Milbank
Insights

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Reporting Revisited: EU Commission Clarifications on Article 7 & Third Country Securitisations

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Overview

On Monday 10 October 2022, the European Commission (the "**Commission**") delivered its report[1] (the "**Commission Report**") to the European Parliament and the Council on the functioning of the EU Securitisation Regulation[2]. In this Client Alert we examine the Commission Report as it relates to the jurisdictional scope of the EU Securitisation Regulation, and the Commission Report's ramifications for existing and future securitisations and the near-term growth of the CLO market.

We focus on the scope of the obligation to make specific information[3] ("**EU Transparency Reports**") available to institutional investors[4] pursuant to Article 7 of the EU Securitisation Regulation ("**Article 7**") as this applies to securitisations where none of the originator, sponsor or SSPE is established in the European Union ("**Third Country Securitisations**").

Since the entry into force of the EU Securitisation Regulation in its final form in 2019, the securitisation market in general, and the loan securitisation market in particular, has taken the view that EU Transparency Reports do not need to be made available to investors in Third Country Securitisations in the specific (and administratively burdensome) format mandated by Article 7.

As we discuss more fully through this Client Alert, in our view it is possible not only that the market approach to the provision of EU Transparency Reports by US-based CLO managers in particular will start to shift, but that we are already seeing the beginning of a trend in that direction.

The Commission Report: Genesis and Summary

Article 46 of the EU Securitisation Regulation mandated the Commission to produce the Commission Report and was preceded by advice[5] (the "**ESAs' Opinion**") and a final report[6] (the "**ESAs' Report**") from the Joint Committee (the "**Joint Committee**") of the European Supervisory Authorities[7] (the "**ESAs**") which amongst other things[8]:

- identified, in the case of the ESAs' Report, significant legal uncertainty in the jurisdictional scope of application of the EU Securitisation Regulation, with the ESAs' Opinion recognising that Third Country Securitisations were unlikely to use ESMA's templates[9] for Article 7 reporting; and
- invited the European Commission to amend the EU Securitisation Regulation or provide interpretative guidance[10] on its correct jurisdictional application.

The Joint Committee particularly noted, in the ESAs' Report, the confusion arising from the use of the words "where applicable" in Article 5(1)(e)[11] of the EU Securitisation Regulation and postulated that these could be read as intending to limit the Article 7 reporting obligation, such that "verification of compliance with the disclosure requirements is not applicable when the originator, sponsor or SSPE to parties is not located in the EU"[12].

This interpretation, which was recognised in the Commission Report[13], also found favour with the High Level Forum on the Capital Markets Union, which in the seventh of the key recommendations in its Final

Report dated June 2020 (the "**HLF Final Report**")[14] for the development of a robust securitisation market invited[15] the Commission to clarify that Article 5(1)(e) did not apply to Third Country Securitisations. Instead, the High Level Forum recommended that such investments should instead be subject to proportionate due diligence as required under Article 5(3) of the EU Securitisation Regulation.

For all these exhortations and suggestions from academics, industry, national regulators and the ESAs, the Commission has instead largely chosen its own approach to the question of jurisdictional application. In the Commission Report, the Commission:

- invites[16] ESMA to review the Article 7 reporting templates, with the aim of better aligning these with investors' needs;
- invites[17] ESMA to bifurcate Article 7 reporting templates to differentiate public securitisations from private securitisations, with the latter being simplified and tailored to the needs of national supervisors;
- concludes that the definition of "private securitisation" is working well and does not need changing[18];
- declares that "institutional investors must verify that the sell-side parties of the transaction, irrespective of their location, comply with the respective obligations under [Articles 6, 7 and 9 of the] regulation" … "EU institutional investors may not invest in securitisations if the sell-side entities are found to be not in compliance with these obligations"[19]; and
- recognises that "the current text of Article 5(1)(e) … de facto excludes EU institutional investors from investing in certain [Third Country Securitisations] … because the third-country sell-side parties might not be interested in providing [EU Transparency Reports]".

Disappointingly, despite the prior volumes of academic analysis, the Commission Report provides no commentary on the inclusion of the words "where applicable" in Article 5(1)(e), choosing to ignore that aspect of the debate entirely. Article 46[20] of the EU Securitisation Regulation also contemplated that the Commission might "if appropriate" accompany its Commission Report with a legislative proposal. However, the Commission has declined to do this, commenting instead that it "is of the opinion that the [EU] Securitisation Regulation seems overall to be fit for purpose and does not see the need for major legislative change at this juncture"[21].

What does this mean for EU investors in Third Country Securitisations

Regardless of any academic dissection of the Commission Report and its legal propriety[22], the Commission's pronouncements are certain to have a compelling effect on the investment activities of regulated European investors and the regulatory activities of national competent authorities.[23] We examine its practical impact on market participants below.

New transactions

Absent an ECJ judgment to the contrary, EU investors will likely take the prudent approach of ceasing to invest in Third Country Securitisations that do not provide EU Transparency Reports. The short term effect is likely to be a reduced investment universe for EU investors and a corresponding reduction in the diversity of their portfolios until relevant Third Country Securitisation markets get up to speed on the requirements and necessary practical steps to compliance.

For new transactions, including those that are still being marketed, the position is therefore straightforward, and we expect that the vast majority of Third Country Securitisations that target European investors will provide for day-1 EU Transparency Reports using the current ESMA templates. It should be noted in this regard that sponsors of US CLOs that constitute Third Party Securitisations will be outside the boundaries of the administrative sanctions and remedial measures set out in Article 32 of the EU Securitisation Regulation regarding the content and delivery of the reports and, where they so elect, would simply be complying with the requirements in order for European investors to meet their due diligence requirement.

As an alternative, sponsors or originators of such Third Country Securitisations, such as the vast majority of US CLOs, whose platforms have historically complied with the 5% risk retention obligation imposed under Article 5(1)(d) and Article 6(1) of the EU Securitisation Regulation but not the Article 7 reporting requirements, may elect to tailor their standard retention compliance covenant package to include a "springing" covenant that the relevant retention holder will agree to comply with the Article 7 requirements where required as a result of a future amendment of the EU Securitisation Regulation (as is contemplated by the Commission Report).

Secondary market trading

For EU investors in the secondary market, Third Country Securitisations with no Article 7 reporting are no longer likely to be considered an appropriate investment, given that the decision to commit would be made post-Commission Report (irrespective of the vintage of the deal itself).

Deals post-pricing but pre-closing

For transactions that had priced but not yet closed when the Commission Report was published, the analysis is more nuanced. EU investors may legitimately take the view that, at the time of their committing to invest, the uncertainty regarding the applicability of Article 7 reporting for Third Country Securitisations prevailed such that they satisfied their due diligence requirement when making such commitment to hold the relevant securitisation position. In practice, however, some such transactions, particularly those with an anchor EU investor, may look to make some accommodations towards Article 7 compliance.

Existing investments

The Commission Report is silent on the treatment of existing investments in Third Country Securitisations that do not provide EU Transparency Reports. Certainly, the Commission rightly fell short of advocating the immediate sale of such positions and any suggestion to do so would clearly conflict with both the Commission's broader aim of "reviving the securitisation market… on a safe and sustainable basis" and with the relevant legislation which, in Milbank's view, provides effective "grandfathering" as follows:

- *CRR*[24] *Credit Institutions and Investment Firms / Insurance and Reinsurance Companies*[25]

Under their respective prudential regimes[26], credit institutions, investment firms, insurers and reinsurers risk increased capital charges in the event of any failure to comply with the EU Securitisation Regulation "in any material respect by reason of negligence or omission".

Given the Commission Report's explicit acknowledgement of the abundant uncertainty regarding the interpretation of Article 5(1)(e) in the case of Third Country Securitisations, EU investors can clearly demonstrate that they satisfied their due diligence requirement and were not negligent in committing to purchase without the provision of EU Transparency Reports. As such, an increased or punitive capital charge is not appropriate for existing investments in Third Country Securitisations.

- *Alternative Investment Funds and UCITS Funds*

The EU Securitisation Regulation[27] itself provides that, where AIF and UCITS managers are exposed to a securitisation that "no longer meets the requirements" of the EU Securitisation Regulation, "corrective action" shall be taken "if appropriate".

It has been made clear that "corrective action…should always be in the interest of the investors and should not involve any direct obligation to sell the assets immediately… therefore avoiding a "fire sale"[28]. AIF and UCITS managers can therefore continue to use credit quality as their primary factor in considering their existing Third Country Securitisation investments, irrespective of any lack of EU Transparency Reports.

It would also seem appropriate for existing investors, in deciding whether the lack of EU Transparency Reports merits trading out of their investment, to give consideration to the extent to which the information contained in the contractual reports for a given securitisation replicate or exceed the information that EU Transparency Reports would have contained had they been prepared and that they require to satisfy their on-going monitoring obligations under Article 5(4) of the EU Securitisation Regulation.

Why this all matters: Friction Costs

Securitisation involves the creation of bespoke financial products that, because they are particularly attuned to the risk appetites of specific investor groups, can be priced more efficiently than the undifferentiated receivables that comprise the input portfolio.

Contrasting this price efficiency, are the additional layers of costs involved in establishing and maintaining a securitisation, in the form of taxes, and fees for arrangers, rating agencies, legal counsel and the various other service providers. Deal volumes are reliant on favourable pricing outcomes that attract investor interest at all levels of the capital stack as well as, ultimately, the protection of the relevant sponsor or originator's projected equity returns.

As issuance volatility continually attests, market health and viability is a finely balanced equation, and higher or unnecessary transactional costs are an impediment to market growth. This is particularly true in the context of arbitrage CLOs, where an accretive erosion of equity returns resulting from increased cost leakage will hinder transaction establishment and consequently investment opportunity. As an arbitrary cost imposed by governments, regulatory costs should arguably only be imposed where there is a proportionate risk mitigation benefit.

Seen in this light, it is easy to attribute a pragmatic sense to the aims of the UK HMT in Article 5(1)(f) of their on-shored version of the UK Securitisation Regulation[29] which for non-UK securitisations, consistent and commensurate with the aim of having a proportionate tool for investor due diligence[30] and restarting high-quality securitisation activity[31], allows reporting on the basis of substantive equivalence with the UK's reporting regime, but retains the onus on institutional investors to ensure they can diligence and monitor[32] securitisations so as to assess the risks involved in an investment and its underlying exposures.

Conclusion: An Opportunity Lost but a Path Forward

In the Interim Period, as we await a revised Disclosure RTS and the adoption of ESMA's new reporting templates (which we anticipate will take 12 to 18 months), it seems likely that European investors will at least continue to be at the same if not a greater competitive disadvantage, with their sphere of investment and diversification opportunities[33] in the securitisation markets reduced where originators or sponsors of Third Country Securitisations choose to restrict issuance to their domestic and other non-EU markets due to the perceived increased administrative burden of reporting when combined with the EU Securitisation Regulation's 'skin in the game' requirement[34].

For all that it notes that "the issue might deserve thorough consideration in the context of a future amendment of the EU Securitisation Regulation"[35], the Commission has arguably forgone an opportunity to further its aim for the development of a robust and thriving securitisation market, particularly where there is a tacit acknowledgement as to the different reporting requirements applicable to private securitisations, which Third Country Securitisations, such as the vast majority of US CLOs, are often structured as.

So, as we look to the future, there is an opportunity for the Commission's interpretive guidance, if sympathetically reflected in ESMA's revised reporting templates, to further such aim by leading to increased uptake of Article 7 reporting by Third Country Securitisations. Even prior to the publication of the Commission Report, we had seen a small number of US-based CLO managers voluntarily pivoting to compliance with Article 7 reporting in order to secure the EU-investor ticket.

We are also sensing increasing market sentiment within the US CLO industry that, in light of the plethora of available portfolio data (as further described in footnote 3 below), by leveraging the expertise of third party services providers experienced in the compilation of such data for European Article 7-compliant transactions (including for various US-based managers' European platforms), that the requirements can and will be complied with. Ultimately, a cost-benefit analysis will need to be undertaken by relevant managers as to whether the juice of obtaining EU institutional investor investment and increased secondary market liquidity outweighs the squeeze of administrative burden and cost associated with compliance.

[1] The English language version of the Commission Report can be found here.

[2] Regulation (EU) 2017/2402, as amended. Note that, as part of the "onshoring" of EU legislation to the UK during the Brexit process, amendments to the EU Securitisation Regulation made by the Securitisation (Amendment) (EU Exit) Regulations 2019 led to a divergence between the UK Securitisation Regulation and its EU counterpart.

[3] This information includes (a) quarterly reports on underlying exposures (Article 7(1)(a)), (b) copies of transaction documents (Article 7(1)(b)), (c) a transaction summary (Article 7(1)(c)), and (d) quarterly investor reports (Article 7(1)(e)). Anecdotally, Milbank's understanding is that investors make little to no use of the quarterly reports. Rather, for both public and private securitisations, deals are marketed, and investors rely, on issuers' contractual undertakings to provide detailed periodic portfolio reports. These reports, which, unlike the regulatory templates, are continually refined and improved to reflect changing market conditions and investor sentiment, reflect decades of rating agency and investor interactions. The need to process the mass of resulting data has also produced a pocket-industry of expert services, that collate and compare deal reports, and provide sophisticated analytical tools allowing investors to interpret and manipulate information to inform their investment decisions. In the CLO market, for instance, the appropriateness of the historical reporting framework and the discipline that they, alongside the transaction structures and underlying eligibility criteria, imposed on the transaction parties was reflected in the way that sector of the market ultimately emerged almost entirely unscathed from the global financial crisis (the "**GFC**") of 2007-2008.

[4] Article 2(12) of the EU Securitisation Regulation.

[5] ESAs' Opinion to the European Commission on the Jurisdictional Scope of Application of the Securitisation Regulation dated 25 March 2021.

[6] Joint Committee Report on the Implementation and Functioning of the Securitisation Regulation dated 17 May 2021.

[7] Being the European Banking Authority (the "**EBA**"), the European Insurance and Occupational Pensions Authority ("**EIOPA**") and the European Securities and Markets Authority ("**ESMA**"). The ESAs established the Joint Committee Securitisation Committee (the "**JCSC**") in accordance with Article 36(3) of the EU Securitisation Regulation and the JCSC authored the ESAs' Opinion and ESAs' Report.

[8] The ESAs Opinion also suggests (in paragraph 13(a)) that where an EU Securitisation Regulation breach occurs after issuance, an EU investor should sell its holding. In Milbank's view the relevant legislation is more nuanced than this, and does not require the fire-sale of non-compliant holdings. See "What does this mean for EU investors in Third Country Securitisations".

[9] These templates were enacted in Commission Delegated Regulation (EU) 2020/1224 (the "**Disclosure RTS"**).

[10] The suggestion for, and subsequent use of, interpretative guidance is a curious approach to legislation and one which, for all its timeliness, creates legal uncertainty and arguably ill-serves the securitisation community and wider financial markets. Although Article 17(1) of the Treaty on European Union broadly empowers the Commission, and charges it to oversee the application of Union law, the specific competencies of the European Union's institutions are addressed in Article 288 of the Treaty on the Functioning of the European Union (the "**TFEU**"), which provides that only regulations, directives and decisions are to have [legally] binding effect. The competency to provide rulings on the interpretation of acts (e.g. regulations) of the EU institutions is reserved to Court of Justice of the European Union in accordance with Article 267 of the TFEU. Interpretative guidelines and answers to legislative questions are customarily addressed by the EBA in its Single Rulebook.

[11] Article 5(1)(e) (Due-diligence requirements for institutional investors) of the EU Securitisation Regulation provides that "Prior to holding a securitisation position, an institutional investor, other than the originator, sponsor or original lender, shall verify that … the originator, sponsor or SSPE has, **where applicable**, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article;" [*emphasis added*].

[12] Paragraph 20(ii), footnote (9) of the ESAs' Report. This ambiguity was the subject of our 12 December 2018 Client Alert: Securitisation Regulation: Application of Disclosure to Non-EU CLOs with widespread recognition amongst national supervisors (per feedback on Question 4 of the feedback statement accompanying the Commission Report), legal commentators and market participants, including the Financial Markets Law Committee who addressed the issue in their letter to the Commission dated 5 November 2019.

[13] Section 11.2 of the Commission Report.

[14] A New Vision for Europe's Capital Markets.

[15] See pages 54 and 64 of the HLF Final Report.

[16] Section 5 of the Commission Report. ESMA has not wasted any time in responding to this request, reaching-out to industry associations such as AFME on 12 October 2022 for their input and suggestions on improving the reporting templates with a view to revising the Disclosure RTS.

[17] Section 6.2 of the Commission Report.

[18] Section 6.3 of the Commission Report. This is welcome news for the CLO industry as under Article 7(2) of the EU Securitisation Regulation, "private securitisations" are exempt from the obligation to make EU Transparency Reports available through a securitisation repository which imposes additional administrative overheads and costs on public securitisations.

[19] Section 11.1 of the Commission Report.

[20] "By 1 January 2022, the Commission shall present a report to the European Parliament and the Council on the functioning of this Regulation, accompanied, if appropriate, by a legislative proposal…".

[21] Section 3, page 7 of the Commission Report.

[22] For the reasons set out in note [9], this approach by the Commission is arguably *ultra vires* or, in the European vernacular, a "détournement de procedure". It is somewhat curious in light of the express authority (noted above) under Article 46 of the EU Securitisation Regulation given to the Commission to accompany its Commission Report with a legislative proposal to improve the functioning of the EU Securitisation Regulation. This alleged impropriety in the Commission's provision of interpretative guidance is compounded by the fact that the wording of Article 5(1)(e) went through multiple iterations as part of the legislative process. The critical words "where applicable" were not included in what was then Article 3(1)(c) of the Commission's original proposal, but were added to the EU Securitisation Regulation by the Council in the third Presidency compromise proposal (ST 14537/15) of 30 November 2015 ECON Committee Members (Petr Ježek, Michael Theurer & Sylvie Goulard) as published in the 'Amendments 109-316' draft report issued by the EU Committee on Economic and Monetary Affairs on 27 July 2016. This new wording was then adopted by all co-legislators in the provisional agreement resulting from interinstitutional negotiations of 28 June 2017. Further, Petr Ježek's contribution during the sitting of the European Parliament of 25 October 2017 (video available here – see 18:11:52) made it clear that the intention behind the EU Securitisation Regulation's final position achieved through the interinstitutional negotiations was growth and not "stifling" of the securitisation markets. As such, it is unclear whether the European Parliament and the Council would share the Commission's view as to the legislative intent of Article 5(1)(e).

[23] Prior customary practice for Article 7 by Third Country Securitisations marketed to EU investors was to provide for risk retention under Article 6 of the EU Securitisation Regulation but not to provide for EU Transparency Reporting.

[24] Regulation (EU) No 575/2013 on prudential requirements for credit institutions (the "**CRR**").

[25] Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance ("**Solvency II**").

[26] Article 270(a) of the CRR (as amended by Regulation (EU) 2017/2401) and Article 257 of Delegated Regulation (EU) 2015/35 supplementing Solvency II, as amended by Commission Delegated Regulation (EU) 2018/1221 as regards the calculation of regulatory capital requirements for securitisations and simple, transparent and standardised securitisations held by insurance and reinsurance undertakings.

[27] Articles 38 and 41 of the EU Securitisation Regulation, respectively.

[28] Recital 69 to Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

[29] The Securitisation (Amendment) (EU Exit) Regulations 2019 (the "**UK Securitisation Regulation**").

[30] See in particular paragraph 10.12 of the HM Treasury Review of the Securitisation Regulation: Report and call for evidence response from December 2021.

[31] See in particular paragraph 2.1 of the HM Treasury Review of the Securitisation Regulation: Report and call for evidence response from December 2021

[32] Articles 5(1)(3) & (4) of the EU Securitisation Regulation.

[33] In particular, European (but not U.K. or U.S.) investors will be deprived of the investment opportunities arising in the currently volatile markets, where we understand that the needs of certain investors to liquidate high-quality assets quickly has produced secondary market prices that, from a historic perspective, are becoming increasingly compelling for buyers.

[34] Article 5(1)(d) and Article 6(1) of EU Securitisation Regulation. Recall also that following the landmark LSTA judgment, US open market CLOs are exempt from their domestic risk retention requirement.

[35] Section 11.2 of the Commission Report.

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