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Alternative Investments

Client Alert

Proposed Amendments to the EU Securitisation Regulation

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1. Introduction

As part of its broader response to facilitate economic recovery from the COVID-19 pandemic, the European Commission, on 24 July 2020 and as part of its Capital Markets Recovery Package[1], published a legislative proposal (the "**Commission Proposal**")[2] to amend Regulation (EU) 2017/2402 (the "**Securitisation Regulation**"[3]). The European Parliament's Committee on Economic and Monetary Affairs has since published a draft report, dated 5 October 2020, proposing revisions to the Commission Proposal (the "**ECON Amendments**"[4] and, together with the Commission Proposal, the "**Draft SR Amendments**").

2. Background

The Draft SR Amendments predominantly seek to (i) extend the scope of the simple, transparent and standardised securitisations regime (the "**STS Regime**") to on-balance sheet securitisations and (ii) recalibrate the retention requirements applicable to non-performing exposure ("**NPE**") securitisations. However, for the purpose of this Client Alert, we focus on analysing certain other Draft SR Amendments

[1]On 28 April 2020 the European Commission proposed targeted "quick fix" amendments to EU banking rules which were then expanded on 24 July 2020 to introduce a capital markets recovery package in order to stimulate economic investment in Europe following the COVID-19 pandemic. The package, in addition to the Draft SR Amendments, contains amendments to Regulation (EU) 2017/1129 (Prospectus Regulation amendments), Directive 2014/65/EU (MiFID II Directive amendments), and Regulation (EU) No 575/2013 (Capital Requirements Regulation amendments). On 19 October 2020, the European Commission published their Working Programme 2021 where these amendments were presented as "priority pending proposals".
[2]https://www.europarl.europa.eu/RegData/docs_autres_institutions/commission_europeenne/com/2020/0282/COM_COM(2020)0282_EN.pdf
[3]Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.
[4]https://www.europarl.europa.eu/doceo/document/ECON-PR-658798_EN.pdf

that may impact European CLO transactions and US CLO transactions that are structured to be European risk retention compliant (together, "**European CLO Transactions**").

3. Executive Summary

The Draft SR Amendments introduce a number of amendments to the Securitisation Regulation which are likely to affect European CLO Transactions, including: (1) requiring the 5 per cent. retention interest to be gross of any issue discount or fee rebate offered in connection with the issuance of the retention notes; (2) requiring European competent authorities to ensure that securitisation special purpose entities ("**SSPEs**") are liable to pay corporate tax and capital gains tax, and (3) a harbinger of more onerous disclosure obligations for "private" securitisations (including European CLO Transactions). However, if adopted in their current form, the Draft SR Amendments are unlikely to otherwise materially alter the existing regulatory framework currently applicable to European CLO Transactions.

4. Proposals affecting the CLO Market

A. EUROPEAN RISK RETENTION CHANGES

The Draft SR Amendments propose that the following new Article 6(3a)(1a) is included in the Securitisation Regulation:

> *"In calculating the 5% retention rate, fees or other structural elements that might in practice be used to reduce the effective material net economic interest shall be duly taken into account"*[5].

Whereas the remainder of the Draft SR Amendments to Article 6 broadly relate to the retention calculations for NPE transactions (which would not capture European CLO Transactions), this amendment appears to apply to retention methodologies as generally described in Article 6 of the Securitisation Regulation and would require that the calculation of the 5 per cent. retention interest be gross of any issue discount or fee rebate offered in connection with the issuance of any retention notes.

The current practice in a number of European CLO Transactions is to measure the 5 per cent. retention interest by reference to the notional amount of the retention notes (i.e. by reference to their principal amount outstanding). The proposed Article 6(3a)(1a) would suggest that this is no longer appropriate where an issue discount or fee rebate has the effect of reducing the material net economic interest of the retention holding below the required 5%.

In light of the proposed Article 6(3a)(1a), and to address future change-in-law risk, CLO market participants should consider adding gross-up provisions to the retention covenants where the retention notes may be issued at a discount, with a fee rebate, or with analogous structural elements.

B. TAX CHANGES

The Draft SR Amendments propose that the following new Article 30(3a) is included in the Securitisation Regulation:

> "*Competent authorities shall ensure that SSPEs are liable to corporate tax and capital gains tax and are not misused to channel funds to non-cooperative jurisdictions for tax purposes*".

This amendment is an example of the increased role that EU institutions are now seeking to play in direct taxation matters. It is interesting that this proposed amendment has not been included in Article 4 (which imposes direct requirements for SSPEs not established in a Member State), but rather Article 30 (which deals with powers of the competent authorities in Europe). It has been proposed that Article

[5]See Amendment 10 of the ECON Amendments.

4 will be amended solely to prevent the establishment of SSPEs in third countries found in the EU list[6] of non-cooperative jurisdictions for tax purposes (this "blacklist" was envisaged in Recital 18 of the Securitisation Regulation but was not adopted at the time the Securitisation Regulation came into force; this revision is therefore of an 'update' nature rather than a change in policy). This suggests that the requirement to ensure that SSPEs are "*liable to corporate tax and capital gains tax and are not misused to channel funds to non-cooperative jurisdictions for tax purposes"* only applies to SSPEs established in European jurisdictions and that, for example, European investors may continue to invest in CLO transactions issued by non-European SSPEs that do not pay any corporate or capital gains taxes (e.g. US CLOs that utilise an SSPE incorporated in the Cayman Islands[7]). This is in keeping with the explanatory statement to the Draft SR Amendments which describes the proposed Article 30(3a) as a "mandate" granted to competent authorities. However, it remains to be seen how the competent authorities will interpret and implement this mandate and how market participants will respond.

From a practical perspective, European CLOs typically utilise either an Irish section 110 company or a Dutch BV[8] entity to issue CLO securities. Dutch BVs are subject to corporate income tax which includes tax on capital gains (we understand Dutch law does not distinguish between income and gains in profit and loss or taxable profit). Irish s.110 companies, however, are subject to corporation tax at a rate of 25 per cent. on their taxable profits (which is routinely confirmed in a standard CLO Irish tax opinion) but, because of the nature of their activities, it is not often considered in such opinions whether they are subject to separate Irish capital gains tax. A strict reading of the amendment might require that the SSPE is liable to *both* corporate tax *and* capital gains taxes but, in our view, as the income and gains of both entities are each within the scope of Irish and Dutch tax (as applicable), any new requirement should be satisfied. Arrangers and collateral managers may wish to address this point explicitly in tax opinions going forwards, if the amendment is implemented.

The impact of the requirement to ensure that SSPEs are not misused to channel funds to offshore jurisdictions is harder to predict. The Irish s.110 rules already impose restrictions on deductibility for payments made to certain connected entities in several non-EU jurisdictions which will not be subject to tax, but the proposed amendment may necessitate further sanctions imposed on payments to other non-connected entities and/or a broadening of withholding tax rules. It will be important for market participants to follow any implementation of this requirement in Ireland and The Netherlands going forwards.

C. USE OF SECURITISATION REPOSITORIES

The Draft SR Amendments propose to add the following new paragraph (ha) in Article 46 of the Securitisation Regulation, the provision requiring the Commission to report on the functioning of the Securitisation Regulation (the "**Article 46 Report**") and, if necessary, propose new legislation:

> "*(ha) the possibilities for further standardisation and disclosure requirements, namely through the use of templates, for the use of the STS designation on both traditional and on balance sheet securitisations, including for bespoke private securitisations where no prospectus has to be drawn up in compliance with Regulation (EU) 2017/1129 of the European Parliament and of the Council*"[9].

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[6]As at the date of this Client Alert the list contains the following jurisdictions: American Samoa, Anguilla, Barbados, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, US Virgin Islands and Vanuatu. The list is updated twice per calendar year and can be found here.
[7]The Cayman Islands have recently been removed from the list of non-cooperative jurisdictions.
[8]Although the popularity of The Netherlands as an issuer jurisdiction has subsided recently owing to the Dutch tax authorities' change in practice in relation to the imposition of VAT on collateral management fees.
[9]See Amendment 24 of the ECON Amendments.

European CLOs are generally considered to be "private" securitisations because their securities are typically marketed in high denominations to qualified investors and listed on multilateral trading facilities[10], meaning that no prospectus is required pursuant to the Prospectus Regulation[11]. Accordingly, European CLO Transactions are not currently caught by the requirement in Article 7(2) of the Securitisation Regulation to make transaction documents, and investor and asset reporting required by the Securitisation Regulation (such documents and reports, the "**Disclosable CLO Documents**"), available by means of a securitisation repository[12]. Disclosable CLO Documents in European CLO Transactions instead remain "semi-private" as they may only be accessed by certain parties (including investors and potential investors in the relevant European CLO Transaction and competent authorities), via a designated website administered by the collateral administrator, upon receipt by the collateral administrator of appropriate confidentiality and permitted-use certifications.

Whilst the Article 46 Report is not due until 1 January 2022, this amendment, makes clear that the European authorities are already considering further disclosure requirements for private securitisations (such as European CLO Transactions), which may include a requirement to utilise a securitisation repository when publishing the Disclosable CLO Documents. If implemented, this would exacerbate the disclosure obligations (including related privacy and confidentiality concerns) and compliance costs for European CLO Transactions.

5. Legislative Timeline

The Draft SR Amendments are currently awaiting the European Parliament's vote as part of the ordinary legislative procedure (ex-codecision procedure) pursuant to Article 114 of the TFEU[13]. The vote in the parliamentary committee and the first single reading of the Draft SR Amendments are scheduled for 9 November this year (see details here). If adopted by the vote, they will be presented back to the Commission and the Council, and the three European bodies will then decide the form of final Regulation to be published in the Official Journal.

The timing of the final amendments is uncertain but the Commission has indicated in its press release that they should be in force before the securitisation framework comprehensive review is due in January 2022.

6. Brexit Interaction

The Draft SR Amendments take the form of a Regulation and therefore will be automatically onshored into the UK system[14] if they come into force and become effective before the expiry of the Brexit transition period. In the more likely event that they take effect after 31 December 2020 (i.e. following the expiry of the transition period), we expect that the UK Government will introduce equivalent domestic measures so to avoid any material regulatory divergence of approach between the UK and Europe.

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[10] As defined in Article 4(1)(22) of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (the "MiFID II Directive").
[11] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC.
[12] Note that US CLOs that are structured to be EU risk compliant do not generally comply with the requirements of Article 7 of the Securitisation Regulation. See our related Client Alert "Securitisation Regulation: Application of Disclosure Requirements to Non-EU CLOs", which can be found here.
[13] Treaty on the Functioning of the European Union, OJ C 326, 26.10.2012, p. 47–390.
[14] See Section 3(1) of the European Union (Withdrawal) Act 2018 incorporating direct EU legislation (i.e. legislation having effect in EU law) so far as operative immediately before the end of the transition period.

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Alternative Investments Practice

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any member of our Alternative Investments Practice.