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CLO Reporting in Europe: the impact of COVID-19

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Executive Summary

- European regulation requires European CLOs and warehouses issued from 2019 onwards (along with certain older deals refinanced or reset after 1 January 2019) to undertake ad-hoc reporting, in the event of "inside information" arising or a "significant event" occurring.
- Most CLOs had not needed to report such "ad-hoc" reporting until the market disruption caused by COVID-19 in Q2 2020.
- The scope of the reporting obligation is unclear and there is not yet any market consistency; however, some helpful themes have emerged over these past 12 months.
- The ELFA wants to highlight the potential parameters of this obligation, and suggest a non-exhaustive list of items that CLO issuers and managers should consider when navigating this topic, based on the past year of collective experience.

Regulatory background

The European Securitisation Regulation (Regulation 2017/2402) (the "**Sec Reg**") applies to all European CLOs (and European CLO warehouses) issued from 1 January 2019 (including those issued prior to such date which have subsequently been refinanced or reset from 1 January 2019). In practice, the Sec Reg also impacts non-European CLOs if they want to be eligible for European investors. One of the more significant elements of the Sec Reg relates to issuer disclosures and reporting (pursuant to Article 7). This falls into three broad categories: (i) pre-pricing (e.g. documentation or a summary thereof); (ii) ongoing recurring reporting (e.g. quarterly reports), and (iii) ad-hoc reporting (the topic of this ELFA Insights).[1] The current status is as follows:

1. **Pre-pricing** disclosures are simple and there are established market practices.
2. "**Ongoing recurring**" reporting for CLOs initially continued in the vein of pre-2019 reporting. However, this changed on 23 September when the ESMA reporting templates (the "RTS") came into force.
3. The "**ad-hoc**" reporting has applied for the past 24 months (to European CLOs issued, refinanced or reset from, and warehouses opened after, 1 January 2019).

The scope of that "ad-hoc" reporting as it pertains to CLOs is this subject of this piece. Most European CLO issuers/managers had not needed to grapple with this requirement in any great detail - until the disruption caused by the COVID-19 crisis. It is clear that whilst market participants are generally aware of the reporting obligation, how it applies in practice is subject to debate and individual interpretation. The purpose of this Insight is therefore to help CLO managers consider events which could trigger this reporting obligation, in light of the volatility which began almost a year ago, and subsequent practices once markets stabilised.

This Insights piece is not legal advice, and it will be for each CLO manager[2] to determine whether the ad-hoc reporting obligation is triggered in individual cases.[3] However, in the context of a relatively new regulation and the current lack of any market consistency, ELFA believes it is helpful to generate wider awareness of this topic – one that is technical in nature, but will have practical and commercial consequences for European CLO managers.

Ad-hoc reporting: scope on paper

The Sec Reg requires European CLOs to make public any "inside information" (if the CLO issuer or originator is caught by the European or UK Market Abuse Regulation ("**MAR**")) and any "significant event" (regardless of whether or not MAR applies). In practice, these two categories are likely to cover the same events, but they are defined differently:

- **Inside information:** this is defined in MAR, and can be summarised as non-public precise information that would be likely to have a significant effect on the price of the CLO notes (i.e. information that a reasonable investor would be likely to use as part of its investment decision).
- **Significant event:** this is undefined, but the Sec Reg provides a non-exhaustive, high-level list (Article 7(1)(g) of the Sec Reg), summarised as follows:
  - a material breach of the obligations in the key CLO documentation (including any remedy, waiver or consent provided in respect of such breach);
  - a change in the structural features that can materially impact the performance of the securitisation;
  - **a change in the risk characteristics of the securitisation or of the underlying exposures that can materially impact the performance of the securitisation**; and
  - any material amendment to transaction documents.

[1] NB: this article does not address differences arising post-Brexit. However, the substance of the ad-hoc reporting obligations still apply to both EU and UK issuers (although this may diverge over time).
[2] The originator, sponsor and issuer of a CLO must decide between them who is responsible for this reporting from a regulatory perspective. It is important to note that EU/UK CLO managers as well as EU/UK domiciled SPVs have a regulatory obligation to comply, regardless of which entity has been designated to do the reporting. However, in practice, the contractual framework of CLO structures will likely require the "non-responsible" party to assist the other. As such, this topic is something that non-European managers of European CLOs should also engage with. It should be noted that whilst the Sec Reg no longer applies directly to UK CLO Managers, UK regulations which substantially reflect the Sec Reg will apply to UK CLO Managers.
[3] Note that we did not seek feedback from trustees / collateral administrators for the purpose of writing this Insights report, and such parties may take differing approaches to certain significant events.

The emboldened limb above is that with which most CLO managers will likely be grappling,[4] given the market volatility and disruption caused by COVID-19. This is particularly pertinent given that general disclosures about the state of the leveraged loan markets are unlikely to satisfy the regulatory requirements.

One thing is clear - relying on information contained in monthly and quarterly reports will usually be insufficient; the ad-hoc reporting obligations require inside information and significant events to be disclosed "without delay". There is often a significant time delay between an event happening and the publication of the monthly reports. Similarly, disclosure of an event by a third party (e.g. a rating agency) does not absolve the CLO issuer/manager of its ad-hoc reporting obligations in relation to that same event.

A note for UK CLO Managers

The Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA) require that a UK based CLO Manager notify them of any inside information and significant event information reporting. There is a form[5] which needs to be completed and sent to a designated email address. The form summarises the event and where the report can be accessed.

Ad-hoc reporting: scope in practice

It is for each CLO manager to decide whether they think a particular event constitutes inside information or a significant event which needs disclosure, in the context of the definitions and guidance above, and in relation to the likely expectations of the CLO investor base. Failure to report could have severe consequences (including fines of the greater of EUR 5m and up to 10% of turnover). Conversely, over-reporting could be operationally burdensome and create unnecessary "noise" without adding any value to actual or potential investors. This is doubly true when you consider that events may also have to be reported if they "change back" (i.e. the reporting obligation covers both negative and positive occurrences within the life of a CLO).

What follows is a non-exhaustive list of events which CLO managers may wish to take into account, when considering whether inside information has arisen and/or a significant event has occurred. It is based on evolving thinking by law firms active in the CLO space, as well as several European managers who are navigating this topic. Importantly, when making their assessment, materiality and impact on the performance of the CLO will be key for each CLO manager – nobody, including an actual or potential CLO investor, is likely to benefit from disclosures that are hair-trigger in nature.

Topic / event	Likely to require disclosure[6]	May require disclosure, but subject to a materiality or other assessment
Rating events	Rating downgrades (and upgrades) of a note tranche where it causes a restricted trading period	Negative rating watch (and removals) on a note tranche
Over-collateralisation test	Breach of a material nature on a determination date	Breach other than on a determination date
Interest diversion test	Breach of a material nature on a determination date	Breach other than on a determination date
Interest coverage test	Breach of a material nature	N/A
Trading ability	Entering into a restricted trading period	Breach of portfolio profile test or collateral quality test, to the extent it impedes the CLO manager's ability to properly manage the portfolio[8]
Noteholder resolutions	Resolutions once passed by noteholders, or amendments consented to by all (or a material percentage of) noteholders	N/A
Noteholder liabilities	Notice of refinancing Notice of reset (i.e. ordinary course notifications)	N/A
Documentation	Material amendments to underlying transaction documentation (where "material" means requiring the consent of a material amount of noteholders)	N/A
Warehouse tests	N/A	Material events of default (NB: this does not include draw-stop events) Breach of borrowing base and margining events (and exercise of cures)

[4]The vast majority of CLO deals will require notification to investors already for the other limbs.
[5]https://www.fca.org.uk/publication/forms/pra-fca-private-securitisation-notification-template.xlsx
[6]Determinations of what is "material" will be for each CLO manager to determine in its sole and reasonable discretion, given its knowledge of both the CLO it is managing and the market and sectoral conditions within which it (and the underlying borrowers of the CLO's loan assets) are operating.
[7]Note that any such determination would be made on a case-by-case basis by each CLO manager and as such the approach may differ

Additional considerations

ELFA has set out below some additional items which managers may wish to incorporate into their internal processes:

1. **Scope:** work with internal and external legal counsel to establish a framework regarding which events the manager considers to be within the scope of the ad-hoc reporting requirements.
2. **Materiality:** consider setting materiality thresholds for in-scope events where possible (e.g. X% exceeding of the CCC bucket).
3. **Collaborate:** ensure that any calculations which need to be reported (e.g. OC test breaches) are reconciled with the trustee (given that the reporting is an issuer/originator disclosure, accuracy is key).
4. **Template:** have a standard form notification template ready to go (if the CLO is privately placed, no ESMA template is required, and the issuer is free to use its own format). Try to keep the content concise, precise and objective.
5. **Publish:** when the disclosure is ready, ensure it is made to the correct audience. In most instances, asking the trustee to publish the disclosure on the CLO website should suffice (but in certain jurisdictions, issuers may also need to disclose to the national regulator).

Conclusion

These relatively new ad-hoc reporting requirements require careful navigation. This is particularly challenging for CLO managers, given the investor base is relatively sophisticated and may not view certain events in the same way as e.g. retail investors might, and may be satisfied with the monthly and quarterly reporting. That said, the potential consequences for non-compliance could be costly, so managers will want to take a consistent and logical approach to a subjective topic.

It will be interesting to see what trends emerge in the CLO reporting space, particularly if we see another bout of sudden market disruption in 2021.

About the ELFA:

The ELFA is a professional trade association comprised of European leveraged finance investors from over 45 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA's website: www.elfainvestors.com.

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