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Securitisation 2015

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A practical cross-border insight into securitisation work

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Country Question and Answer Chapters:

EDITORIAL

Welcome to the eighth edition of *The International Comparative Legal Guide to: Securitisation*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of securitisation.

It is divided into two main sections:

Five general chapters. These are designed to provide readers with a comprehensive overview of key securitisation issues, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in securitisation laws and regulations in 38 jurisdictions.

All chapters are written by leading securitisation lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor, Mark Nicolaides of Latham & Watkins LLP, for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.co.uk.

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CLOs and Risk Retention

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Risk retention requirements for collateralised loan obligations ("CLOs") marketed to European investors have now been in effect for more than four years.[1] These requirements have already undergone changes,[2] and more may be on the way. With U.S. regulators recently announcing the final rules implementing risk retention for CLOs subject to their jurisdiction, this is an opportune time to compare the two regimes. While the EU rules have adopted an "indirect" approach which places the burden of ensuring compliance on investors, the U.S. rules follow a "direct" approach which places the primary compliance burden on the CLO's collateral manager (the "CLO manager"). Both regimes allow the CLO manager or certain of its affiliates to be the risk retainer, but these parties are defined in a very limiting way in the EU rules. On the other hand, while both regimes permit the originator of loans in the CLO's portfolio to be the party which retains the risk, the U.S. rules define an originator much more restrictively. In the future, an increasing percentage of CLOs will attempt to comply with both the U.S. and the EU risk retention requirements, but the discrepancies between the two regimes will make it challenging to structure CLOs which comply on a "universal" basis with risk retention requirements within both the EU and the United States.

U.S. Risk Retention

Introduction

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Section 941")[3] added Section 15G ("Section 15G") to the Securities Exchange Act of 1934, which directs the Securities and Exchange Commission (the "SEC") and U.S. federal banking regulators (together with the SEC, the "Agencies")[4] jointly to adopt regulations that require the "securitiser" of an asset-backed security ("ABS") to retain an unhedged economic interest in at least 5 per cent of the credit risk that is transferred through the issuance of such ABS. Securities issued by a CLO are included in the definition of ABS. Section 15G also directs the Agencies to allocate risk retention obligations between a securitiser and an originator from which it purchases assets.[5]

The Agencies jointly proposed rules to implement this credit risk retention requirement in 2011[6] and again in 2013 (the "Revised CRR Proposal").[7] During 2014, the Agencies reviewed comments from the public and worked together to reach consensus on the final U.S. risk-retention requirements (the "Final U.S. Rule")[8] to implement Section 941. The Agencies approved the Final U.S. Rule in October 2014. The provisions of the Final U.S. Rule applicable to CLOs were adopted largely unchanged from the Revised CRR Proposal, with one notable exception: the elimination of the proposed "cash trap" on distributions to a sponsor holding an eligible horizontal residual interest. The Agencies rejected proposals from CLO market participants and their trade associations that would have exempted certain types of CLOs from risk retention requirements or offered greater flexibility for CLOs (e.g., a reduced retention requirement for "Qualified CLOs" or a third-party retention option).

The Final U.S. Rule will become effective for CLOs on 24 December 2016. CLO securities issued before this date will generally not be subject to the U.S. risk retention requirements.[9]

Risk Retention Requirement

The Final U.S. Rule requires the sponsor to retain an economic interest in the credit risk of the securitised assets in an amount equal to at least 5 per cent of the CLO securities issued in the transaction (the "Required Retention Interest"). The Required Retention Interest must not be transferred to a third-party (except a "majority-owned affiliate" of the sponsor as discussed below) and may not be hedged. The Required Retention Interest may be held in any of the following forms: (i) an eligible vertical interest in each class of ABS interests issued in the securitisation that constitutes 5 per cent of the "*face value*" (i.e. par value) of each tranche issued by the CLO ("EVI"); (ii) an eligible horizontal residual interest (i.e. a first loss interest) equal to 5 per cent of the "*fair value*" of all securities issued by the CLO, determined using a fair value methodology under U.S. GAAP ("EHRI"); or (iii) any combination of EVI and EHRI.[10] *In lieu* of retaining all or any part of an EHRI, at the closing of the transaction the sponsor may, subject to the conditions specified in the Final U.S. Rule, fund a cash reserve account for the benefit of the issuing entity in an amount equal to the EHRI.[11]

The CLO Manager is the Sponsor

The sponsor is defined in the Final U.S. Rule as "a person who organises and initiates a securitisation transaction by selling or transferring assets, either directly or indirectly, through an affiliate, to the issuing entity".[12] A securitisation transaction is a transaction involving the offer and sale of ABS by an issuing entity.[13] Although a CLO manager does not sell assets to a CLO and, therefore, does not seem to fall under the definition of a sponsor, the Agencies have ruled that a CLO manager is a "sponsor" under Section 15G, because the CLO manager is the "person who organises and initiates" a CLO by: (i) selecting the commercial loans to be purchased by the CLO; (ii) directing the CLO to purchase such loans in accordance with its investment guidelines; and (iii) then managing the securitised loans

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on behalf of the CLO. As a result, the CLO manager is subject to the risk retention requirements of the Final U.S. Rule.[14]

Majority-Owned Affiliate of a CLO Manager

A CLO manager may satisfy its obligations under the Final U.S. Rule either by holding the Required Retention Interest directly or through a "majority-owned affiliate", which is "an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with" the CLO manager.[15] Majority control means "ownership of more than 50 per cent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined by GAAP".[16] If the affiliate of the CLO manager is a "variable interest entity" under GAAP, ownership of less than a majority of the equity is sufficient, provided that the requisite controlling financial interest exists.[17] Generally, a "majority-owned affiliate" is a company, partnership or other entity that is part of the same consolidated accounting group as the CLO manager under GAAP. This should enable a CLO manager (or the holding company for a CLO manager) to organise and control an entity which obtains 80 per cent or more of its capital from third-party investors and uses it to invest in the Required Retention Interest in CLOs for which such CLO manager is the sponsor. In this respect the Final U.S. Rule is more permissive than EU risk retention requirements, which strictly limit the affiliates of the CLO manager which may hold the risk. An alternative method for the CLO manager to employ capital from third-party investors to invest in the Required Retention Interest is by bringing third-party capital directly into the CLO manager, and the Final U.S. Rule does not limit the amount or percentage of third-party capital which may be invested in the CLO manager.

The Originator Option

An "originator" may hold some or all of the Required Retention Interest, so long as the interest held is proportionate to the assets in the CLO that it originated. An originator is defined in the Final U.S. Rule as a "person who, through an extension of credit or otherwise, creates an asset that collateralises an asset-backed security; and sells the asset directly or indirectly to a securitiser or an issuing entity".[18] If a single originator provides 100 per cent of the securitised assets to a CLO, it could hold the entire Required Retention Interest.[19] Alternatively, the sponsor may offset the amount of its risk retention requirement by the amount of eligible interests retained by an originator, so long as such originator originated at least 20 per cent of the securitised assets. The EU rule also allows the originator to retain risk but, unlike the U.S. Rule, does not require the originator to have made the original loan creating the securitised credit asset; it allows an originator which sells at least 50 per cent of the loans to a CLO (or which is also the CLO manager) to hold 100 per cent of the Required Retention Interest.[20]

Lead Arranger Option for Open Market CLOs

For "open market CLOs", the CLO manager is exempt from the risk retention requirement if the CLO holds only "CLO eligible loan tranches" in which the lead arranger[21] agrees to hold without hedging 5 per cent of each such loan tranche until repayment, maturity, involuntary and unscheduled acceleration, payment default or bankruptcy default.[22] An "open market CLO" is a CLO which: (i) holds only senior, secured syndicated term loans acquired directly from the sellers thereof in "open market transactions"[23] and servicing assets; (ii) is managed by a CLO manager; and (iii) holds less than 50 per cent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or the CLO manager or originated by originators that are affiliates of the CLO or the CLO manager.[24] The requirements for CLO-eligible loan tranches are not consistent with current leveraged loan market practice and, therefore, we do not expect this exemption to be widely used.

Qualifying Commercial Loans

The Final U.S. Rule exempts from risk retention requirements a securitisation of "qualifying commercial loans" that meet specific underwriting guidelines with respect to debt coverage, leverage, amortisation periods and other loan terms.[25] Most loans acquired by CLOs today would not satisfy these underwriting standards, and, therefore, this exemption is even less likely to be widely used than the exemption for open market CLOs.

Transfer and Hedging of Required Retention Interest

A CLO's sponsor (or its majority-owned affiliate) is prohibited from hedging or transferring the Required Retention Interest until the latest of: (i) the date the unpaid principal balance of the CLO's portfolio is reduced to 33 per cent of the original unpaid principal balance; (ii) the date the unpaid principal obligations issued by the CLO are reduced to 33 per cent of the original unpaid principal obligations; and (iii) two years after the closing date of the CLO.[26] Generally, hedging that is materially related to the credit risk of the Required Retention Interest or of the assets collateralising the transaction is prohibited.[27]

Financing of Required Retention Interest

The Required Retention Interest cannot be financed or pledged as collateral unless the financing is full recourse to the CLO manager or the majority-owned affiliate, as applicable.[28] Financing has been available for risk retention in European CLOs (especially for the "vertical slice option"), and we expect it to be available for risk retention in U.S. CLOs, although there is uncertainty about how to interpret the requirement that the financing be on a full recourse basis if the sole asset of a majority-owned affiliate is the Required Retention Interest.

Disclosure Requirements

The Final U.S. Rule requires a sponsor that holds a Required Retention Interest in the form of an EHRI to disclose to potential investors prior to the sale of the ABS: (i) the fair value and the dollar amount of the EHRI that the sponsor plans to retain or, if specific prices, sizes or interest rates of each tranche are not yet available, a range of fair values based on *bona fide* estimates or models with disclosure of the method used by the sponsor to determine the range; (ii) the material terms of the EHRI; (iii) the valuation methodology used to calculate the fair value or range of fair values of all classes of ABS interests, including the EHRI; (iv) a list or a comprehensive description of key inputs or assumptions used to calculate the fair value or range of fair values; and (v) certain other rates, including discount rates, default and recovery rates and prepayment rates used in the valuation methodology. The overarching requirement is that the disclosure must include "at a minimum descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's

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ability to evaluate the sponsor's fair value calculations" and a summary of the reference data set or other historical information used to develop the key inputs and assumptions. After the closing of the CLO, the sponsor must disclose to investors: (i) the fair value of the EHRI retained by the sponsor based on actual pricing, tranche sizes and interest rates; (ii) the fair value of the EHRI that the sponsor is required to retain to satisfy its risk retention requirement; and (iii) any material differences between the methodologies used to calculate fair value at closing and those previously disclosed to investors.[29]

Refinancings, Re-Pricings and Additional Issuances

The Final U.S. Rule applies to securitisation transactions which take place after the effective date in December 2016. Therefore, the collateral manager of a CLO which offers and sells its securities prior to that date will not be required to comply with the Final U.S. Rule, unless the CLO takes an action after the effective date, which constitutes the "offer and sale" of ABS. These post-closing actions are not specified in the Final U.S. Rule but may include a refinancing, a re-pricing, an additional issuance of CLO securities or a significant amendment to the CLO's indenture. An additional issuance by a CLO of new securities after its closing date most likely will be considered a new "offer and sale". Similarly, a refinancing in which existing securities are redeemed and new securities are issued by a CLO after the effective date may be considered a new "offer and sale" unless the Agencies provide clarification on this point. Re-pricings, on the other hand, may only involve a change in interest rate on notes previously issued by the CLO and (if the CLO implements the re-pricing without redeeming notes and issuing new notes) may not involve a new "offer and sale". Because U.S. regulators have sometimes viewed a significant change to the terms of securities as equivalent to a new issuance of securities, concern has been expressed that a fundamental amendment to a CLO indenture after December 2016 may cause the CLO to become subject to the Final U.S. Rule. If the risk retention requirements in the Final U.S. Rule are determined to apply to CLO transactions issued prior to the effective date, it is not clear how such legacy CLOs will comply with the rule. The CLO manager often does not have approval or veto rights over refinancings, re-pricings, additional issuances or indenture amendments. Should the CLO manager be deemed to be a sponsor under the Final U.S. Rule solely by virtue of a refinancing, re-pricing, additional issuance or indenture amendment over which it has no control? In addition, current and legacy CLO documentation generally does not include a right of first refusal or other contractual provision that would enable a CLO manager to acquire the securities necessary to satisfy the Final U.S. Rule.

Extraterritorial Application

The Final U.S. Rule may become applicable to CLOs that have only a limited nexus to the United States. For example, even if the CLO issuer, the CLO manager and the borrowers in the CLO's portfolio are domiciled outside the United States, a CLO will not qualify as a "foreign-related transaction" exempt from the Final U.S. Rule if more than 10 per cent of the dollar value of the CLO's securities are sold or transferred to "U.S. Persons" (as defined in the Final U.S. Rule).[30]

EU Risk Retention

Introduction

Although risk retention requirements have been applicable to CLOs marketed to investors in the EU since 2011, these requirements were modified in 2014. On 1 January 2014, Regulation (EU) No 575/2013 (the "CRR") on prudential requirements for credit institutions and investment firms became effective.[31] Articles 404-410 of the CRR replaced the risk retention requirements previously found in Article 122a of the Capital Requirements Directive 2006/48/EC (as amended by Directive 2009/111/EC)[32] and restrict European Economic Area ("EEA")-regulated institutions and their consolidated group affiliates (including those based outside of the EEA) (each, an "Affected CRR Investor") from investing in asset-backed securities unless Part Five of the CRR[33] and Regulatory Technical Standards published and adopted by the European Commission in June 2014 (the "RTS",[34] and together with the CRR, the "CRR Retention Requirement") are satisfied including that: (i) the originator, sponsor or original lender has disclosed to the Affected CRR Investors that it will retain, on an on-going basis, a net economic interest of not less than 5 per cent in respect of certain specified credit risk tranches or asset exposures;[35] and (ii) the Affected CRR Investor has undertaken due diligence in respect of the securitisation and the underlying exposures and has established procedures for monitoring them on an ongoing basis.[36]

National regulators in EEA member states impose penalty risk weights on securitisation investments in respect of which the CRR Retention Requirement has not been satisfied in any material respect by reason of the negligence or omission of the investing credit institution or investment firm.[37] If the CRR Retention Requirement is not satisfied in respect of a securitisation investment held by a non-EEA subsidiary of an EEA credit institution or investment firm, then an additional risk weight may be applied to such securitisation investment when taken into account on a consolidated basis at the level of the EEA credit institution or investment firm.[38]

Permitted Forms of Risk Retention

Under Article 405, there are five permissible methods of risk retention: (i) vertical slice, i.e. retention of no less than 5 per cent of the nominal value of each of the tranches sold or transferred to the investors; (ii) *pari passu* share, i.e. in the case of revolving exposures, retention of the originator's interest of no less than 5 per cent of the nominal value of the securitised exposures; (iii) on balance sheet, i.e. retention of randomly selected exposures equivalent to no less than 5 per cent of the nominal value of the securitised exposures, provided that the number of potentially securitised exposures is no less than 100 at origination; (iv) first loss tranche (and, if necessary, other tranches that have the same or a more severe risk profile than those transferred or sold to investors and do not mature earlier), so that the retention equals no less than 5 per cent of the nominal value of the securitised exposures; and (v) retention of a first loss exposure of no less than 5 per cent of every securitised exposure in the securitisation.[39]

The Originator Structure

Article 405 of the CRR requires the "originator", "sponsor" or "original lender" to retain the 5 per cent net economic interest.[40] A CLO manager may retain the risk of a CLO if it has been authorised as an investment firm subject to CRD IV. An "originator" is defined for purposes of Article 405 to include "an entity that purchases a third party's exposures for its own account and then securitises them".[41] To date, CLO transactions marketed in the EU have typically been structured on the basis that an entity which acquires loans in the secondary market holds those loans for a period of time and subsequently sells those loans to the CLO may qualify as the originator for that CLO. Although the percentage of the risk which must be retained is 5 per cent under both the Final U.S. Rule and

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Article 405, the method used to calculate whether this requirement has been satisfied is different, particularly in the case of an EHRI as compared to a "first loss tranche". An originator which meets the requirements of Article 405 and transfers at least 50 per cent of the CLO's portfolio to the CLO (or is both an originator and the CLO manager) may hold the entire risk retention interest and is not limited (as it is under the Final U.S. Rule) to holding a portion of the risk retention interest that is proportionate to the percentage of the CLO's portfolio which it originated.

Disclosure Requirements

Under CRR Article 409, originators and sponsors are required to ensure that prospective investors have access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation as well as information necessary to conduct stress tests on the cash flows and collateral values supporting the underlying exposures.[42]

Article 23 of the RTS states that "materially relevant" data on the individual underlying exposures should, in general, be provided on a loan-by-loan basis; however, in certain instances data provided on an aggregate basis may be sufficient. In assessing whether aggregate information is sufficient, factors to be taken into account include the granularity of the underlying pool as well as whether the management decisions in respect of the exposures in that pool are based on the pool itself or are made on a loan-by-loan basis.[43]

CRR disclosure requirements are not overly prescriptive, but, rather, adopt a principle-based approach to make available to investors the information necessary to perform due diligence. The final RTS do not refer specifically to any particular loan-level template.

The EBA Report

The European Banking Authority (the "EBA") published a report in December 2014 (the "EBA Report") in which it made a series of recommendations to the European Commission for improving the risk retention requirements.[44] At the time of this writing, it is unclear what changes will be made on the basis of the recommendations in the EBA Report.

The EBA Report made ten recommendations. The first recommendation was to retain the current "indirect approach" to risk retention, but to use a "direct approach" as a complement. The "indirect approach" places the onus on the investor to ensure that the risk retention requirements are satisfied. The "direct" approach, which is the approach taken in the Final U.S. Rule, puts the obligation on the originator, original lender or sponsor to comply with the risk retention requirements. Under the complementary approach originators, sponsors and original lenders would be required to publicly disclose the retention form using a standardised format in order to facilitate the investors' due diligence. The EBA Report discussed the advantages of the indirect approach as: (i) enhancing the sophistication of the institutions investing in the securitisation; (ii) conducive to enforcement because it governed the investment behavior of EU-regulated institutions; and (iii) preventing European investors from investing in securitisations issued in jurisdictions where there is not an equivalent risk retention framework. The disadvantages of the indirect approach are that: (i) uncertainty under the regime may discourage potential investors; (ii) additional layers of complexity are created by placing the compliance burden on investors; and (iii) it does not require EU originators to retain any economic interest in transactions sold to non-EU investors. The EBA Report recognised that the direct approach improves legal certainty for investors; but the EBA contended that it also could result in: (i) EU investor institutions being duped into investing in securitisations in which the originating parties retain no risk; and (ii) potential additional cost to originators, original lenders and sponsors.[45]

The second recommendation was to retain the five forms of permissible risk retention without adding any additional options. The EBA Report rejected the inclusion of an "L-shaped" form of retention where retention is held through a combination of a vertical slice and the first loss tranche. Although permitted under the Final U.S. Rule, the EBA stated that the "L-shape" form of retention may not be as effective in aligning interests and mitigating risks for investors and may also complicate the ongoing measurement of compliance.[46]

More broadly, in recommendation three, the EBA concluded that alternative mechanisms for aligning interests other than risk retention should not be considered as a substitute for risk retention requirements. The EBA rejected the performance-based structure of fees for CLO managers as an alternate way to align the CLO manager's and the investors' interests and concluded that it was less effective because the manager was not putting its capital at risk.[47]

In recommendation four, the EBA considered whether to authorise risk retention by an affiliate of a CLO manager or originator that is part of the same consolidated group for financial accounting purposes, similar to a "majority-owned affiliate" under the Final U.S. Rule. However, the EBA recommended against this approach, largely based on the concern that authorities may not have regulatory jurisdiction over entities consolidated with the retaining entity on an accounting basis. Article 405(2) of the CRR is limited to cases where the parent entity is a CRR-regulated EU parent credit institution, EU financial holding company or EU mixed financial holding company and allows for retention on a consolidated basis where either of these entities or one of their subsidiaries, as originator or a sponsor, securitises exposure from several credit institutions, investment firms or other financial institutions which are included in the scope of supervision on a consolidated basis.[48]

In recommendation five, the EBA concluded that additional exemptions should not be added to the few existing exemptions in Article 405(3) and Article 405(4) of the CRR. In particular, the EBA considered whether independently managed arbitrage CLOs should be distinguished from balance-sheet securitisations and recognised the difficulties which CLO managers have in complying with the risk retention requirement of the CRR. However, the EBA concluded that there are sufficient ways to comply with the retention rule and, therefore, declined to recommend additional exemptions or exceptions, expressing concern that providing further exceptions could lead to abuse of the rules.[49] It did recommend authorising a change in the identity of the risk retainer in "exceptional circumstances" (such as insolvency of the CLO manager).

In recommendation six, the EBA opined that the "originator" definition in CRR Article 4(13) should be narrowed and defined in greater detail. The EBA stated that market participants may have taken advantage of the broad definition of "originator" in Article 4(1)(13) of the CRR in order to structure originators that met the legal requirements of the regulation but not the spirit of the regulation. The EBA said that the entity claiming to be the originator should be of "real substance" and should always hold some "actual economic capital on its assets for a minimum period of time". In particular, the EBA Report noted that the following structures would not meet the "spirit" of the regulation: (i) an "originator SSPE" funded by third-party equity investors that acquires a third party's exposures and securitises these exposures within one day; or (ii) an "originator SSPE" that has asymmetric exposure to a securitisation and benefits from any "upside" but not "downside" of the retained interest. The

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EBA Report does not specify what may be required for there to be "real substance" to the originator, what the minimum period of time the originator would need to hold third-party exposures may be or the type of risk that the originator would need to take in respect of such exposures.[50]

In recommendation seven, the EBA considered whether the disclosure requirements should include more prescriptive reporting templates and concluded that the disclosure requirements as presently constituted are sufficiently comprehensive and "fit for purpose" to ensure investor protection and financial stability.[51]

Similarly, in recommendation eight, the EBA considered the due diligence requirements as presently constituted to be sufficient to enable investors to conduct due diligence. The EBA stated that the due diligence requirements ensure that investors buy securitisations with a reasonable understanding of the risk they are taking and without relying solely on external ratings. It acknowledged that these requirements exceed those applicable to other investment products, but it viewed them to be appropriate because of the additional level of complexity inherent in securitisation positions compared to such other investment products.[52]

In recommendation nine, the EBA opined that the current sanctions consisting of additional risk weights and administrative penalties are adequate. Pursuant to Article 407 of the CRR, an additional risk weight is imposed in situations where an investment does not meet either the retention, due diligence or disclosure requirements in accordance with Article 409 of the CRR in a material respect by reason of the omission or negligence of the investing institution, resulting in higher regulatory charges for the investor in respect of the securitisation investment.[53]

Finally, in its last recommendation, the EBA noted, after reviewing the new risk retention requirements in the United States, that there are significant inconsistencies between the jurisdictions. It supports the IOSCO peer review which was launched in Spring 2014 to assess the implementation of the G20 commitments at a global level and to encourage further convergence between regimes. The EBA noted that if the EU regime and the Final U.S. Rule are not harmonised, it may "drive a real wedge" in the global securitisation markets and may further reduce the potential for EU issuers to benefit from the global investor base and the potential for EU investors to benefit from global securitisation investments.[54]

Application of Risk Retention Requirements to Other EEA Investors

Requirements similar to the CRR Retention Requirement are expected to become applicable to investments in CLOs by other types of EEA investors, such as insurance and reinsurance undertakings (when Solvency II comes into force) and by funds requiring authorisation under the UCITS Directive (once level 2 measures are adopted under the UCITS Directive[55]). Risk retention requirements are also applicable to alternative investment funds, the managers of which are regulated under Article 17 of the Alternative Investment Fund Managers Directive.[56]

Conclusion

There are important differences between the risk retention regimes in effect in the EEA and in the United States which may make it difficult for a CLO to comply with both regimes. The EBA Report was published after the Final U.S. Rule and, therefore, the EBA had an opportunity to recommend changes that would harmonise the EU requirements with the U.S. risk retention requirements. Although the EBA Report expressed support for such harmonisation in its recommendations, it rejected adoption of changes that would have made Article 405 more consistent with the Final U.S. Rule. In a similar vein, many CLO market participants and trade associations submitted comment letters to the Agencies before the Final U.S. Rule was promulgated, suggesting that the Final U.S. Rule should be consistent with the EU risk retention requirements that were already in effect, but the Agencies largely ignored these comments. Nonetheless, some CLOs are already being structured in ways which purport to be compliant with both regimes.

There continue to be efforts to make risk retention less of a burden on the CLO market. Litigation pending in the United States courts seeks a ruling that the risk retention requirements in the Final U.S. Rule as applied to CLOs are invalid.[57] There have also been (as yet unsuccessful) efforts in the U.S. Congress to amend Section 15G to reduce risk retention requirements for CLOs. Although the EBA Report failed to recommend significant reductions in risk retention requirements for CLOs, the European Commission did issue in February 2015 a Consultation Document on criteria for "high quality securitisations", seeking information which might lead to "modification" of risk retention requirements for at least some types of CLOs in the EU.[58]

Endnotes

1 Craig Stein & Paul Watterson, CLOs: An Expanding Platform, *International Comparative Legal Guide to: Securitisation 2013* (6th ed.), at 9 (note 2 and associated text).

2 Craig Stein & Paul Watterson, CLO 3.0: The Impact of Regulations, *International Comparative Legal Guide to: Securitisation 2014* (7th ed.), at 9.

3 Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 941 (2010).

4 The U.S. federal banking regulators comprise the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency of the Department of the Treasury, the Department of Housing and Urban Development and the Federal Housing Finance Agency.

5 See *infra* note 18 and associated text for definition of "originator".

6 Credit Risk Retention, 76 Fed. Reg. 24090 (29 April 2011).

7 Credit Risk Retention, 78 Fed. Reg. 57928 (20 September 2013).

8 Credit Risk Retention, 79 Fed. Reg. 77602 (24 December 2014).

9 But see *infra* "Refinancings, Re-Pricings and Additional Issuances".

10 Credit Risk Retention, *supra* note 8, at 77742.

11 *Id.*

12 *Id.*

13 *Id.* at 77741.

14 *Id.* at 77659.

15 *Id.* at 77741.

16 *Id.*

17 FASB issued new guidance in February 2015 (Accounting Standards Update No. 2015-2) which modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities or voting interest entities, and which eliminates the presumption that a general partner should consolidate a limited partnership. Therefore, a CLO manager should review with its accountants whether it (or its holding company) has a "controlling financial interest" in an affiliate

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(or in the CLO manager, in the holding company context) in light of this new guidance.

18 Credit Risk Retention, *supra* note 8, at 77741.

19 *Id.* at 77752.

20 RTS, *infra* note 34, at Art. 3 Sec. 4.(b), 2014 O.J. L 174/19.

21 Credit Risk Retention, *supra* note 8 at 77750. The lead arranger of a CLO-eligible loan tranche must have taken the largest allocation, and an initial allocation of at least 20 per cent, of the aggregate principal balance at origination.

22 *Id.* at 77751.

23 *Id.* at 77750. An "open market transaction" is defined as either: (1) an initial loan syndication transaction or a secondary market transaction in which a seller offers senior, secured syndicated loans to prospective purchasers in the loan market on market terms on an arm's-length basis, which prospective purchasers include, but are not limited to, entities that are not affiliated with the seller; or (2) a reverse inquiry from a prospective purchaser of a senior, secured syndicated loan through a dealer in the loan market to purchase a senior, secured syndicated loan to be sourced by the dealer in the loan market.

24 *Id.*

25 *Id.* at 77756.

26 *Id.* at 77753.

27 *Id.* The prohibition on hedging does not include hedging of interest rate risk or foreign exchange risk or taking positions in an index of instruments so long as the share of any securities included in such index that were issued in conjunction with the CLO for which the risk retention position is required is below specific thresholds prescribed in the Final US Rule.

28 *Id.*

29 *Id.* at 77742.

30 *Id.* at 77763.

31 REGULATION (EU) NO 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. L 176/1.

32 See DIRECTIVE 2013/36/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, 2013 O.J. L 176/424.

33 CRR, *supra* note 31, at Art. 404-410, 2013 O.J. L 176/237-240.

34 COMMISSION DELEGATED REGULATION (EU) No 625/2014 of 13 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council by way of regulatory technical standards specifying the requirements for investor, sponsor, original lenders and originator institutions relating to exposures to transferred credit risk, 2013 O.J. L 174/16.

35 CRR, *supra* note 31, at Art. 405, 2013 O.J. L 176/238.

36 *Id.* at Art. 406, 2013 O.J. L 176/238. *See also* Art. 404, 2013 O.J. L 176/237.

37 *Id.* at Art. 407, 2013 O.J. L 176/239.

38 *Id.* at Art. 14 Sec. 2., 2013 O.J. L 176/31.

39 CRR, *supra* note 31, at Art. 405, 2013 O.J. L 176/238.

40 *Id.*

41 *Id.* at Art. 4(1)(13), 2013 O.J. L 176/19.

42 *Id.* at Art. 409, 2013 O.J. L 176/239.

43 RTS, *supra* note 34, at Art. 23, para. 2.(c), 2014 O.J. L 174/25.

44 European Banking Authority, EBA report on securitisation risk retention, due diligence and disclosure (22 December 2014), available at https://www.eba.europa.eu/documents/10180/534414/Securitisation+Risk+Retention+Report.pdf.

45 *Id.* at Sec. 2.1.1.

46 *Id.* at Sec. 2.1.2.

47 *Id.* at Sec. 2.1.3.

48 *Id.* at Sec. 2.1.4 (i).

49 *Id.* at Sec. 2.1.4 (ii).

50 *Id.* at Sec. 2.1.4 (iii).

51 *Id.* at Sec. 2.2.3.

52 *Id.* at Sec. 2.3.1.

53 *Id.* at Sec. 2.4.1.

54 *Id.* at Sec. 2.5.2.

55 DIRECTIVE 2009/65/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), 2009 O.J. L 302/32.

56 Section 5 of Chapter III of the COMMISSION DELEGATED REGULATION (EU) No 231/2013 of 19 December 2012 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, 2013 O.J. L 83/36. *See also* DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, 2011 O.J. L 174/26.

57 *The Loan Syndications and Trading Association v. Securities and Exchange Commission*; Board of Governors of the Federal Reserve System, Docket No. 14-1240 (D.C. Cir., filed Nov. 10, 2014).

58 Available at http://ec.europa.eu/finance/consultations/2015 securitisation/docs/consultation-document_en.pdf.

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