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CLO Group Client Alert. Risk Retention Round-Up: Update on latest developments affecting CLOs

After a quiet three weeks, the end of January 2019 saw a flurry of activity in the CLO regulatory space with the publication:

1. on 29 January, of an update[1] from the Loan Syndications and Trading Association (the "**LSTA**") on their engagement with the Japanese Financial Services Agency (the "**JFSA**"), as regards its proposal to introduce a risk retention rule (the "**JRR Proposal**");[2]

2. on 31 January, of an opinion (the "**ESMA Opinion**") from the European Securities and Markets Authority ("**ESMA**") proposing revised regulatory technical standards (the "**Revised RTS**") for disclosure under the Securitisation Regulation, along with a related Q&A document (the "**Disclosure Q&A**");[3] and

3. on 31 January, jointly by the UK Prudential Regulation Authority (the "**PRA**") and the Financial Conduct Authority (the "**FCA**") of their final direction (the "**Joint Reporting Direction**") on reporting of private securitisations.[4]

In this Client Alert, we provide a short update on all three publications, focussing in particular on the ESMA Opinion.

BACKGROUND TO THE ESMA OPINION

The Securitisation Regulation[5] (the "**Securitisation Regulation**") came into effect on 1 January 2019, bringing a number of changes to the European risk retention regime for CLO transactions; in particular, Article 7 of the Securitisation Regulation introduced new transparency and disclosure requirements applicable to issuers, sponsors and

[1] https://www.lsta.org/news-and-resources/news/japanese-risk-retention-the-lsta-weighs-in
[2] The JRR Proposal has been previously discussed in the joint Client Alert published by Milbank and Anderson Mori & Tomotsune on 14 January 2019. See here.
[3] Both documents are available on ESMA's website at https://www.esma.europa.eu/press-news/esma-news/esma-publishes-opinion-and-qa-disclosure-technical-standards-under
[4] https://www.bankofengland.co.uk/prudential-regulation/publication/2018/securitisation-regulation-pra-and-fca-joint-statement-on-reporting-of-private-securitisations
[5] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017.

originators of European[6] CLO transactions. Most notably, Articles 7(1)(a) and (e) introduced quarterly information disclosure obligations relating to, respectively, the underlying exposures and investor reports. ESMA was mandated[7] to prescribe the content and format for this information by way of standardised templates which it duly proposed by way of draft regulatory technical standards in a Final Report[8] published on 22 August 2018. Of particular relevance for the CLO industry were Annexes 4 (corporate underlying exposures information) and 12 (investor report information). Annexes 14 (inside information) and 16 (information on significant events), which have now been combined into the single Annex 14 in the Revised RTS, also apply in the case of "public securitisations"[9] but are not applicable to unlisted transactions, to transactions listed on an exchange-regulated market such as the Global Exchange Market of Euronext Dublin, or to transactions listed outside of the European Union.[10]

However, in response to market feedback, the European Commission (the "**Commission**") wrote to ESMA on 30 November 2018,[11] requesting amendments and expressing concern that ESMA's proposals could "place an excessive burden on the disclosing entity" and that "disproportionately strict disclosure requirements risk disrupting securitisation issuance .... counter to the very objectives of the Securitisation Regulation". In particular, the Commission suggested that ESMA could expand the application of "No Data"[12] responses to more fields in the draft templates. The dialogue between ESMA and the Commission has now culminated in publication of the ESMA Opinion incorporating the Revised RTS. In addition, recognising market participants' need for additional guidance towards implementation of the reporting templates,[13] and to try to enable a smooth transition to the requirements of the Revised RTS, ESMA has taken the unusual step of publishing the Disclosure Q&A[14] "even before these technical standards are adopted by the Commission".

[6] Readers are reminded of the analysis in our Client Alert dated 12 December 2018, and Milbank's view that "there is no legal requirement for Non-EU CLOs to comply with the requirements of Article 7 of the Securitisation Regulation". See here.
[7] Articles 7(3) and (4) of the Securitisation Regulation.
[8] https://www.esma.europa.eu/sites/default/files/library/esma33-128-474_final_report_securitisation_disclosure_technical_standards.pdf
[9] Defined in Article 1(9) of the Revised RTS as "a securitisation where a prospectus has been drawn up in compliance with Directive 2003/71/EC of the European Parliament and of the Council".
[10] Reiterated in ESMA Opinion, Section 4, paragraph 23 and in A5.1.2.2 of the Disclosure Q&A. CLO managers contemplating a public securitisation should be mindful, in particular, of the CLO Manager information section of Annex 14 (inside information or significant event information) which threatens to provide greater utility to competitors than to investors.
[11] The letter is reproduced on pages 13-14 of the ESMA Opinion.
[12] The 'No Data' option is outlined in Annex 1 of the Revised RTS (ESMA Opinion, page 29), comprising, "ND1": Data not collected as it is not required by the lending or underwriting criteria; "ND2": Data collected on underlying exposure application but not loaded into the originator's reporting system; "ND3": Data collected on underlying exposure application but loaded onto a separate system from the originator's reporting system; "ND4": Data collected but will only be available from a certain year; and "ND5": Not applicable.
[13] ESMA Opinion, Section 3, Paragraph 10.
[14] https://www.esma.europa.eu/file/50164/download?token=No79809A

SUMMARY OF CHANGES IN, AND IMPACT OF, THE REVISED RTS

Comparing the Revised RTS with its predecessor, the majority of the changes are largely cosmetic. Yet there is a significant and helpful change, as foreshadowed by the Commission's letter, in the expansion of the permitted No Data fields responses. This is perhaps most useful with respect to the very granular reporting requirements of Annex 4 (corporate underlying exposures information), where a greater number of the more esoteric fields that may not be readily available to secondary market participants do now permit certain "No Data" responses.[15] The ESMA Opinion includes a chart[16] summarising this expansion, an extract from which, highlighting the Annexes pertinent to CLOs, follows:

Table 2: Amendments to ESMA draft securitisation disclosure templates

TEMPLATE CATEGORY	*Total No. of fields*	*# fields allowing ND1-4*			*# fields allowing ND5*			*Fields where no ND options allowed*
		Previous RTS	Amended RTS	*Change*	Previous RTS	Amended RTS	*Change*	
ANNEX 4: Corporate Underlying Exposures	*111*	33	53	*20*	70	83	*13*	*12*
ANNEX 11: ABCP Underlying Exposures	*44*	9	39	*30*	4	38	*34*	*6*

Disappointingly, but unsurprisingly to those that have been following the process closely, ESMA failed to address industry concerns about the usefulness and practicality of the information requirements, particularly in relation to private transactions. The ESMA Opinion recites[17] that ESMA has again considered the high-level issues relating to the disclosure requirements and (i) their applicability to "private securitisations", (ii) their geographic scope, and (iii) requests by market participants for a transitional introductory period, but in each case determined, as with its prior analysis,[18] that these were outside the scope of its mandate under the Securitisation Regulation.

On timing, ESMA has highlighted in A5.1.1.1 of the Disclosure Q&A that the Revised RTS will specify the date that it enters into force. As it stands, Article 13 (Entry into force) of the Revised RTS provides perhaps a glimmer of hope for the introduction of a transitional period, with the application date for the Revised RTS marked as "[TBD]".

In the meantime, the transitional arrangements imposed under Article 43(8) of the Securitisation Regulation will continue to apply as discussed in our 3 December 2018 Client Alert.[19]

[15] For example, Field CRPL 38 (original underlying exposure balance (inclusive of fees)) and Field CRPL 86 (recourse to obligor's assets).
[16] ESMA Opinion, Section 4.4, paragraph 13.
[17] ESMA Opinion, Section 3, paragraph 13 and Section 4.3, paragraphs 26 and 27.
[18] See https://www.esma.europa.eu/sites/default/files/library/esma33-128-474_final_report_securitisation_disclosure_technical_standards.pdf, in particular paragraphs 12, 13 and 17.
[19] https://www.milbank.com/en/news/disclosure-requirements-under-the-securitisation-regulation-delayed-application-of-cra3-transitional-provisions.html

PRA/FCA DIRECTION ON REPORTING OF PRIVATE SECURITISATIONS

A5.1.2.1 of the Disclosure Q&A provides guidance that "Absent any instructions or guidance provided by national competent authorities, reporting entities are free to make use of any arrangements that meet the conditions of the Regulation" in how they report private securitisation transactions.[20] As regards the UK,[21] the Joint Reporting Direction comprising such instructions has been issued by the FCA and the PRA pursuant to regulation 25 of the Securitisation Regulations 2018 (the UK legislation complementing the Securitisation Regulation)[22] and imposes an additional reporting obligation on loan securitisation participants operating in the UK to ensure information regarding private securitisations is made available to the UK regulators.

The Joint Reporting Direction applies to private securitisations (i.e. those warehouses and public CLOs where no Prospectus Directive compliant prospectus is produced or required; for example, those listed on the Global Exchange Market of Euronext Dublin) where the originator, sponsor or SSPE (i.e. issuer) is established in the UK. Practically, the Joint Reporting Direction is therefore of relevance principally to UK-based CLO managers who are authorised and regulated by the PRA or FCA (as applicable) ("**Regulated UK Managers**").

The Joint Reporting Direction, which took effect immediately upon issuance and applies retrospectively as of 1 January 2019, obliges Regulated UK Managers to (i) file a notification in a specified form[23] with the FCA/PRA (as applicable) upon "pricing"[24] of a private securitisation and (ii) update that notification at any subsequent time that information is required to be disclosed pursuant to Article 7(1)(f) (inside information) or (g) (significant events) of the Securitisation Regulation.

Regulated UK Managers may file such notification directly (by email), or through the responsible reporting entity designated pursuant to Article 7(2)(1) of the Securitisation Regulation (typically the CLO issuer). Whilst the contents of, and data fields, set out in the required notification are uncomplicated and, in our view, uncontroversial (for example, name and identification number of the originator/sponsor of the CLO and type and size of the securitisation), the Joint Statement nevertheless imposes an additional administrative burden on CLO transaction participants at a time of significant change

[20] Helpfully, A5.12.3 of the Disclosure Q&A also clarifies that "There is no prohibition on originators, sponsors, or SSPEs also providing the same information via a second investor report format" – meaning that CLOs can continue to produce reports in the form that investors are accustomed to.

[21] In relation to competent authorities in jurisdictions that have not provided guidance, we suggest that the reporting requirement can be satisfied for listed securities via the inclusion of appropriate disclosure in the relevant offering document. However, for unlisted securitisation transactions (e.g. warehouses), consideration should be given to specific notification to the relevant competent authority.

[22] As required by Article 29 of the Securitisation Regulation.

[23] See https://www.fca.org.uk/publication/forms/pra-fca-private-securitisation-notification-template-2019.xlsx

[24] Paragraph 5 of the Joint Reporting Direction provides that for non-ABCP securitisations which do not involve the issuance of securities, notification should be provided "before pricing prior to the creation of any new securitisation positions". As a CLO warehouse may not involve the issue of securities, and is unlikely to involve "pricing" in the sense understood in the securities market (the financing obligations will only become legally binding upon execution of the warehouse documents), we interpret this as a requirement that warehouse notifications should be provided immediately prior to execution.

for the industry. Nonetheless, this reporting requirement will be significantly less burdensome than the administrative overhead associated with securitisation repository filings required in connection with a public securitisation.

LSTA UPDATE RELATING TO THE JRR PROPOSAL

Following consultation with CLO transaction and industry participants, under the guidance of Elliot Ganz and his team, the LSTA has submitted a letter (the "**Industry Response Letter**") to the JFSA commenting on the JRR Proposal and advocating, in particular, that investors in "open market" CLOs should be excluded from the higher capital charges contemplated by the JFSA.

The LSTA has now advised[25] members that it is meeting the JFSA in Tokyo on 6 February 2019 to discuss the Industry Response Letter, and to further advocate and provide input into the process of finalisation of the JRR Proposal along with any accompanying industry FAQs that may be published. The final rules resulting from the JRR Proposal are expected to go into effect on 31 March 2019.

[25] https://www.lsta.org/news-and-resources/news/japanese-risk-retention-the-lsta-weighs-in

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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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