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CLO Group Client Alert: Securitisation Regulation: Application of Disclosure Requirements to Non-EU CLOs

BACKGROUND

The EU Securitisation Regulation (the "**Securitisation Regulation**")[1] will apply to securitisations issued on or after 1 January 2019 and will introduce a number of changes to the European risk retention regime for CLO transactions[2].

With the application date of the Securitisation Regulation fast approaching, one of the key questions that arrangers, managers and institutional investors are focused on is what impact the Securitisation Regulation will have on CLOs that have a non-EU issuer and a non-EU manager (and neither of which is a subsidiary of an EU bank[3]) (a "**Non-EU CLO**"). Of particular interest and importance is the extent to which those Non-EU CLOs will need to comply with the Securitisation Regulation to be able to market to EU investors.

APPLICATION OF THE SECURITISATION REGULATION TO NON-EU CLOS

It is clear that Non-EU CLOs that market to EU investors will still be required to comply with the indirect retention requirement (i.e. in practice the originator, sponsor or original lender must retain a 5% economic interest in the CLO)[4]. What is less clear is the extent to which those Non-EU CLOs will also need to comply with the other requirements in the Securitisation Regulation.

In this Client Alert we focus on Article 7 of the Securitisation Regulation, which will increase the scope and nature of the transparency and disclosure requirements applicable to originators, sponsors and issuers of CLO transactions, and, in particular, whether or not Non-EU CLOs that are marketed to EU investors will be required to produce underlying exposure reports and investor reports using the reporting templates currently being prepared by ESMA once they are finalised.

ARE NON-EU CLOS REQUIRED TO COMPLY WITH ARTICLE 7?

Is there a direct requirement for non-EU CLOs to comply with article 7?

There is no express statement in Article 7 of the Securitisation Regulation that it only applies to originators, sponsors and issuers established in the EU, which would initially suggest that Article 7 has extra-territorial effect.

When read in isolation, Article 5(1)(e) appears to support this view as it states that institutional investors must verify that "the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7". This might suggest that all CLO transactions will be required to comply with the requirements of Article 7.

However, when these provisions are read in the wider context of the full Securitisation Regulation, a stronger case can be made that in fact there is no direct requirement for Non-EU CLOs to comply with Article 7.

Articles 5(1)(c) and (d) of the Securitisation Regulation, which set out certain due diligence requirements that institutional investors must comply with, draw a clear distinction between originators, sponsors and original lenders that are established in the EU and those that are not. Article 5(1)(c) applies to those established in the EU and requires the 5% retention to be retained "in accordance with Article 6" and the disclosure to have been made "to institutional investors in accordance with Article 7". In contrast, Article 5(1)(d) applies if the originator, sponsor or original lender is established in a non-EU country, and simply requires the amount of the 5% retention to be "determined in accordance with Article 6" and the disclosure to have been made "to institutional investors", and omits any explicit reference to Article 7.

This distinction indicates that, consistent with other European legislation, Articles 6 and 7 are not intended to have extra-territorial effect and when Article 5(1)(e) is read in conjunction with the remainder of Article 5(1), the alternative (preferable) interpretation of that provision emerges. The reference therein to "where applicable" is the key, suggesting that institutional investors are only required to verify this point for transactions to which Article 7 actually applies (i.e. transactions where the originator, sponsor or issuer is established in the EU) rather than in all cases.

This view is supported by both the EBA, who confirmed in its responses to the consultation on its Draft Regulatory Technical Standards published on 31 July 2018 that Article 6 should only apply to "originators, sponsors and original lenders established in the EU" [5], and the Commission who expressed the same view in the Explanatory Memorandum[6] to its original proposal for the Securitisation Regulation. We think there is a reasonable basis to infer that if Article 6 was not intended to apply to entities outside of the EU, neither was Article 7.

Further support for this argument can be found in Articles 29(2), (3) and (4) of the Securitisation Regulation, which designate which competent authority is responsible for supervising compliance by sponsors, originators, original lenders and issuers with Articles 6, 7, 8 and 9 of the Securitisation Regulation. These provisions only specify who the competent authority will be for such entities established in the EU. No supervisory entity is appointed to supervise compliance by entities that are established outside of the EU. This, in our view, is a further indication that it was only intended that originators, sponsors, original lenders and issuers established in the EU will be required to comply with Articles 6, 7, 8 and 9.

On the basis of the above, we consider that there is no direct requirement for Non-EU CLOs to comply with the requirements of Article 7. If there were such a requirement, all Non-EU CLOs, whether or not they were being marketed to EU investors, would be required to comply with the Securitisation Regulation, which is counter-intuitive and in our view was not the intention of the legislature.

Is there an indirect requirement for non-European CLOs to comply with Article 7?

The justification given by the EBA and the Commission for Article 6 not having direct effect with respect to Non-EU CLOs is that the indirect requirements set out in Article 5, that are applicable to European institutional investors, create a level-playing field[7]. This means that while Non-EU CLOs do not need to comply with the specific requirements of Article 6, they cannot be marketed to EU institutional investors without the retention of a 5% economic interest in the CLO by an appropriate entity.

The same argument could be made in respect of Article 7, that while there is no direct requirement on Non-EU CLOs to comply with Article 7, by virtue of Article 5 Non-EU CLOs will have an indirect requirement to ensure that a certain level of information is provided to EU investors.

The crucial question is therefore whether investors can get comfortable that their due diligence requirements under Article 5 can only be satisfied via provision of the underlying exposure reports and investor reports provided for in Article 7. The answer to this question largely depends on whether the requirements under Article 5 expand significantly on the due diligence requirements set out in Articles 405 to 409 of the Capital Requirements Regulation[8] (the "**CRR**") and Article 17 of the Alternative Investment Fund Managers Directive[9] (the "**AIFMD**"), as implemented by Section 5 of the AIFMD Level 2 Regulation[10], as the precursors to the Securitisation Regulation that investors are already having to comply with.

The table below sets out our analysis of the relevant requirements under Article 5 and whether or not investors are already subject to an equivalent requirement under the CRR.

Securitisation Regulation Requirement[1]	CRR Requirement	Summary of the requirement	Summary of the change	Article 7 reports necessitated?
5(1)(a)	408	Credit Granting Criteria disclosure	Credit granting criteria used by corporates are required to follow the same requirements as credit institutions and investment firms.	**X**
5(1)(b)	N/A	Credit Granting Criteria disclosure	Extends the provisions of Article 5(1)(a) to originators and original lenders in non-EU countries	**X**
5(1)(c)	405(1)	Risk Retention disclosure	EU retention holder to retain and disclose retention in accordance with Article 7	✓
5(1)(d)	N/A	Risk Retention disclosure	Non-EU retention holder to retain and disclose retention	**X**

5(1)(e)	409	Information to be supplied to investors	EU originator, sponsor or issuer must make Article 7 information available to investors[2]	✓
5(3)(a)	406(1)	Risk assessment of securitisation positions and underlying exposures	No change	**X**
5(3)(b)	406(2)	Risk assessment of structural features of the securitisation	No change	**X**
5(4)(a)	406(2)	Investor's written procedures to monitor compliance with Article 5(1) and Article 5(3)	No material change	**X**
5(4)(b)	406(1)	Stress Tests	No material change	**X**
5(4)(d) Internal Reporting	N/A	Internal Reporting	Requires internal reporting to investors' management body	**X**
5(4)(e)	406(1)	Internal record-keeping and understanding	Investors need to demonstrate to their competent authorities an understanding of the underlying exposures in addition to their securitisation positions	**X**

[1] Articles 5(2), 5(3)(c), 5(4)(c) and 5(4)(f) are not relevant in the context of a CLO transaction and are therefore not referenced in this table.

[2] As discussed above, Article 5(1)(e) is not applicable where the originator, sponsor and issuer are non-EU entities that are not subsidiaries of an EU bank.

As shown in the table above, the only material difference between the existing due diligence requirements imposed on institutional investors and the due diligence requirements set out in Article 5 of the Securitisation Regulation that is relevant in the context of a CLO is the new requirement in Article 5(4)(e) that the institutional investor must also have a thorough understanding of "its underlying exposures". The remainder of the requirements under Article 5 of the Securitisation Regulation that are applicable to CLOs are substantially similar to the existing due diligence requirements.

This suggests that, while there is an indirect requirement on Non-EU CLOs to ensure that a certain level of information is provided to EU investors, there is no indirect requirement to produce the underlying exposure reports and investor reports provided for in Article 7. While undoubtedly such reports would be helpful for investors in the absence of other disclosure,

a very large (and arguably more relevant) quantity of data is already contained in the monthly reports and payment date reports that investors are already accustomed to receiving and analysing (including detailed information on the underlying exposures) and therefore investors can reasonably conclude that the existing level of disclosure is sufficient for them to satisfy their due diligence requirements. No significant change is being made to the due diligence requirements that would necessitate the delivery of these additional reports to investors.

OTHER REQUIREMENTS UNDER ARTICLE 7 OF THE SECURITISATION REGULATION

The focus of this Client Alert has been on the requirements set out in Articles 7(1)(a) and (e), but the conclusions drawn are equally applicable to the additional requirements under Articles 7(1)(b) (underlying documents), (c) (transaction summary), (f) (inside information) and (g) (significant events). As such, our view is that Non-EU CLOs should also have no requirement to:

- make copies of the transaction documents available prior to pricing;
- prepare a transaction summary;
- report insider information that is required to be made public in accordance with the Market Abuse Regulation[11]; and
- report significant events such as a material breach of obligations, a material amendment, a change in the structural features of the CLO and/or a change in the risk characteristics of the CLO.

CONCLUSION

While in our view there is no legal requirement for Non-EU CLOs to comply with the requirements of Article 7 of the Securitisation Regulation, as noted in our previous Client Alert[12] on the topic of the Securitisation Regulation, it is possible that (i) the parties to a transaction take the view that some or all of the obligations are not particularly onerous (e.g. making transaction documents available to investors prior to pricing) and choose to comply with the provisions of Article 7 in order to put the investors in those Non-EU CLOs on a more equal footing with the investors in European CLOs, and/or (ii) certain, more conservative investors in Non-EU CLOs may seek an equivalence of Article 7 information between EU CLOs and Non-EU CLOs (so as to be abundantly clear) that they have complied with their due diligence obligations. We will need to see how the market develops in this regard and the first few Non-EU CLOs marketed to EU investors will be pivotal in establishing market expectation

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[1] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017.

[2] The Securitisation Regulation is of general application to "securitisations"; however, this Client Alert confines our observations to particular effects on the CLO market.

[3] This is relevant because Article 14 of the CRR as amended by Article 1(11) of Regulation (EU) 2017/2401 of the European Parliament and of the Council of 12 December 2017 ("**CRR Amendment Regulation**") applies the transparency obligations under Article 7 of the Securitisation Regulation (together with the other requirements in Chapter 2 of the Securitisation Regulation) to EU institutions subject to the CRR on

a consolidated basis. The consequence of this being that non-EU subsidiaries of an EU bank could be required to comply with Article 7 of the Securitisation Regulation. However indicative relief on this point has been provided by a statement from the Joint Committee of the European Supervisory Authorities advising that the European Supervisory Authorities expect this to be amended as part of the proposals to amend the CRR (known as "CRR 2") so that Article 14 of the CRR will only apply the Article 5 due diligence requirements in the Securitisation Regulation on a consolidated basis. It is not clear however when these further changes to Article 14 of the CRR will be made. The procedure files for the Capital Requirements Regulation indicate that the European Parliament will debate and vote on the proposals at its plenary session to be held between 15 and 18 April 2019 with any finalisation, agreement and publication of the resultant legislation likely to follow several months thereafter.

[4] This "indirect" approach to risk retention has been a deliberate feature of legislators' approach ever since the introduction of Article 122a of Capital Requirements Directive II and was intended to ensure a level playing field for EU investors in EU CLOs and Non-EU CLOs.

[5] See page 27 of the EBA Fund Draft Regulatory Technical Standards published by the EBA on 31 July 2018.

[6] See page 14 of the Explanatory Memorandum published by the European Commission on 30 September 2013.

[7] See page 14 of the Explanatory Memorandum published by the European Commission on 30 September 2015.

[8] Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013.

[9] EU Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011.

[10] EU Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing the AIFMD.

[11] It should be noted however that if the securities of the Non-EU CLO are traded on a regulated market, an MTF or an OTF in the EU, they will still be required to comply with their obligations under the Market Abuse Regulation to report such inside information to the public.

[12] https://www.milbank.com/en/news/disclosure-requirements-under-the-securitisation-regulation-delayed-application-of-cra3-transitional-provisions.html

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Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our CLO Group.

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