ADVISORY | Finance and Tax

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FATCA AND CLOS - A PRIMER

The Foreign Account Tax Compliance Act (FATCA) was enacted in 2010 as part of a broader effort to prevent U.S. persons investing in offshore entities from evading U.S. income tax. It requires non-U.S. entities to provide the IRS with information on their U.S. accountholders and investors and imposes 30% withholding on payments of U.S. source investment income to foreign entities that fail to comply. Implementing regulations were proposed in February 2012 and are expected to be finalized later this year.

This note first describes certain key features of FATCA, based on the proposed regulations in their current form, and then reviews the expected impact on collateralized loan obligations (CLOs). That impact would differ for pre- and post-FATCA deals:

- New vintage CLOs have been documented with a view to future FATCA compliance. The compliance burden is expected to be manageable.
- The impact could be more severe for older CLOs, with transaction documents not designed with a view to FATCA compliance. In order to avoid the 30% withholding penalty, non-complying CLOs would be able to hold only "grandfathered" loans originated before January 1, 2013, and would effectively be required to dispose of loans that are materially modified after that date. As a result, older vintage CLOs may be forced to pay down more quickly than would otherwise have been the case.

The Loan Syndications and Trading Association (LSTA) is pushing for a broader exemption for pre-FATCA CLOs and for a more limited interpretation of what constitutes a "material modification" leading to a loss of grandfathered status for pre-2013 loans, in order to eliminate or mitigate the effect on pre-FATCA CLOs. A full evaluation of FATCA's impact on CLOs will need to await the final regulations.

FATCA – BASIC FEATURES

FATCA requires "foreign financial institutions" (FFIs), broadly defined to include securitization vehicles such as CLOs, to become "participating FFIs" (PFFIs) by entering into an agreement with the IRS (an "FFI Agreement"). Under the FFI Agreement, the CLO would be required to collect and report to the IRS information on the CLO's direct or indirect U.S. investors or accountholders. The CLO also would be required under their agreement with the IRS to withhold on certain payments to investors and accountholders who fail to provide information that the PFFI needs to comply with FATCA, as well as on certain payments to FFIs that are not FATCA-compliant. Non-complying FFIs would suffer 30% withholding on U.S.-source investment income, including (starting in 2015) gross proceeds from the sale of securities that produce dividends or interest. Withholding will not apply to "grandfathered" obligations outstanding as of January 1, 2013, unless they are subsequently "materially modified."

CLOs are FFIs. The FATCA requirements apply with respect to "foreign financial institutions" (FFIs). The FFI concept is broadly defined to include a range of foreign investment entities, such as private equity funds, hedge funds and securitization vehicles. CLO issuers, typically organized in the Cayman Islands, would be FFIs.

Compliance. In order to comply with FATCA, an FFI generally will need to become a "participating FFI" (PFFI) by entering into an FFI Agreement with the IRS. FFI Agreements will require the PFFI:

- to obtain information from each of its investors to determine whether the investor is a U.S. person or (for certain entity investors) is owned by a U.S. person;
- to report information on its direct and indirect U.S. investors to the IRS;
- to withhold 30% of any "withholdable payment" made to any investor that does not provide the requisite information or to any FFI that is not a PFFI;
- to terminate the investor relationship if foreign law prevents the reporting of the requisite investor information; and
- to adopt compliance policies and undertake verification, due diligence and review procedures.

Penalty for Failure to Comply. If an FFI does not comply, a broad range of U.S.-sourced payments to the FFI will become subject to 30% withholding. Withholding will apply to:

- U.S. sourced "fixed or determinable annual or periodical" (FDAP) income, including U.S. source interest, dividends and other types of passive income (starting in 2014);
- gross proceeds from the sale and other disposition of assets that produce U.S. investment income, including principal repayments from U.S. borrowers (starting in 2015); and
- other (so-called "passthru") payments from PFFIs that are attributable to other withholdable payments (starting in 2017).

Grandfathering. The proposed regulations provide that the withholding requirement will not apply to obligations outstanding pursuant to a legally binding agreement prior to January 1, 2013. However, any material modification of an obligation after January 1, 2013, would be deemed a new issuance and lead to a loss of grandfathered status. The proposed regulations define "materially modified" broadly (*i.e.*, spread change of 25 bps, 5% change in annual yield, or a material deferral or extension of payments) with the result that many loan agreement amendments would be captured.

FATCA COMPLIANCE – NEW CLOS

FATCA is not expected to create significant problems for CLOs launched after FATCA was enacted. The transaction documents for newer vintage deals equip the CLOs for FATCA compliance. Moreover, because the proposed regulations contemplate that the FATCA information reporting and withholding duties held through clearing systems would be carried out by the clearing systems, the actual compliance burden for CLOs and their managers would be limited to non-cleared securities.

FATCA Compliance in Transaction Documents. Relevant provisions in newer transaction documents are described below.

- ***Noteholder Information.*** Transaction documents provide that the holders of CLO securities agree to provide information and documentation necessary for FATCA compliance and to allow the issuer and/or trustee to provide that information to the IRS and to take other actions, including withholding, that may be required for FATCA compliance.

- ***Forced Sale***. If a noteholder fails to provide the required information, in addition to withholding the CLO can force the non-complying noteholder to sell its security or sell the security on its behalf.
- ***Indenture Amendments***. Indenture amendments necessary or advisable to achieve FATCA compliance are permitted without the consent of noteholders.
- ***Tax Redemption***. Withholding under FATCA, subject to certain limitations on overall compliance costs and withholding amounts, may be excepted from the circumstances allowing for tax event redemption.

Compliance Burden Limited to Non-Cleared Securities. The proposed regulations generally allow FFIs to treat their debt and equity securities that are held through clearing systems (DTC, Euroclear or Clearstream) as being held by the clearing systems for FATCA purposes. As a result, because most CLO securities are held through clearing systems, CLOs should not face substantial FATCA information or withholding duties for the large majority of their securities. Those duties would be limited to non-cleared securities.

IMPACT OF FATCA ON EXISTING CLOS

FATCA's impact on existing CLOs -- launched before FATCA was enacted and thus before its requirements could be taken into account in their transaction documentation -- is considerably more problematic.

Compliance Difficulties. Existing CLOs would face difficulties in complying with FATCA requirements.

- ***Obtaining and Reporting Information***. The ability of existing CLOs to comply with FATCA by entering into PFFI Agreements and obtaining the requisite information on U.S. investors is questionable. Older indentures do not provide for the forced sale threat for non-complying noteholders. However, because the relevant reporting obligation would be limited to holders of non-cleared securities, and because the issuer may be able to identify those holders and persuade them to provide needed information in some situations, the determination as to whether compliance is possible should be made on a case-by-case basis.
- ***Indenture Amendments***. The likelihood that the transaction documents for existing CLOs may be amended to allow for compliance by introducing provisions similar to those found in newer CLOs is similarly uncertain. More recent indentures may allow for amendments necessary to avoid withholding taxes without noteholder consent, but older indentures generally do not.
- ***Withholding on Non-Grandfathered Obligations***. As noted above, the penalty for non-compliance would be the imposition of 30% withholding on interest and (ultimately) principal payments and sale proceeds from non-grandfathered collateral obligations.

Effect on Existing CLOs. Anticipated effects on existing CLOs include the following:

- ***Existing CLOs Limited to Grandfathered Loans***. To the extent they are unable to comply, existing CLOs would be limited to holding grandfathered (pre-2013) loans in order to avoid withholding. Moreover, existing CLOs would have to sell older loans if they are "materially modified" and thereby lose their grandfathered status. The sale would have to occur prior to the amendment in order to avoid withholding (starting in 2015) on the sale proceeds.
- ***CLOs Outside Their Reinvestment Periods Would Pay Down Faster***. The proposed regulations define "material modification" broadly, such that most loan agreement "amend and extends" likely would be captured. Because relevant amendments are common -- LSTA materials cite

some 125 amendments to the 674 loans in the S&P/LSTA Index over a 12-month period -- the effect could be significant. Existing CLOs would be forced to sell out of loans that are undergoing amendments, with the result that CLOs outside their reinvestment periods may amortize significantly faster than would otherwise have been the case. Faster paydown may be welcomed by some noteholders, in particular by those that bought at a discount and would benefit from greater than projected returns.

- ***Reinvestment Capability Limited to Grandfathered Loans; Pricing Dislocations***. Existing CLOs still in their reinvestment periods would be also limited to holding and reinvesting in grandfathered loans. The pool of qualifying pre-2013 loans will shrink over time. Competition from other, similarly affected CLOs looking for reinvestment opportunities may cause prices for pre-2013 loans to rise. Conversely, prices for loans undergoing amendments (and thus losing grandfathered status) could fall as existing CLOs are required to sell.

OUTLOOK

The FATCA story for CLOs is not yet fully written. The Treasury Department and IRS are continuing their consultations with interested parties, and final regulations are expected in late 2012.

In its most recent comment letter, the LSTA has argued for two further changes to the FATCA regulations:

- ***Exemption for Existing CLOs***. The LSTA has argued for an exemption for existing securitization vehicles for which substantially all payments on debt and equity securities are made through clearing systems, a trustee or a paying agent that performs the FATCA function. Since payments on substantially all non-cleared securities are made through trustees and/or paying agents, this change could exempt most existing CLOs. And since the proposed regulations already contemplate that the reporting functions will be carried out by the clearing systems for cleared securities, this represents only a minor extension.
- ***Material Modification***. The LSTA has argued that the definition of "material modification" should be limited, and in particular that modifications that do not extend the maturity of a loan should not lead to a loss of grandfathered status.

The first change would, if accepted, solve the potential problems for existing loans. The second change would not provide complete relief, but would significantly mitigate the expected challenges for existing CLOs.

If you have any questions concerning the material discussed in this client advisory, please contact the following members of our tax and finance practice groups:

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