CLEARY GOTTLIEB

ALERT MEMORANDUM

CLO Regulation in Europe – More Uncertainty?

June 20, 2016

On 6 June 2016, the Committee on Economic and Monetary Affairs of the European Parliament ("**ECON**") published a draft report (the "**Draft Report**") on the proposal for a regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation (the "**STS Regulation**"). The Draft Report sets out suggested amendments to the proposal previously published by the European Commission and contains an explanatory statement by the rapporteur Paul Tang MEP. Whilst the most significant proposed amendment set out in the Draft Report is an increased risk retention requirement, other proposed changes could also have a significant impact on CLO transactions.

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1. Increased risk retention requirement under the amended Article 4, paragraph 1(1).

The most significant amendment suggested in the Draft Report is the obligation that the entity which is required to hold a percentage of the securities in a securitisation on an on-going basis to fulfil the EU risk retention requirements (the "**Retention Holder**") should now hold a material net economic interest in the securitisation of not less than 20%. This marks a substantial departure from the 5% required under the current CRR and RTS regime, and indeed under all previous proposals for the STS Regulation and the equivalent regime in the U.S. This proposal is a surprising and major departure from the established position and it is unclear why such a drastic change has been suggested at this stage in the legislative process.

This proposed change seems at odds with the stated purpose behind the STS Regulation which is to revive the EU securitisation market which has not recovered as quickly as the U.S. market after the financial crisis. On the contrary, this proposal would place the EU securitisation market at a significant competitive disadvantage to the U.S. market, where the risk retention requirement is, and is intended to remain at, only 5%. Therefore, it is unlikely that the EU market will be as attractive as the U.S. market under the regime proposed in the Draft Report.

In addition, further uncertainty has been introduced by the amendment to Article 4, paragraph 6 which provides the European Banking Authority ("**EBA**"), in cooperation with the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority, with a discretion to "*amend the level of risk retention where it has reason to deviate from the level of 20% laid down in this Article*". This widely drafted discretion could lead to a substantial degree of uncertainty for market participants as to the extent to which the EBA will deviate from the 20% requirement in individual circumstances. This uncertainty might again discourage market participants from choosing the EU market to set up securitisations and it may therefore prevent the positive effect on the market which was initially intended by the STS Regulation.

Based on our intelligence and through informal dialogue with those involved at the European Parliament in this process, our sense is that the increase to 20% is the result of the European Parliament giving more weight to political considerations in the regulation of securitisations. The aim here is to show the public at large that there is a true alignment of interest between the risk retainer (i.e., the Retention Holder) and the securitised assets. Of course, other market participants have pointed out that this may have the effect of making some proposed transactions uneconomic.

2. The newly inserted requirements for securitisation special purpose entities ("SSPEs") will disqualify most SSPEs currently used in the market.

The proposed new Article 2(b) in the Draft Report provides that SSPEs shall not be established in third countries which, *inter alia*, promote themselves as off-shore financial centres or in which there are no or nominal taxes. This would exclude SSPEs which are based in the Cayman Islands, BVI or other typical jurisdictions.

Various other factors also influence the choice of jurisdiction for SSPEs. Such factors include lower overall transaction costs as well as lower expenses incurred in setting up the vehicle. Furthermore, often SSPEs can be set up faster due to the friendlier regulatory environment in certain jurisdictions and the burden of on-going reporting requirements is lower. All of these benefits would be likely lost with the suggested prohibition and the advantages and cost savings could no longer be passed on to investors.

3. Inconsistency as to whether only a sponsor or, under the new proposal, each of the sponsor, originator and original lender are required to be EU regulated entities.

The proposed new Article 2(a) appears to suggest that a sponsor, an originator and an original lender all have to be EU regulated entities. Under the current CRR

regime and the previous drafts of the STS Regulation, there was only a requirement for sponsors to be EU regulated entities as the sponsor definition required the existence of an "*institution*". An "*institution*" is defined in the CRR as a credit institution or an investment firm for the purposes of the Markets in Financial Instruments Directive (Directive 2004/39/EC).

This development may prove to be problematic. It had been suggested that the restrictive approach requiring sponsors to be EU regulated would be remedied in the STS Regulation rather than exacerbated by extending the requirement to include originators and original lenders. The current regime already effectively precludes U.S. managers from acting as sponsor and, therefore, such U.S. managers can only be involved in EU securitisations which follow an originator or original lender structure. If these managers were now also required to be EU regulated, this might preclude U.S. managers from being involved in EU law compliant securitisations altogether.

However, the Draft Report does not seem to be consistent in requiring originators and original lenders to be EU regulated. Contrary to new Article 2(a), the amendment to Article 3 paragraph 1(a) reads the following: "*where the originator or original lender is not a credit institution or investment firm …*". It is hard to see how this situation could be relevant in the light of the requirement in Article 2(a) because the latter requires all sponsors, originators and original lenders to be EU regulated. It is essential that this issue is addressed and clarified in any subsequent draft.

4. Deletion of the "sole purpose" test for originators without offering a different test?

The most recent draft of the STS Regulation published by the Commission contained the following requirement for originators: "*an entity shall not be considered an originator where the entity has been established or operates for the sole purpose of securitising exposures*". The inclusion of a codified requirement in the legislation constituted a positive development as it reduced the uncertainty of the "*substance*" and "*hold period*" concepts applicable today under the CRR and RTS. Under the current regime, these concepts have been used to prevent "*originate to distribute*" structures by prohibiting originators from being mere pass-through vehicles without an independent business and strategy and which are subject to immediate forward sale agreements.

The "*sole purpose*" test was also an improvement in relation to a previously leaked version of the STS Regulation which included a "*primary purpose*" test which would have carried an undesirable amount of uncertainty and thus not been a significant improvement to the current law.

However, the latest Draft Report has introduced further ambiguity in this respect by deleting the "*sole purpose*" requirement in Article 4 paragraph 1(2) entirely. Given that there is no alternative test proposed to replace the deletion, the "*substance*" and "*hold period*" concepts applicable today under the CRR and RTS would likely be retained, if only informally, and would add to the market uncertainty.

One reason for the deletion of the "*sole purpose*" test may be on the basis that originators will be EU regulated entities (see paragraph 3 above) but this is unclear.

5. EU legislative procedure and next steps

The Commission has submitted its legislative proposal to the European Parliament earlier this year and it is now on its first reading. The President of the European Parliament then referred the proposal to ECON, which appointed rapporteur Paul Tang to draw up the Draft Report suggesting amendments to the proposal put forward by the Commission. The suggested amendments will then be voted on first by ECON and then by the European Parliament as a whole, at a sitting currently scheduled to be held on 13 December 2016.

Thereafter, the proposal will be forwarded to the Council and the process could continue through several subsequent stages at which the European Parliament and Council could further amend the text of the STS Regulation. Given the legislative process, it is

hard to predict at this point when the STS Regulation will come into force. Furthermore, as it is possible for amendments to be suggested at each stage in the process, it will be interesting to see whether the amendments suggested by the rapporteur in the Draft Report will make it into the final text of the STS Regulation.

6. Conclusion

The Draft Report has introduced some far reaching amendments to the legislation. There is clearly a political impetus behind some of these and there is still a long way to go in the legislative process. Although there is significant uncertainty and the situation is far from ideal, it is probably best, at this stage, to adopt a "wait and see" approach to see how things progress.

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