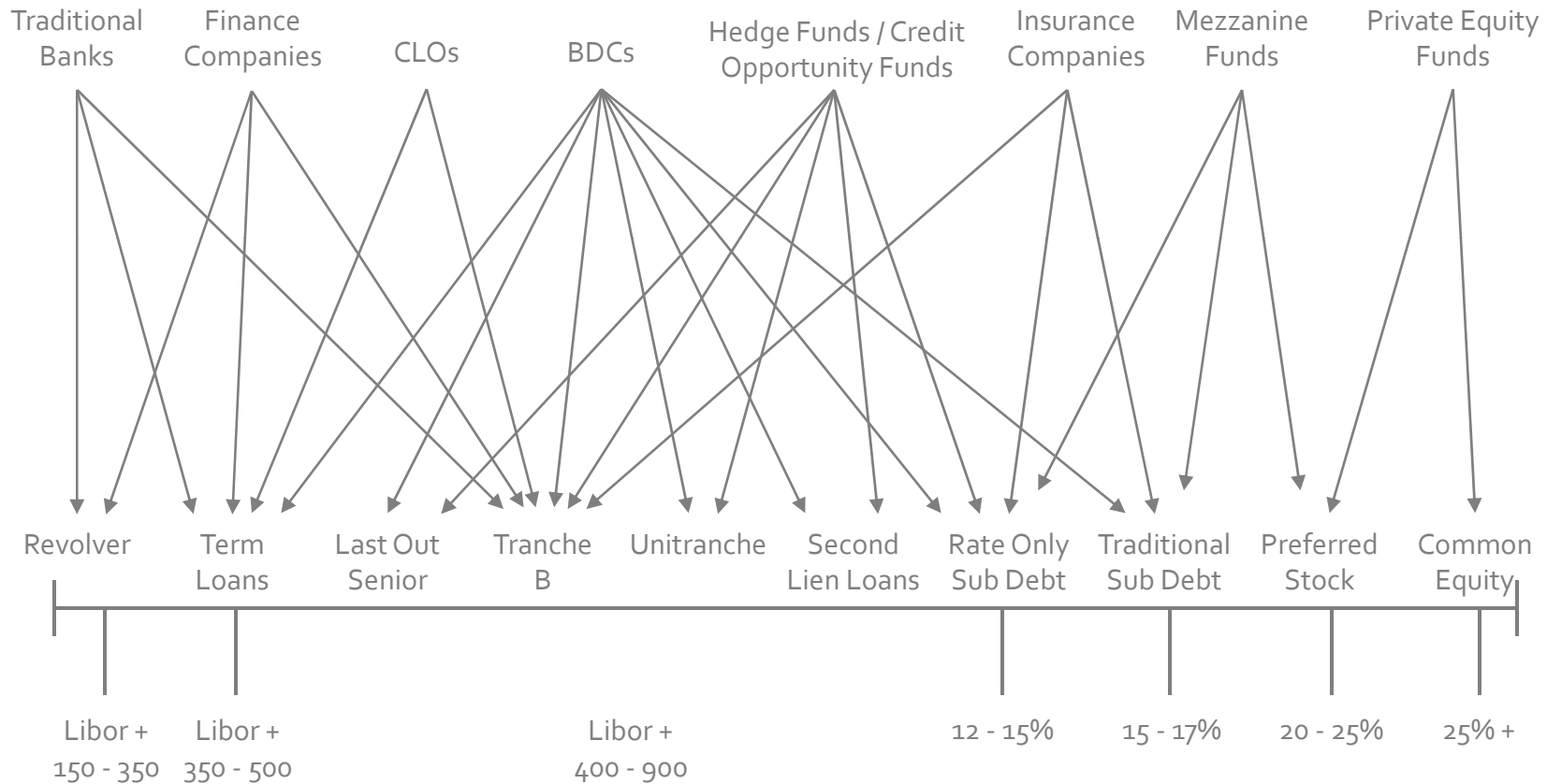


TRAILING 12 MONTH ORIGINATIONS PEAK IN 2013



THE COMPETITIVE LANDSCAPE FOR MIDDLE MARKET LENDING IS BECOMING MORE COMPLEX AND DIVERSE

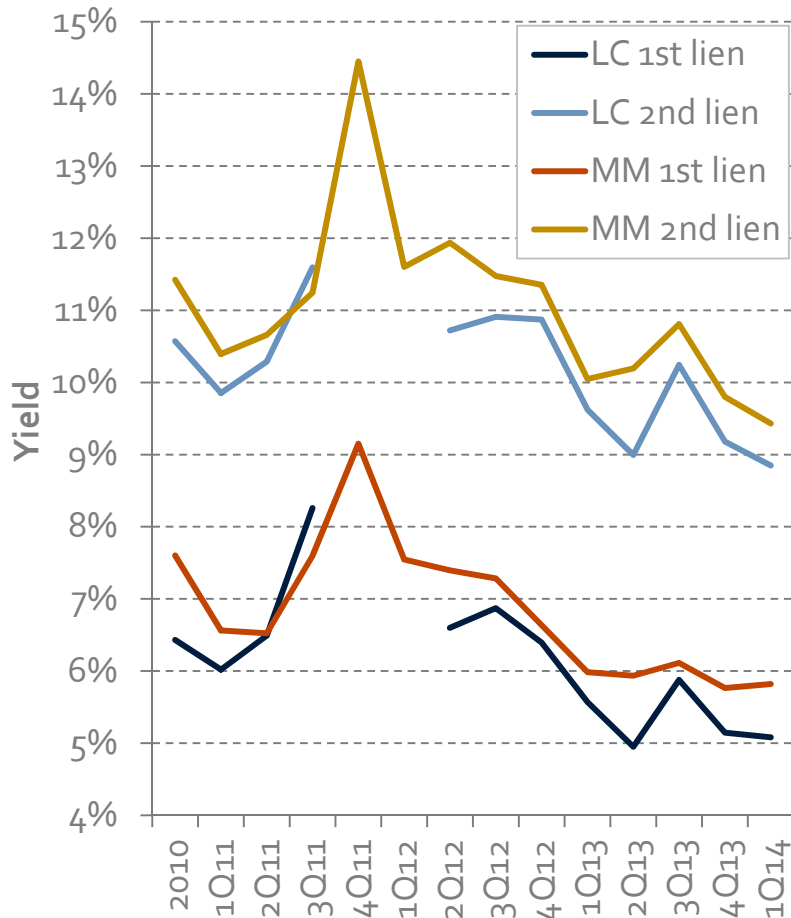
SOURCES AND TYPES OF AVAILABLE DEBT CAPITAL



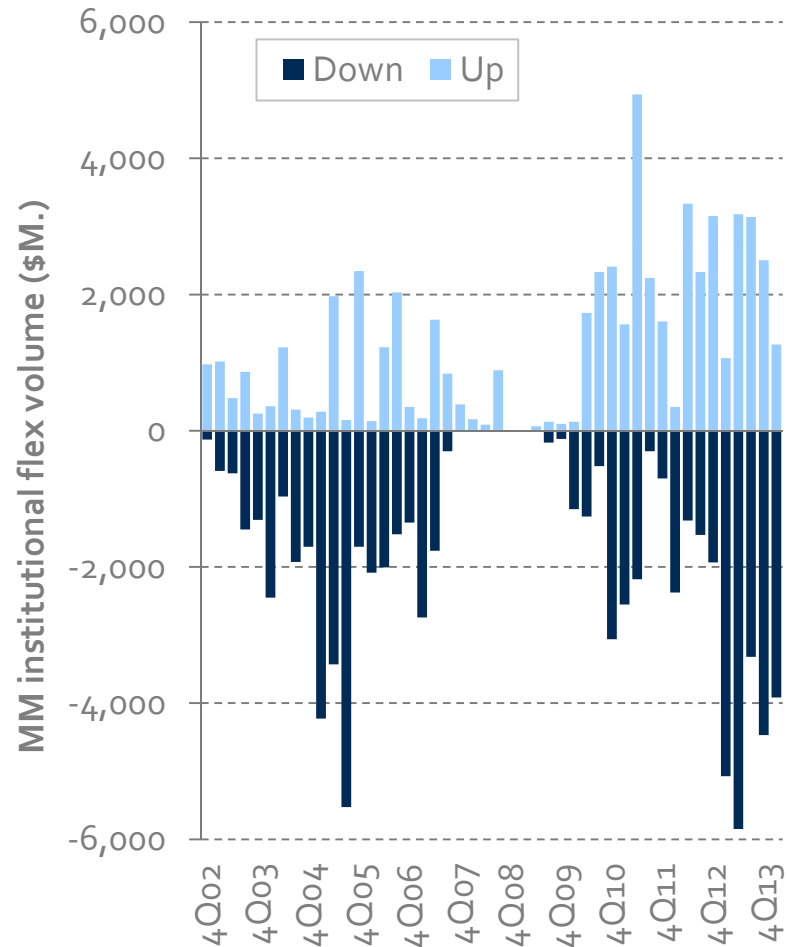
Alternative financing products, like unitranche facilities, comprise a growing portion of middle market leveraged financings today

ABUNDANT LIQUIDITY DRIVES YIELDS LOWER ACROSS THE CAPITAL STRUCTURE

YIELDS TIGHTEN IN LEVERAGED LAND

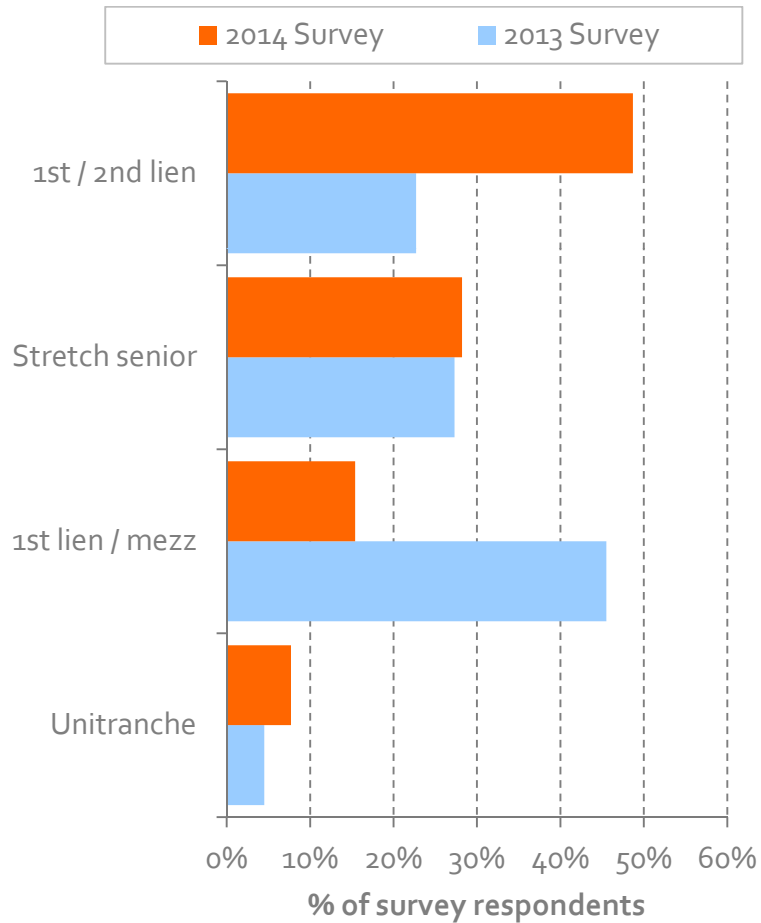


DOWNWARD FLEXES DOMINATE IN MM

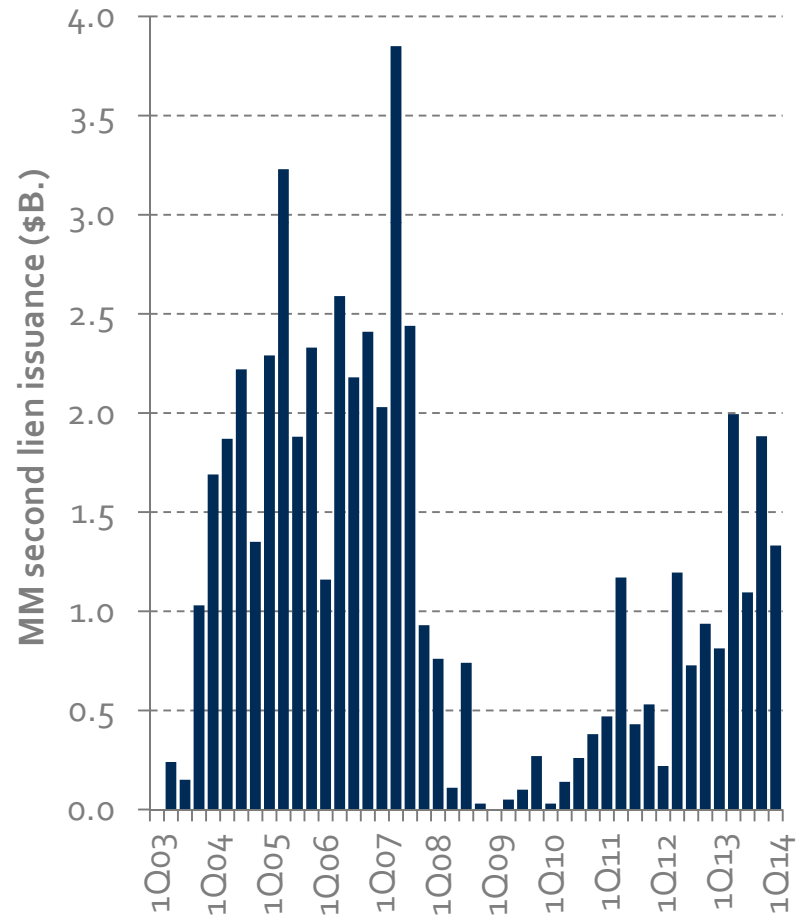


SECOND LIENS ARE IN VOGUE IN 2014

WHAT STRUCTURE WILL SPONSORS FAVOR?

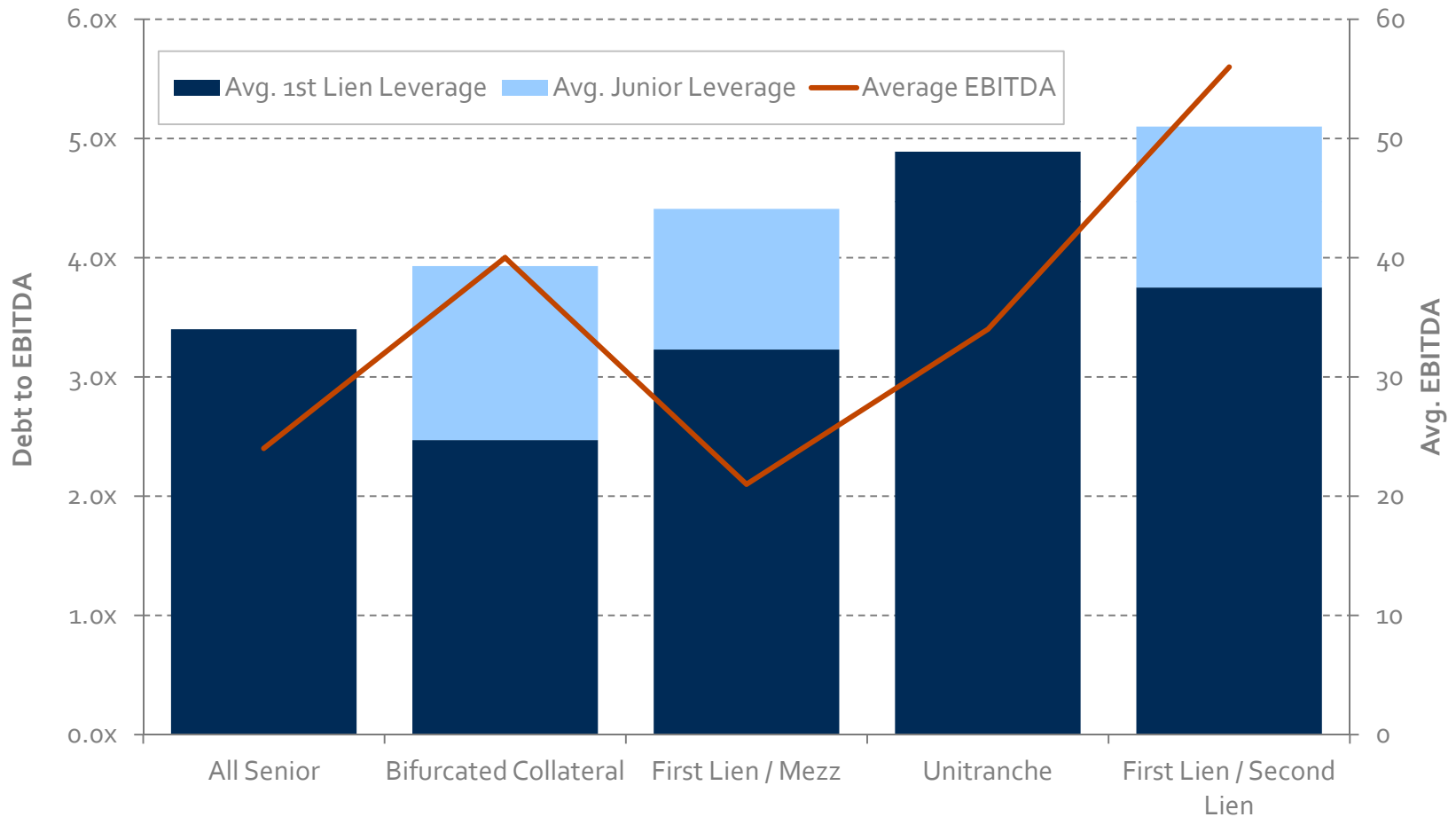


MM SECOND LIEN VOLUME



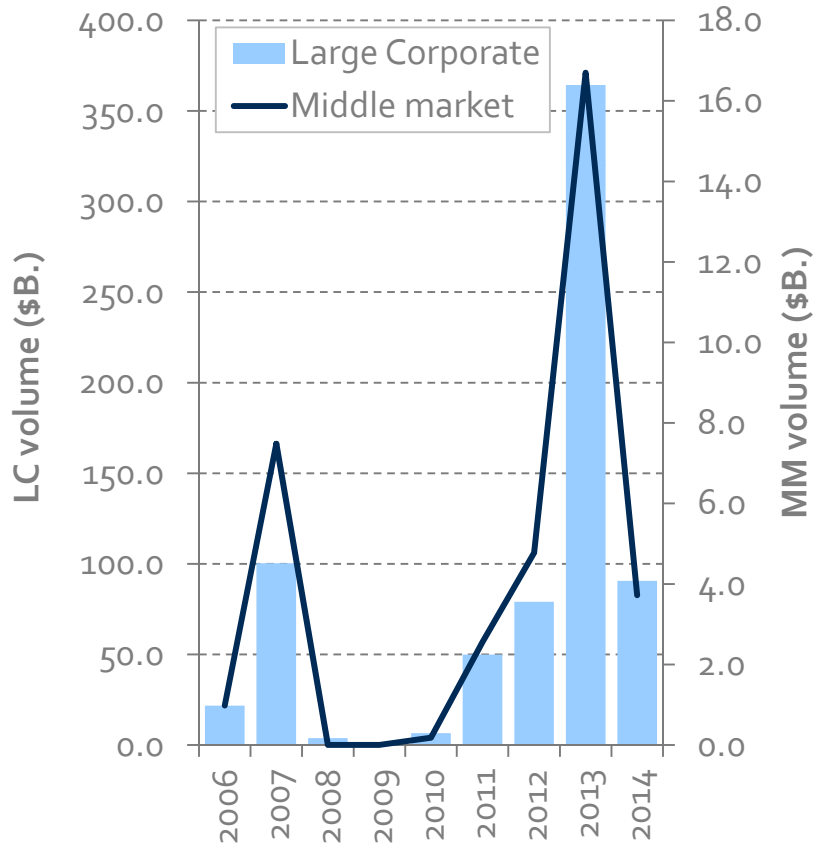
FIRST LIEN / SECOND LIEN STRUCTURE EXHIBITED THE MOST AGGRESSIVE LEVERAGE LEVELS IN 2013

2013 AVERAGE LEVERAGE BY FINANCING STRUCTURE FOR CLUB MM DEALS

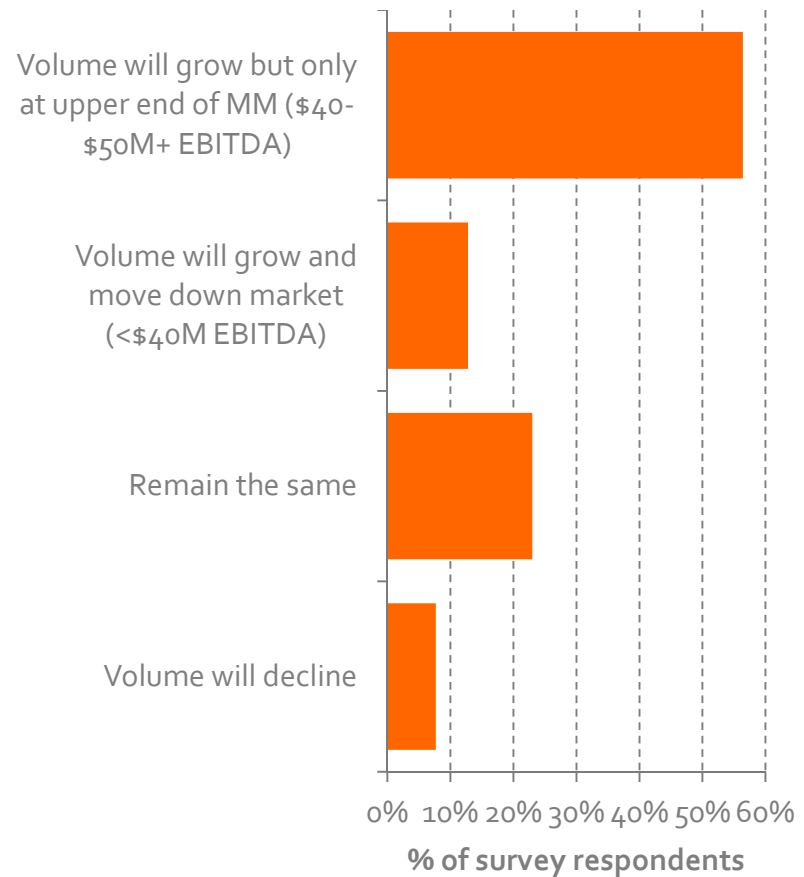


COVENANT-LITE VOLUME REACHED NEW HEIGHTS IN 2013; HOW FAR DOWN MARKET CAN COVY-LITE GO?

**COVENANT-LITE VOLUME
LARGE CORPORATE VS. MIDDLE MARKET**

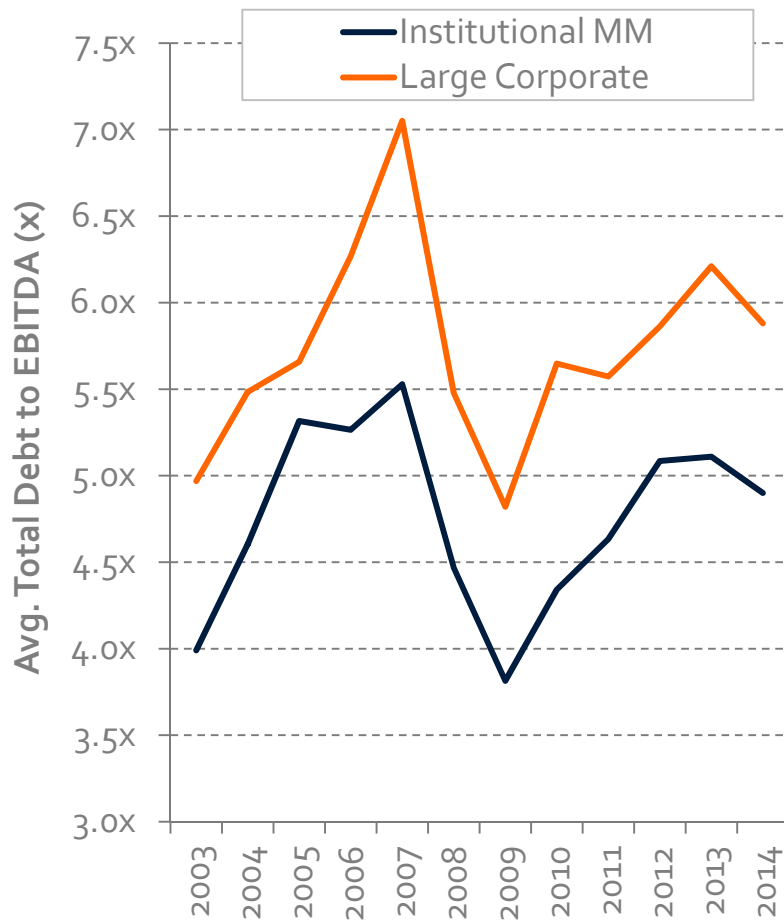


**MIDDLE MARKET COVENANT LITE
EXPECTATIONS FOR 2014**

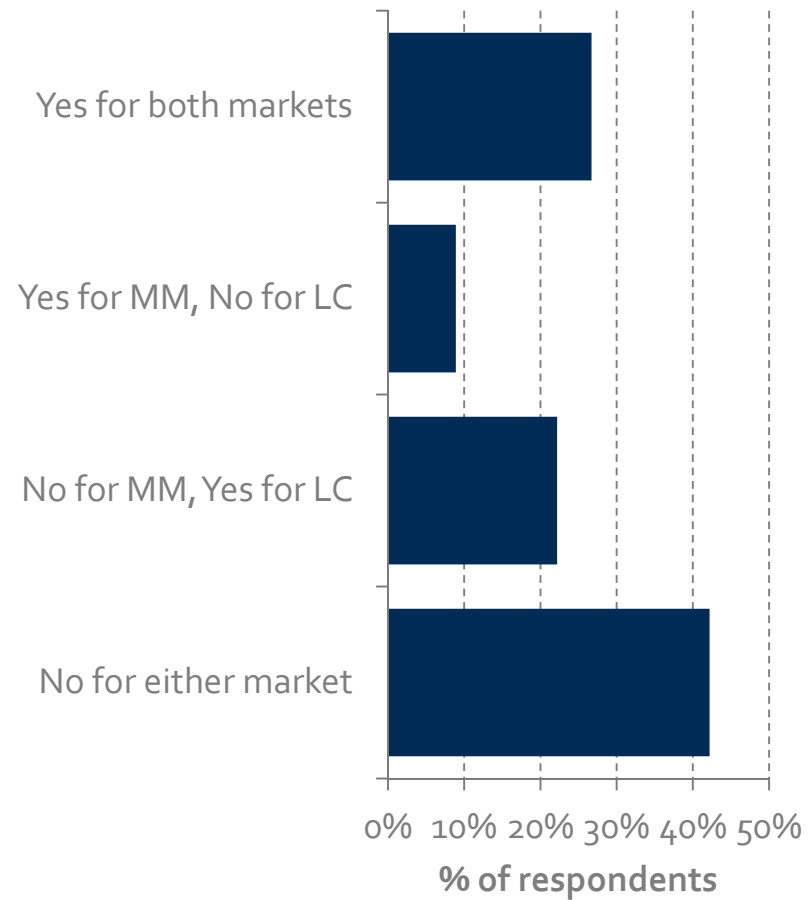


LEVERAGE ROSE ON LBO DEALS IN 2013 ARE WE HEADED BACK TO PEAK LEVELS IN 2014?

DEBT TO EBITDA FOR LBO DEALS

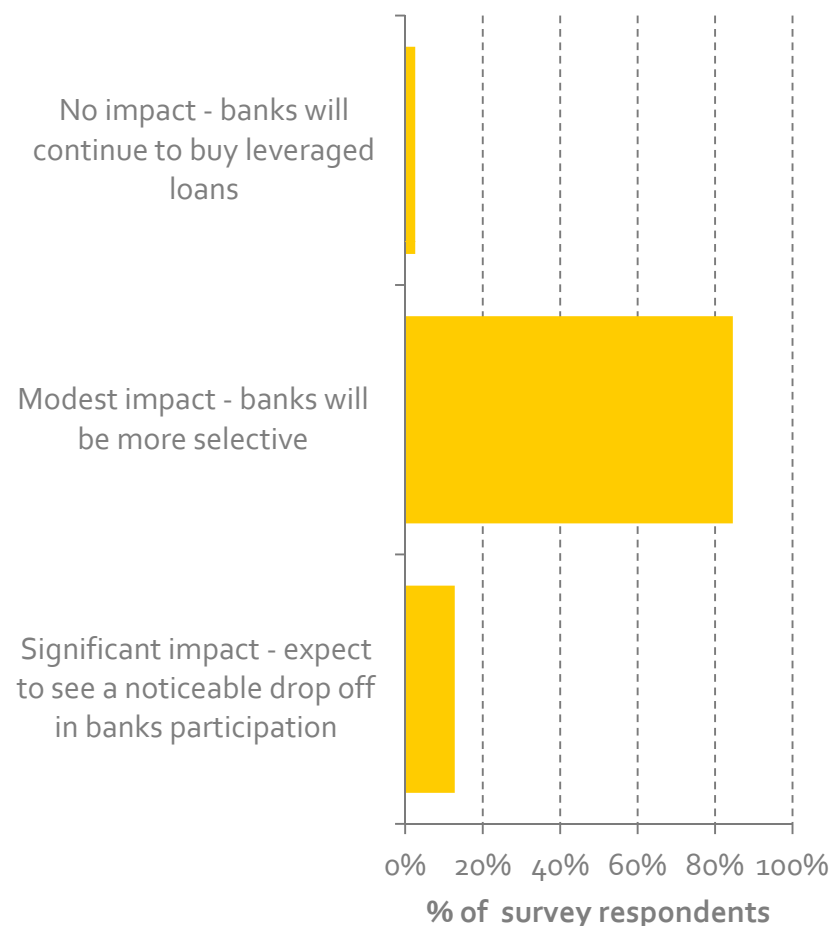


IS LEVERAGE HEADING BACK TO PEAK LEVELS?



BANK BEHAVIOR IS CHANGING FOLLOWING FINALIZED LEVERAGED LENDING GUIDANCE

HOW MUCH WILL LLG IMPACT BANKS IN 2014?

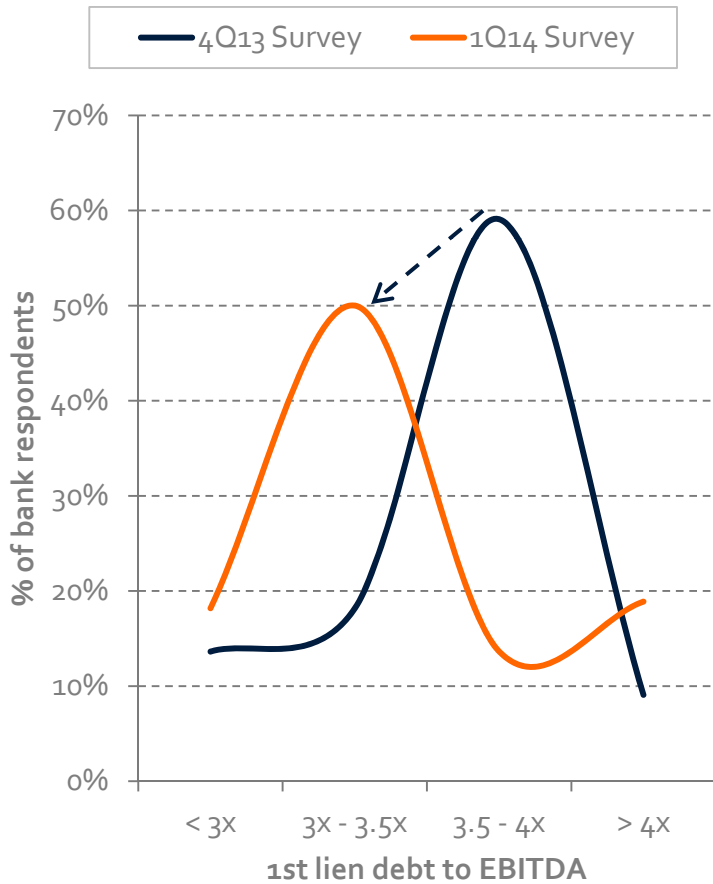


LEVERAGED LENDING GUIDANCE SUMMARY

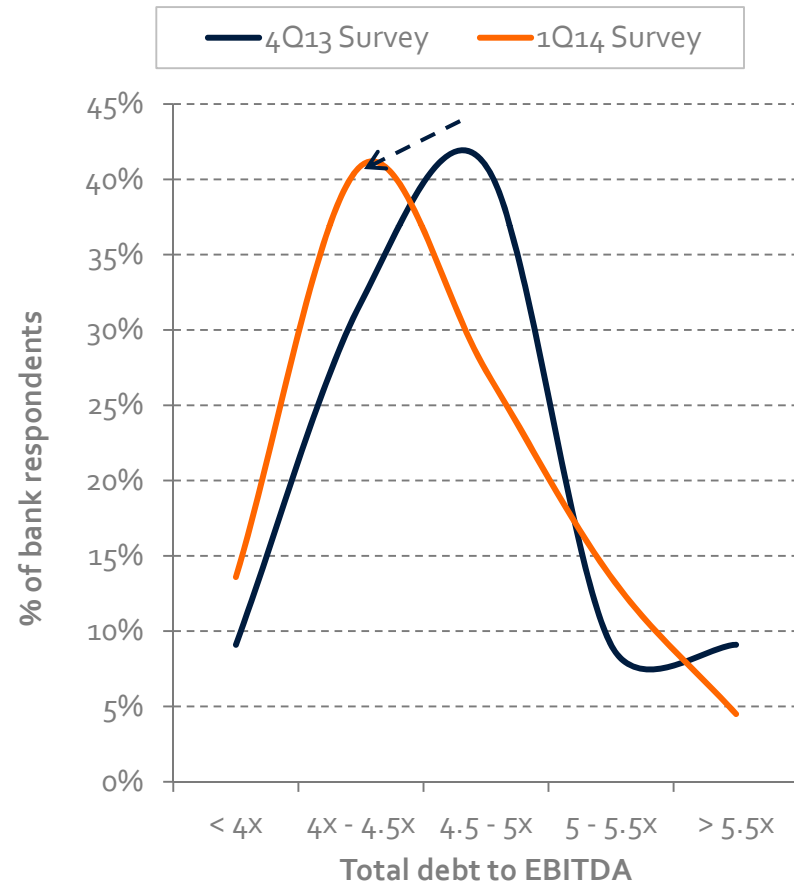
- Deals treated as **“leveraged”** include:
 - Proceeds used for buyouts, dividends, etc.
 - Senior debt/EBITDA > 3x
 - Total debt/EBITDA > 4x
 - Loans to vehicles that engage in leveraged finance (CLOs, BDCs, etc.)
 - Fallen angels* (included only upon modification or waiver)
 - ABL* (incl. only if part of entire debt structure of a leveraged borrower)
- Deals treated as **“criticized”** include:
 - If a company cannot show the ability to amortize 100% of its senior debt or 50% of its total debt within 5 to 7 years
 - Issuers with leverage in excess of 6x debt/EBITDA after asset sales

BANKS LOWER THEIR LEVERAGE TOLERANCE FOR MIDDLE MARKET DEALS AS LLG IS FRONT AND CENTER

SPONSORED: SENIOR DEBT TO EBITDA



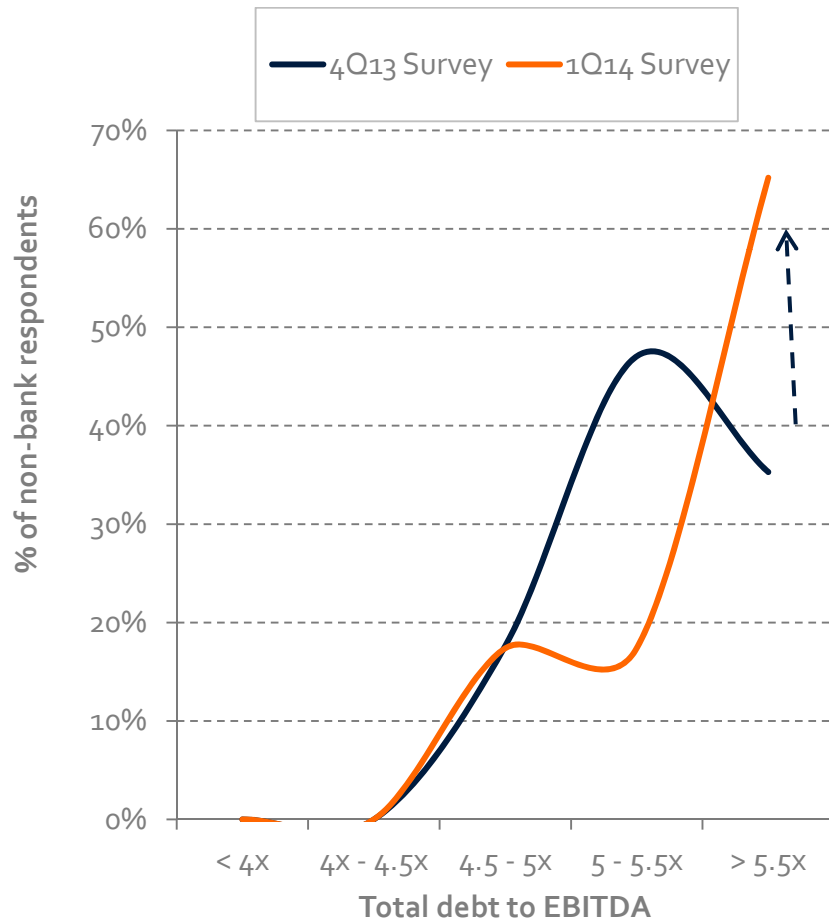
SPONSORED: TOTAL DEBT TO EBITDA



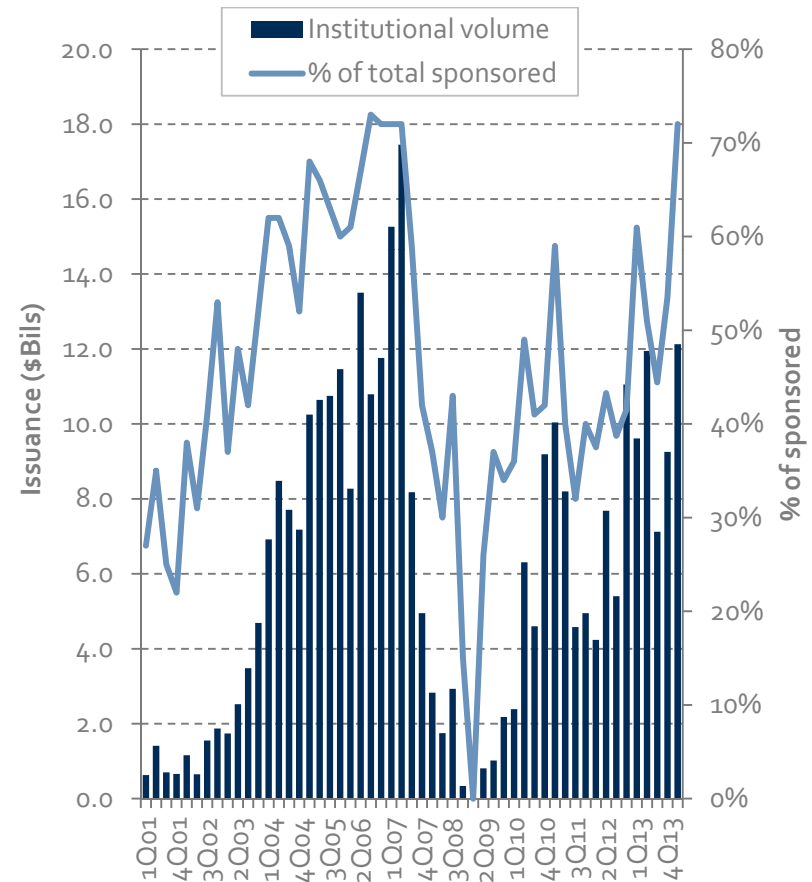
SOURCE: THOMSON REUTERS LPC'S QUARTERLY LENDER SURVEY

BUT, NON-BANK LENDERS CONTINUE TO EXHIBIT HIGHER TOLERANCE FOR LEVERAGE

SPONSORED: TOTAL DEBT TO EBITDA



MM SPONSORED INSTITUTIONAL VOLUME



WHAT WILL BE THE BIGGEST CHALLENGE IN THE MIDDLE MARKET FOR THE REMAINDER OF THE YEAR?

SURVEY RESPONSES AGGREGATED ACROSS COMMON THEMES

- Low M&A transaction volumes
- Too much money chasing too few deals
- Institutional investors continue to be hungry for assets and move down market
- Maintaining pricing integrity
- Chasing volume and yield by going deeper and lower in the capital structure
- High leverage multiples
- Adjusting to new regulatory issues
- Leveraged lending guidance – banks getting more conservative
- Competing with high hold levels
- Erosion of credit quality
- Maintaining discipline on documentation, covenants
- Growing assets

2ND ANNUAL THOMSON REUTERS LPC MIDDLE MARKET LOANS CONFERENCE

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CLOs in the Heartland

State of Middle Market Lending and Middle Market CLOs

Derek Miller
Senior Director

March 2014

State of Middle Market Lending and Middle Market CLOs Panelists

- Michael Hopson, Head of U.S. Structured Finance, Natixis
- Josh Niedner, Managing Director, Madison Capital
- Kelli O'Connell, Director, NXT Capital

Regulatory Update

March 19, 2014

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Volcker Rule – Jan Stewart

Volker Rule – Dodd-Frank Section 619

- Final Regulation approved December 10, 2013 and effective April 1, 2014.
- Prohibitions on a “banking entity” under US Bank Holding Company Act from:
 - Proprietary trading in securities, derivatives and other instruments
 - Sponsoring, investing in and entering into transactions with covered funds

Volcker Rule – Steps in Analyzing its Application

- Is the fund a covered fund?
- Is the banking entity sponsoring or acquiring an ownership interest in the covered fund?
- Super 23A Provisions
 - Are the banking entity's activities exempt?
 - Does the prohibition on covered transactions under Super 23A apply?
 - With respect to exempt activities, do they involve material conflicts of interest, high risk activities or risk to financial stability?

Prohibition on Ownership of Covered Funds

- Hedge funds and private equity funds are intended to be defined as “Covered Funds”
- Covered Funds are those funds that would be subject to the Investment Company Act of 1940 *but for* the exemptions provided by Sections 3(c)(1) and 3(c)(7)
- Many ABS (including CLOs) rely on those same exemptions and are swept in as covered funds under the proposed rule ***but there is no indications that ABS was targeted by Congress under the Volcker Rule***

Savings for Loan Securitization

- There is an overriding savings provision in the Dodd-Frank Act mandating that **nothing in the rule limit or restrict the sale or securitization of loans**
- Loan Securitization Exemption
 - Exclusion for securitization issuers of ABS that are backed solely by: (i) loans, (ii) certain related contractual rights and other incidental assets, (iii) interest rate or foreign exchange derivatives that hedge the permitted assets of the issuer and (iv) special units of beneficial interest and collateral certificates issued by a special purpose vehicle that itself meets the exclusion.
 - Permitted assets of an LSE issuer do not include (i) any security (other than cash equivalents or securities received in lieu of permitted loan assets), (ii) any other derivatives or (iii) any commodity forward contract.

Volcker: Avoiding Ownership Interests in Covered Funds

- Ownership Interests Defined
 - Any equity partnership interest or “similar interest,” voting or non-voting, including both general and limited partnership interests, options and other derivatives.
 - Debt security or other interest included if “exhibits substantially same characteristics” – voting, share in profits and losses, earn return based on performance of the fund.
 - Many CLOs have senior debt tranches with right to replace defaulting collateral managers. Does this create an ownership interest?

Proposed Volcker Rule's "Super 23A" Provisions

- Covered Funds – including loan securitizations, are subject to “Super 23A” provisions when sponsored or advised by banking entities or affiliates
- “Covered Transactions” between a sponsor or advisor and a covered fund are prohibited
- Exempt Activities not subject to Prohibition
 - Fund activities conducted solely outside of the US
 - Funds offered and organized in connection with *bona fide* fiduciary and advisory services to customers
 - Organizing asset-backed securitizations
 - Market-making and underwriting activities

Volcker Rule's Advocacy for Modifications

- TruPS CDO Litigation and Interim Rule
- Congressional Action
 - Letters from members of Congress to fix Volcker ownership interest for CLOs
 - H.R. 4167 to extend conformance period by two years to 2017
- Industry Advocacy
 - In-person meetings with regulators
 - Trade associations (LSTA/SIFMA/SFIG) offer suggested fixes

US Risk Retention – Sagi Tamir



US Risk Retention – Dodd-Frank Section 941

- Dodd-Frank created a new Section 15G of Exchange Act
- Purposes:
 - Align ABS “securitizers” incentives with investors
 - Require ABS “securitizers” to have “skin in the game”
- Generally requires the entity that initiates or originates an ABS to retain a 5% economic interest in the credit risk of the securitized assets
 - Applies to both registered and unregistered deals
- Compliance Dates:
 - RMBS: One year after final rules
 - Everything else: Two years after final rules

US Risk Retention – Implementing Rules

- Both the 2011 Initial Proposed Implementing Rules and 2013 Re-proposed Implementing Rules envision the CLO manager retaining 5% of the face value of the CLO notes
- The LSTA has argued that Dodd-Frank required credit risk retention does not apply to managers of “Open Market CLOs”
 - Dodd-Frank requires retention by the “securitizer” – the entity that initiates or originates an ABS by **selling** or **transferring** assets to the Issuer
 - In “Open Market CLOs” there is no single seller or transferor
 - imposing risk retention on CLO managers equals **risk assumption**
 - Risk retention is economically unfeasible for many CLO managers
- Notwithstanding, the 2013 Re-proposed Implementing Rules do not exempt CLOs or CLO managers

US Risk Retention – Re-proposed Rules

- Under the Re-proposed Implementing Rules, “Open Market CLOs” would be subject to risk retention in one of two ways:
 - The Manager Option – the CLO manager would retain 5% of the face value of the CLO notes
 - The Arranger Option – the CLO manager would be exempt from risk retention if it limits the assets in the portfolio to tranches of syndicated loans where the lead arranger agrees to hold 5% of the entire notional tranche amount
- Under both options, hedging or selling the exposure is prohibited for the life of the CLO / loan
 - LSTA has argued that the Arranger Option is an illusory – no lead arranger would agree to retain 5% of an institutional term loan without the ability to hedge or sell for the life of the loan

US Risk Retention – LSTA’s “Open Market” CLO Proposals

- In response to the Re-proposed Implementing Rules, the LSTA has proposed:
 - Developing a category of high quality leveraged loans that would not attract risk retention (similar to qualified residential mortgages)
 - Allowing third party equity investors to act as sponsors so long as they have a role in developing the asset selection criteria for the CLO
- The LSTA’s “Qualified CLO” Proposal
 - CLOs that satisfy certain restrictions / protections intended to ensure strong collateral, alignment of incentives and investors protection
 - CLO manager would only have to retain 5% of the equity (as opposed to 5% of the notional amount of the CLO)

US Risk Retention – LSTA’s “Open Market” CLO Proposals (Cont.)

- The LSTA’s “Qualified CLO” Qualifications
 - **Asset Quality** – at least 90% cash and senior secured loans to companies; loans must be held by three or more unaffiliated investors; no more than 60% cov light
 - **Portfolio Composition** – no loan can be higher than 3.5% of the portfolio and no more than 15% concentration in any one industry
 - **Structural Features** – CLO equity must be at least 8% and structure must include IC and OC tests
 - **Alignment of Interests** – must be an “Open Market CLO,” equity can remove manager for cause, majority of manager’s fee subordinated to rated notes, manager must retain 5% of the equity, limited discretionary trading, U.S investors must be Qualified Investors

US Risk Retention – LSTA’s “Open Market” CLO Proposals (Cont.)

- The LSTA’s “Qualified CLO” Qualifications (Cont.)
 - **Transparency and Disclosure** – manager must provide monthly reports that provide significant information on the underlying assets and the portfolio, OC and IC tests status and all purchases, repayments and sales
 - **Regulatory Oversight** – CLO manager must be a registered investment advisor
- Bottom line – **U.S. CLOs will likely have to be compliant with some form of risk retention**

US Risk Retention Rules – Timing

- U.S. risk retention was supposed to have been finalized by April, 2011, but disagreement among regulators delayed finalization
- Implementing rules were re-proposed in August 2013
- After they are finalized, there likely will be a two-year implementation period
- Thus, in a worst-case scenario, CLOs can be likely issued through early 2016 without having to fully comply

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EU Risk Retention – Larry Berkovich



CRR—Article 122a no longer applies

- The Article 122a securitization risk retention provisions no longer apply as of January 1, 2014. They are replaced by the Capital Requirements Regulation (CRR).
- On December 17, 2013, following the closing of a consultation period, the European Banking Authority (EBA) published final draft regulatory technical standards (RTS) for CRR.
- The European Commission has to adopt, amend or reject the draft RTS. (Expected outcome is that the draft RTS will be adopted in its current form.)
- Concerns raised by market participants notwithstanding, the draft RTS does not provide for full grandfathering for transactions completed prior to current guidance.
- In deciding whether additional risk penalties will be imposed, compliance with Rule 122a will be considered.

CRR—Retention Requirement

- Retention Provider needs to retain an economic interest of a least 5% of the outstanding balance of the CLO collateral.
- Retention requirements may be satisfied by holding (i) 5% of each underlying loan; (ii) the first-loss tranche (equity) or (iii) *pro rata* portion of all tranches.
- RTS does not contain Rule 122a's provision permitting the retention requirement to be met on a consolidated basis.
- Entities that are not credit institutions are unable to meet the retention requirement on an unfunded basis.

CRR—Who may act as Retainer?

- Retention providers must meet the definition of sponsor, originator or original lender.
- Original lenders under underlying loans have little interest in committing to retain 5%.
- U.S. collateral managers generally do not fall within the definition of sponsor.
- Definition of sponsor is generally limited to entities that are subject to the requirements of the EU Markets in Financial Instruments Directive (MiFID).

CRR—Retention by Originators

- CLOs managed by US-based managers generally rely on clause (b) of the definition of Originator.
- 'Originator' means an entity which: (a) itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) **purchases a third party's exposures for its own account and then securitises them** [emphasis added].

CRR—Retention by Originators

- CLOs designates an entity (*e.g.* a loan fund that is also managed by the collateral manager) to acquire loans and sell them to the CLO issuer.
- The Originator could satisfy the retention requirement by (i) retaining 5% of all loans that it sells or (ii) by retaining CLO tranches.
- Originator must have a beneficial interest in the loans it sells to the CLO. [Some deals permit for the settlement of loans directly with the CLO issuer.]

CRR—Retention by Originators

- Originator must be an operating company.
- Can't be a mere “flow-through .”
- A material portion of the net asset value of the Originator must include investments and other assets that are not related to the CLO that the Originator is supporting.
- Multiple originators are permitted.

CRR—Retention by Originators

- RTS also provides that the retention requirement may be satisfied by a single Originator if it also “established and is managing the program or securitisation scheme.”
- The collateral manager may now be able to act as a retainer as long as it acquires one or more loans for its own account, and then sells the loans to the CLO.

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FATCA and other Tax



FATCA and Cayman CLOs – Overview

- Foreign Account Tax Compliance Act (FATCA) is the law
 - Signed by President Obama on March 18, 2010
 - Proposed Regulations issued on February 8, 2012 (published on February 15, 2012)
 - Final Regulations issued on January 17, 2013 (officially published January 28, 2013)
 - Corrections/Amendments issued in September 2013 and February 2014
 - Bilateral Intergovernmental Agreements (“IGAs”) can modify outcomes under the Final Regulations
- New withholding tax and information reporting system for payments made to “foreign financial institutions” (FFIs), including CLOs
- Similar system of withholding tax and information reporting for payments made to “non-financial foreign entities” (NFFEs)
- Designed to reduce the incidence of improper tax avoidance by US investors through the use of offshore accounts and non-US investments
 - FATCA targets financial institutions serving US investors rather than the US investor itself
 - Goal: increased information reporting and transparency
 - Enforcement mechanism: 30% withholding tax imposed on US payments (including payments by FFIs that are re-sourced as US payments) to certain non-compliant non-US persons

Withholding on Payments made to CLOs

- Any “withholdable payment” made to a non-US entity is potentially subject to FATCA
 - Withholdable payment means (i) any payment of US source FDAP income (*i.e.*, interest, dividends, rents, premiums, annuities, etc.) and (ii) any gross proceeds from the sale or other disposition (occurring after 12/31/16) of any property of a type which can produce interest or dividends that are US source FDAP income
 - However, no such withholding will apply if the FFI recipient is a “participating FFI” or otherwise deemed compliant
- A participating FFI is an FFI that enters into an agreement with the IRS (FFI Agreement) to report on their account holders and to withhold on payments, if necessary

Withholding on Payments made to CLOs (cont.)

- Payments made with respect to preexisting obligations (i.e., those existing as of 7/1/14 that are not equity for U.S. federal tax income tax purposes) may be grandfathered and exempt from FATCA unless “materially modified” after 7/1/14
- As such, unless a Cayman CLO can qualify as (a) an LLDIE or (b) a compliant entity under the US-Cayman IGA, it will need to become a participating FFI and undertake reporting/withholding obligations with regard to its investors in order to be exempted from withholding on payments made to it (although payments made be grandfathered)

Special Rule for Legacy Securitization Vehicles (LLDIEs)

- Certain legacy (e.g., pre-FATCA) securitization vehicles (e.g., CLOs) cannot comply with the registration and due diligence requirements of FATCA pursuant to their terms
 - e.g., the trustee or directors may not be permitted to register the vehicle as a participating FFI or comply with the due diligence requirements
- The regulations permit these securitization vehicles to qualify as “certified deemed-compliant” FFIs
 - If available, this relief continues for the life of the vehicle (absent change in circumstances)
 - Vehicles do not need to register with the IRS
 - Recent changes expand/ease some of the requirements, but significant uncertainty remains as to whether the requirements will be further modified and how such concept/term will be picked up in the US-Cayman IGA

Special Rule for Legacy Securitization Vehicles (LLDIEs) (cont.)

- Six-pronged test:
 - FFI is an “investment entity” that issued one or more classes of debt/equity interest to investors pursuant to a trust indenture or similar agreement and all of such interests were issued on or before January 1, 2017
 - FFI was in existence as of January 17, 2013, and has entered into a trust indenture or similar agreement that requires the FFI to pay to investors holding substantially all of the interests in the FFI, no later than a set date or period following the maturity of the last asset held by the FFI, all amounts that such investors are entitled to receive from the FFI
 - FFI was formed and operated for the purpose of purchasing or acquiring specific types of debt instruments or interests therein and holding those assets subject to reinvestment only under prescribed circumstances to maturity

Special Rule for Legacy Securitization Vehicles (LLDIEs) (cont.)

- Six-pronged test (cont.):
 - Substantially all of the assets of the FFI consist of debt instruments or interests therein
 - All payments made to the investors of the FFI (other than holders of a de minimis interest) are either cleared through a clearing organization or custodial institution that is a participating FFI, reporting Model 1 FFI, or U.S. financial institution or made through a transfer agent that is a participating FFI, reporting Model 1 FFI, or U.S. financial institution
 - The FFI's trustee or fiduciary is not authorized through a fiduciary duty or otherwise to fulfill the obligations of a participating FFI and no other person has the authority to fulfill the obligations of a participating FFI on behalf of the FFI

Alternative Regime: Intergovernmental Agreements (IGAs) CLOs in the Heartland

- As of March 14, 2014, US has signed agreements with 24 countries
- Special rule for legacy securitization vehicles not contained in Model agreements (e.g., not contained in US-Cayman IGA)
- Must review applicable agreement (including partner jurisdiction law implementing the agreement) to determine whether the legacy securitization vehicle rule applies

Alternative Regime: Intergovernmental Agreements (IGAs) (cont.)

CLOs in the Heartland

- US-Cayman IGA was signed on 11/29/2013
- LLDIE rule not contained in US-Cayman IGA
- Uncertainty of registration requirements since LLDIE definition not included
- Timing of Cayman Legislation to implement the IGA:
 - May/June 2014 – amend primary legislation
 - July/August 2014 – adopt regulations and guidance notes
- These rules are extremely complex and continue to evolve – CLOs, managers and sponsors should consult tax advisors

Circular 230 Disclaimer

The authors intend that no person may use this presentation, and it may not be used, to avoid tax penalties that may be imposed by U.S. law. This presentation does not render tax advice, which can be given only after considering all relevant facts about a specific transaction. Consult a professional tax advisor for tax advice.

New “Publicly-Traded” Rules for Debt Modifications



In General

- Treatment of a debt instrument as publicly traded will generally affect the U.S. federal tax consequences to issuers and holders of a modification of a debt instrument that results in a “deemed exchange,” including:
 - Cancellation of debt income (“COD”) of the issuer
 - Gain or loss to the holder
 - Original issue discount (“OID”) treatment of the “new” debt

Consequences of a Modification of a Debt Instrument that Results in a “Deemed Exchange”

- Certain “significant modifications” of a debt instrument will result in a deemed exchange of the unmodified debt instrument (the old debt) for the modified debt instrument (the new debt)
 - The form of the modification is generally irrelevant and could occur, for example, through a debt-for-debt exchange by the issuer or an amendment to a loan agreement
- The old debt will be treated as redeemed for an amount equal to the “issue price” of the new debt
- The new debt will be treated as a newly issued debt instrument with a new issue price

Consequences of a Modification of a Debt Instrument that Results in a “Deemed Exchange” (Cont.)

- Consequences to Issuer
 - Redemption of old debt
 - If the issue price of the new debt is less than the “adjusted issue price” of the old debt (which in most circumstances will be the principal amount of the old debt), the issuer will generally have COD income
 - If the issue price of the new debt is greater than the adjusted issue price of the old debt, the issuer will generally have deductible premium (which may not be immediately deductible)
 - Issuance of new debt
 - If the issue price of the new debt is less than the “stated redemption price at maturity” (which in most circumstances will be the principal amount of the new debt) by more than a *de minimis* amount, the new debt will have OID, which will generally be deductible by the issuer
 - If the issue price of the new debt is greater than the SRPM of the new debt, the premium will reduce interest deductions

Consequences of a Modification of a Debt Instrument that Results in a “Deemed Exchange” (Cont.)

- Consequences to Holder
 - Redemption of old debt
 - The holder will generally have gain or loss equal to the different between the issue price of the new debt and the holder’s basis in the debt instrument, which will usually be a capital gain or loss
 - Issuance of new debt
 - If the issue price of the new debt is less than the “stated redemption price at maturity” (which in most circumstances will be the principal amount of the new debt) by more than a de minimis amount, the new debt will have OID, which will generally be includible as income by the holder over the term of the new debt
 - If the issue price of the new debt is greater than the stated redemption price of the new debt, the premium will be deductible over the term of the instrument, if the holder elects

Consequences of a Modification of a Debt Instrument that Results in a “Deemed Exchange” (Cont.)

- If the issue price of the new debt is less than the SRPM:
 - The issuer will have an immediate COD income inclusion that will generally be offset by OID deductions but only over the term of the new debt
 - An initial holder will generally have a capital loss and will have OID inclusions over the term of the new debt that are ordinary

Modification Resulting in Deemed Exchanges

- A deemed exchange will occur upon a “modification” that is a “significant modification”
 - Any change to a right or obligation of the issuer or holder will result in a “modification,” unless, in most circumstances, it is pursuant to the terms of the debt instrument (e.g., a scheduled increase in the interest rate)
 - A modification will be “significant” if it falls within one of 5 enumerated categories below or, if not addressed in a category, is “economically significant”
 - Certain changes in yield (generally, by more than 20bps)
 - Certain changes in timing of payments (generally, more than 50% of term)
 - Certain changes in obligor or security
 - Change in nature of debt instrument (i.e., new instrument is not debt)
 - Certain changes in accounting or financial covenants (generally, of non-“customary” covenants)

Determination of Issue Price of New Debt

- The issue price of the new debt will depend upon the status of the debt instrument (old or new) as “publicly traded”
 - If the debt instrument is not publicly traded, in most circumstances the issue price of the new debt will equal its principal amount
 - The typical consequence of this is that an Issuer has neither COD income nor redemption premium, an initial holder generally recognizes no gain or loss, and the new debt does not have OID
 - If the debt instrument is publicly traded, the issue price will equal the fair market value as determined under the Regs.
 - This will result in the consequences described above

Determination of Publicly Traded Status and Fair Market Value

- Under the new tax regulations, a debt instrument will be publicly traded if, within 15 days before or after the deemed exchange there exists:
 - A sales price
 - One or more firm quotes
 - One or more indicative quotes
- Exception—A debt instrument will not be treated as publicly traded if the principal amount for the issue (generally the class) is \$100MM or less at the time of determination

Determination of Publicly Traded Status and Fair Market Value (Cont.)

- Sales Price
 - A price for an executed purchase within the 31-day period is “reasonably available” within a “reasonable period of time”
 - “Reasonably available,” if it appears in a medium available to:
 - Issuers of debt,
 - Persons that regularly purchase or sell debt, or
 - Brokers
 - A “reasonable period of time” is not defined but it is clear that it extends beyond 15 days after the deemed exchange
 - Presumably, it does not extend beyond the 90-day period in which the issuer is required to make information available to holders, as described below

Determination of Publicly Traded Status and Fair Market Value (Cont.)

- Firm Quotes
 - A price quote is available from a broker, dealer, or pricing service (including a subscription service or service of limited circulation)
 - The price quote must be substantially the same as the price for which recipients could purchase or sell the property
 - The party requesting the quote is irrelevant
 - The identity of the quote provider must be reasonably ascertainable
 - The quote must be:
 - Designated as a firm quote by the provider, or
 - The price at which market participants typically buy or sell (even if the provider is not legally obligated to buy or sell at the price)

Determination of Publicly Traded Status and Fair Market Value (Cont.)

- Indicative quotes
 - Any price quote available from at least one broker, dealer, or pricing agent that is not a “firm quote”
 - Obviously, extremely broad

Determination of Publicly Traded Status and Fair Market Value (Cont.)

- Fair Market Value Determination
 - The fair market value is presumed to be the sales price or quoted price
 - If two or more sales prices, quoted prices, or sales and quoted prices exist, a reasonable method consistently applied is acceptable
 - For indicative quotes, the presumption of fair market value may be rebutted if it is established that:
 - The indicative quote materially misrepresents the fair market value, and
 - The method chosen more accurately reflects the value
 - (No volume discount may be applied)

Determination of Publicly Traded Status and Fair Market Value (Cont.)

- Anti-abuse rules
 - Any temporary restriction on trading a purpose of which is to avoid these rules will cause the debt instrument to be treated as publicly traded, regardless of whether it is imposed by the issuer
 - Note that a such a temporary restriction is not simply disregarded but automatically results in publicly traded status
 - A sales price or quotation a principal purpose of which is to cause publicly traded status will be disregarded

Determination of Publicly Traded Status and Fair Market Value (Cont.)

- Issuer responsibility to determine and report
 - The issuer is required to determine publicly traded status and fair market value
 - The issuer must use “reasonable diligence” to determine:
 - Whether and how many sales have occurred,
 - The sales price,
 - The existence of firm or indicative quotes, and
 - Any other relevant information
 - If the issuer determines that the debt is publicly traded, it must:
 - Make a determination regarding the fair market value, and
 - Make the information available to holder in a “commercially reasonable” fashion, including electronic publication, within 90 days

Determination of Publicly Traded Status and Fair Market Value (Cont.)

- Holder Responsibilities
 - The holder is required to report in the manner disclosed by the issuer, unless it explicitly discloses its contrary position on a timing filed tax return for the year
 - If the issuer does not provide the fair market value, the holder must determine the fair market value

Thank you



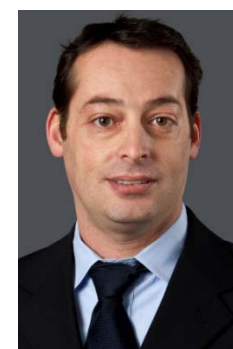
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CLOs in the Heartland

CLOs 3.0

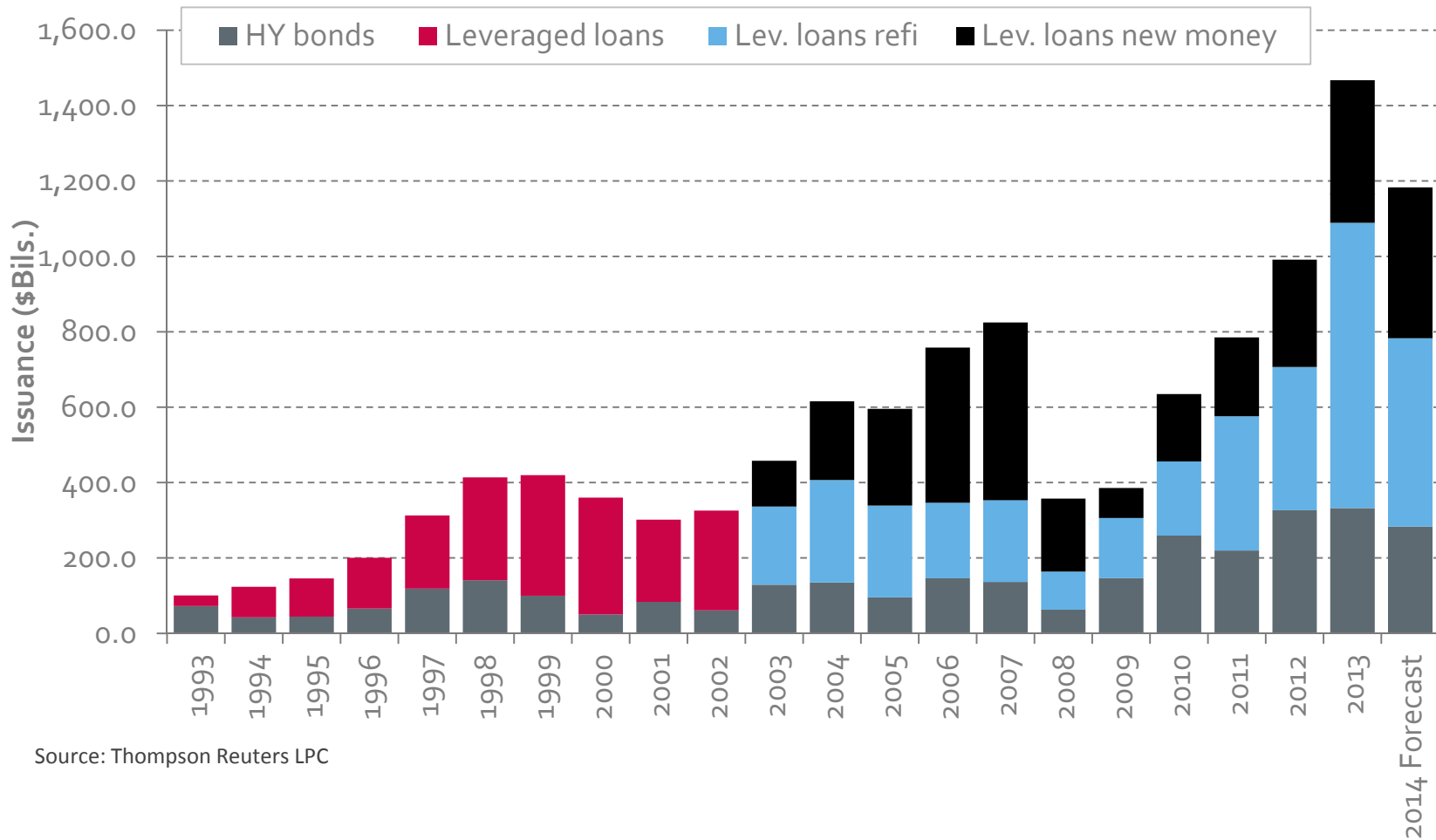
Kevin Kendra
Managing Director

March 2014

CLOs 3.0 Panelists

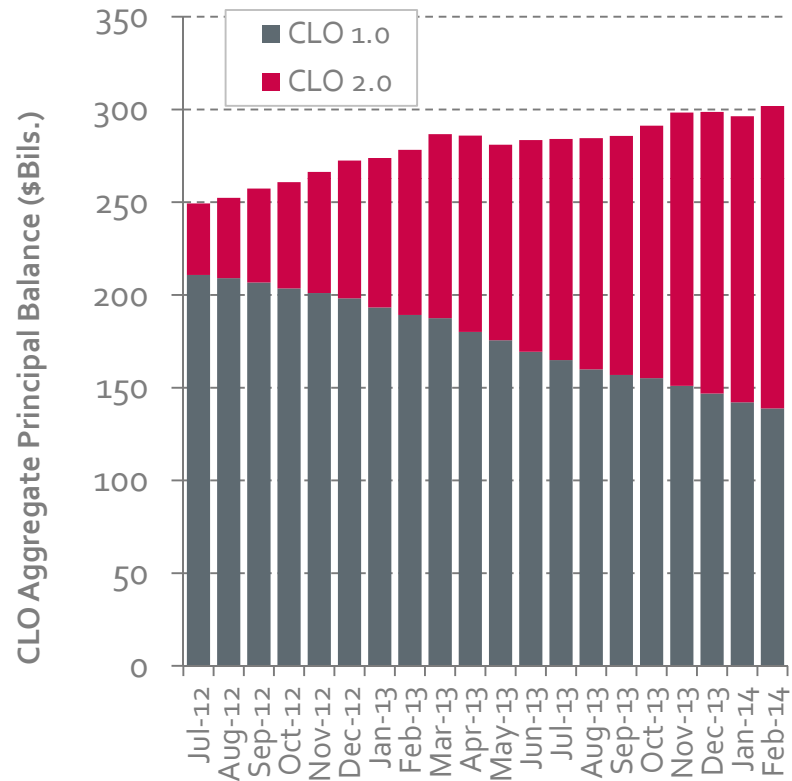
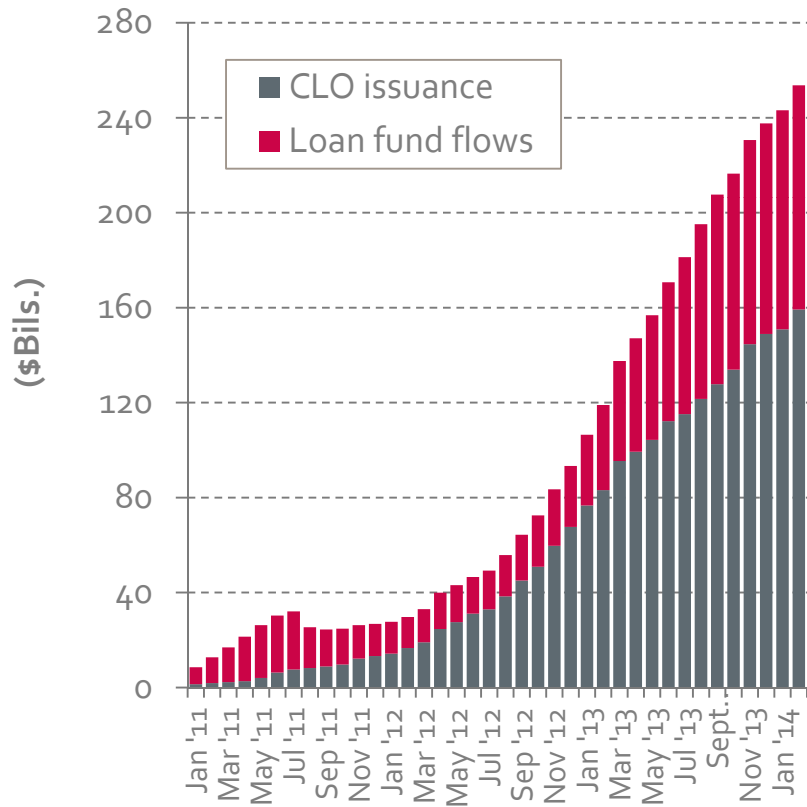
- Michael Loehrke, Co-Head, Sr. Portfolio Manager, Golub Capital
- Levoyd E. Robinson, Managing Principal, Chicago Fundamental Investment Partners
- Allan Schmitt, Vice President, Wells Fargo Securities

Leveraged Loan Issuance Mostly Refinancing



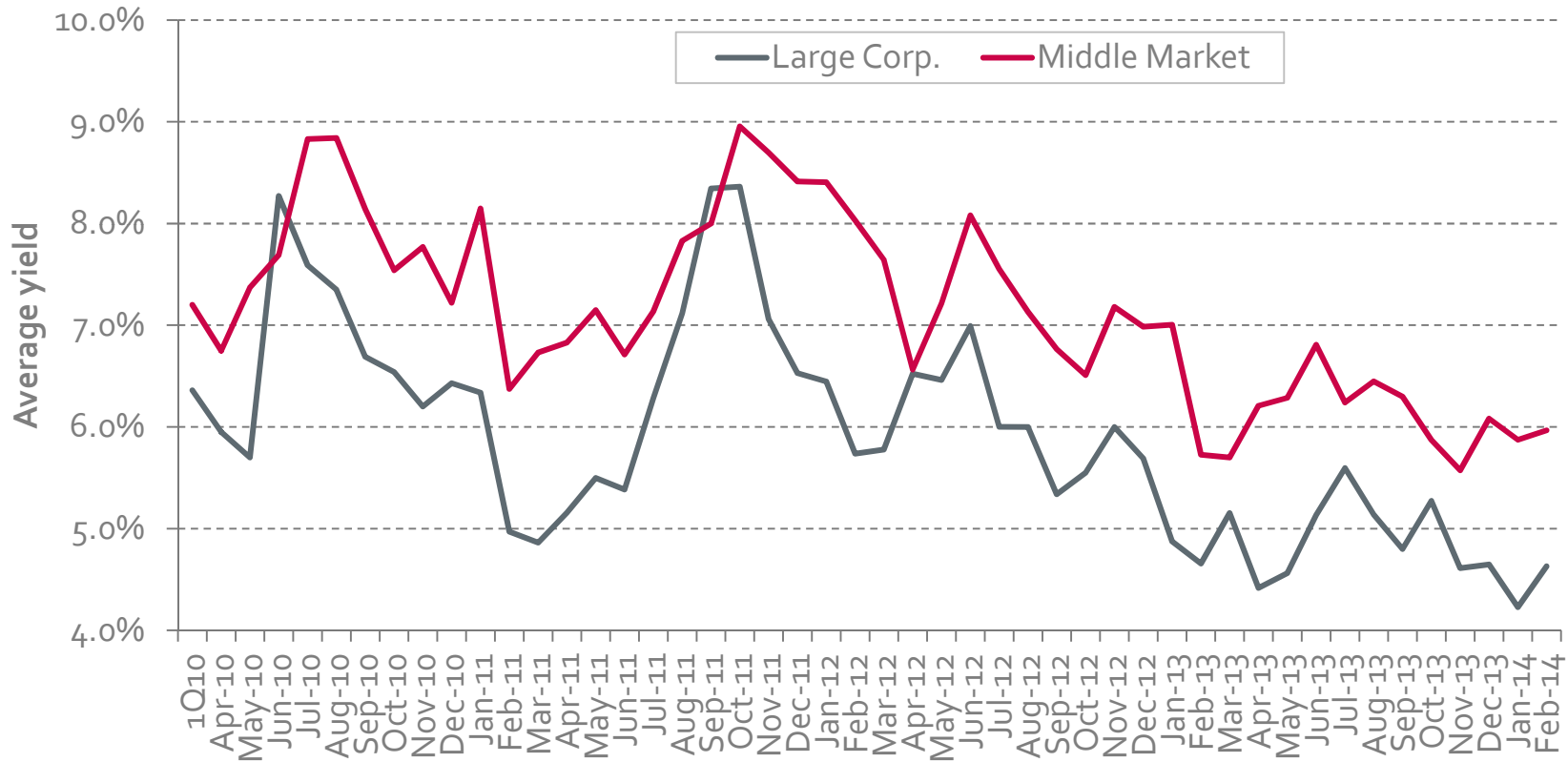
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CLOs and Retail Funds Driving Demand



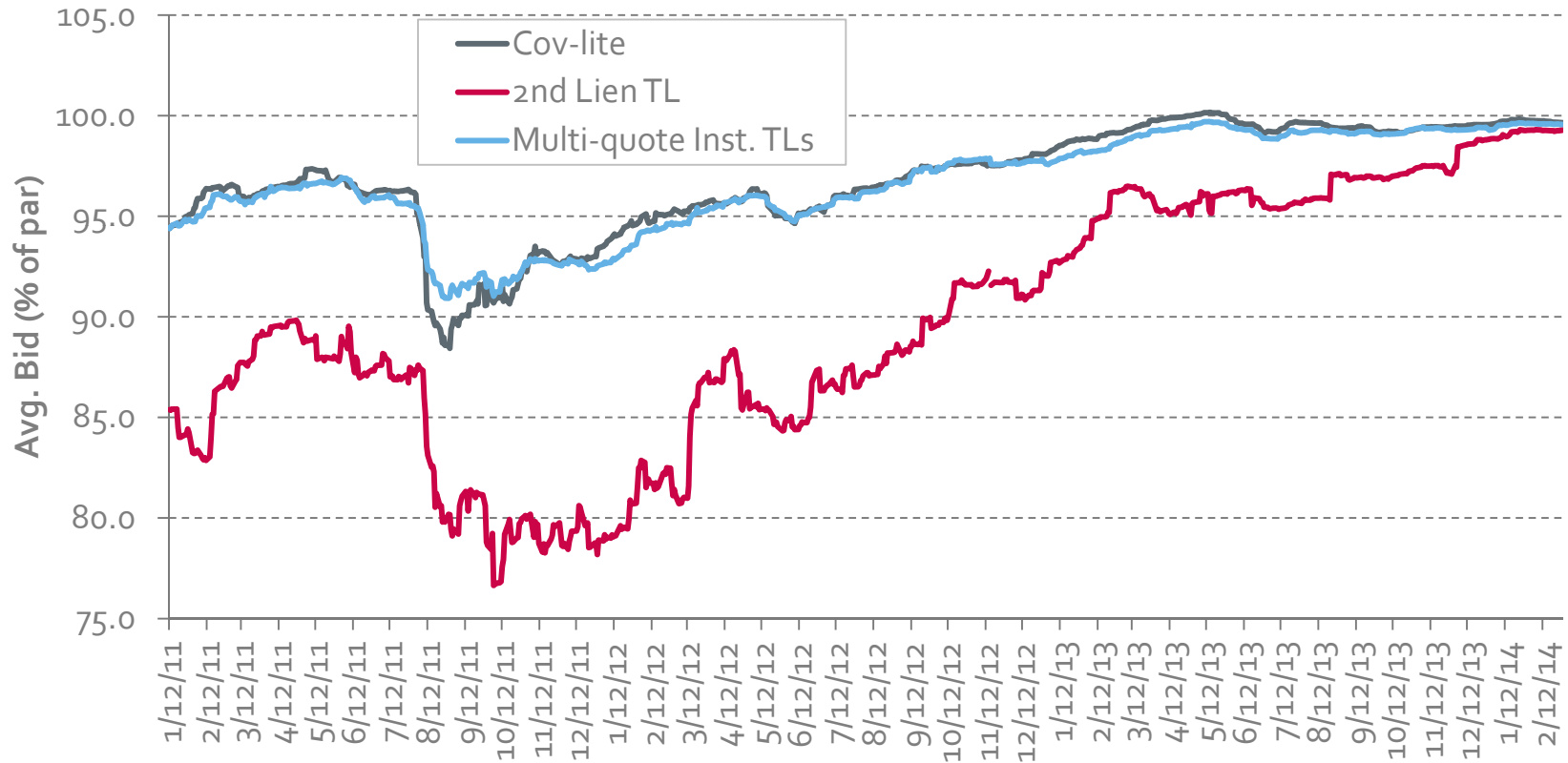
Source: Thompson Reuters LPC

Strong Demand Impacts Primary Market Yields



Source: Thompson Reuters LPC

Limited Differentiation in Secondary Market Bids



Source: Thompson Reuters LPC

CLOs in the Heartland

Closing Remarks

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