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Securitisation 2019

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PREFACE

On behalf of Latham & Watkins, I would like to thank Global Legal Group for their efforts in publishing the 12th edition of *The International Comparative Legal Guide to: Securitisation*.

Maintaining an accurate and up-to-date guide regarding relevant practices and legislation in a variety of jurisdictions is critical, and the 2019 edition of this *Guide* accomplishes that objective by providing global businesses, in-house counsel, and international legal practitioners with ready access to important information regarding the legislative frameworks for securitisation in 26 individual jurisdictions.

The invitation to participate in this publication was well received by the world's leading law firms, thereby validating the continued growth and interest in securitisation around the world. We thank the authors for so generously sharing their knowledge and expertise, and for making this publication so valuable a contribution to our profession. The *Guide*'s first 11 editions established it as one of the most comprehensive guides in the practice of securitisation. On behalf of Latham & Watkins, I am delighted to serve as the *Guide*'s contributing editor and hope that you find this edition both useful and enlightening.

Sanjev Warna-kula-suriya
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CLOs in the Current Regulatory Environment

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Introduction

Since the 2008 financial crisis, securitisation transactions, including collateralised loan obligation ("CLO") transactions, have been the subject of several regulations in the United States, the European Union and throughout the world. These regulations continue to evolve over time as regulators and industry participants assess the effectiveness of such regulations and the markets react to the ever-changing regulatory landscape. This article discusses significant updates to certain major regulations affecting CLOs.

The EU Securitisation Regulation

General

On January 1, 2019, the EU Securitisation Regulation[1] (the "Securitisation Regulation") came into effect in the European Union. It applies to securitisations, including CLOs, issued on or after January 1, 2019. The Securitisation Regulation repealed the securitisation provisions in the Capital Requirements Regulation ("CRR"), Solvency II Delegated Regulation ("Solvency II"), and the Alternative Investment Fund Managers Directive ("AIFMD"), and replaced them with a new regime. The "indirect" approach to risk retention, and investor due diligence obligations applicable to banks, insurers, and alternative fund managers under CRR, Solvency II and AIFMD, respectively, continue in the new regime and are extended to new categories of institutional investors in the EU, such as pension funds and undertakings for collective investments in transferable securities ("UCITS"). The Securitisation Regulation also introduced new "direct" risk retention and transparency obligations applicable to originators, sponsors, original lenders, and securitisation special purpose entities. In addition, the Securitisation Regulation introduced the rules for securitisation transactions labelled as simple, transparent and standardised ("STS") securitisations.

Risk Retention[2]

Under the CRR, Solvency II and AIFMD, the rules imposed the obligations to comply with the risk retention requirements only on the investors in securitisations – the "indirect" approach. There was no "direct" obligation on the risk retainer to retain. Under the Securitisation Regulation, originators, sponsors and original lenders now also have obligations to retain – the "direct" approach. EU investors will still be obligated to ensure that their investments comply with risk retention. Thus, both the "direct" and "indirect" approach are in effect. This means that EU originators and sponsors will need to satisfy the risk retention requirements even where there is no requirement from investors, i.e., when all investors are non-EU entities.

There has been no change to the 5 per cent retention requirement. The retention holder must retain a material net economic interest of 5 per cent using one of the permitted retention methods. The five accepted methods of retention also have not changed – vertical slice, originator share, random selection, first loss on a portfolio basis and first loss on an asset-by-asset basis.

The entities that are eligible to retain are still the originator, sponsor or original lender. However, the Securitisation Regulation specifies that an entity is not considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures. An originator will need to establish that it has a "broader business enterprise". The regulatory technical standards ("RTS") provide that the originator must demonstrate the capacity to meet payment obligations consistent with a broader business enterprise (involving material support from capital, assets, fees or other income available to the entity, disregarding any securitisation assets and income), that it has responsible decision makers with the required experience to enable it to pursue the business strategy, and that it has an adequate corporate governance arrangement.

The Securitisation Regulation also contains an adverse selection test. It prohibits originators from intentionally securitising assets which are more likely to suffer losses than comparable assets held on its balance sheet. All originators, sponsors and original lenders will be required to apply the same sound and well-defined criteria for credit granting to exposures to be securitised as are applied to exposures held on their balance sheet. An originator which purchases a third party's exposures for its own account and then securitises them is required to verify that the original lender also met such credit granting criteria.

Transparency

Article 7 of the Securitisation Regulation contains new disclosure requirements. Originators, sponsors and securitisation special purpose entities ("SSPEs") must make available to investors, competent authorities and potential investors, specific information on the transaction and the underlying assets. Public transactions must disclose the information to a securitisation repository or, if no securitisation repository exists, on a website that meets specific requirements. Private transactions are not required to disclose information publicly to the securitisation repository or website, but must make a transaction summary available to investors, competent authorities and potential investors.

Full transaction documentation, including a prospectus where required or deal summary where a prospectus is not required, loan level data, investor reports, and reports of any significant events and material amendments must be provided to investors, competent authorities and potential investors. The Securitisation Regulation requires the use of specific templates for loan level data and investor reporting. The transaction documentation and prospectus or deal summary must be provided before pricing, and the loan level data and investor reports provided on a quarterly basis.

Due Diligence

Due diligence requirements under the old regulations were imposed on credit institutions, investment firms, alternative investment fund managers, insurers and reinsurers. The Securitisation Regulation expands the requirement to UCITS management companies, internally managed UCITS and pension funds. Such institutional investors investing in CLO securities must perform due diligence on the loan portfolio of the CLO and the entities involved in the CLO. They will also need to establish written procedures for monitoring loan portfolio performance and compliance by the originator, sponsor or original lender of the securitisation with risk retention requirements. Such investors will be required to confirm that all information required to be disclosed to investors has been disclosed.

Application of Transparency Requirements to Non-EU CLOs

It is unclear whether or not originators, sponsors and SSPEs that are not established in the EU are subject to the Article 7 Transparency Requirements. The territorial scope of Article 7 is not specified. However, since the Securitisation Regulation took effect, a market consensus has developed that the "direct" obligations of Article 7 are not intended to apply to transactions where none of the originator, sponsor or SSPE is an EU entity. This view is based on the statement in the explanatory memorandum that accompanied the original proposal for the Securitisation Regulation that "indirect" obligations were not intended to apply where the originator, sponsor or original lender is not established in the EU, as well as the textual interpretation of the investor due diligence obligations in Article 5. The market view is less uniform in respect of the "indirect" application of these requirements. In the absence of further guidance from EU regulators, some EU institutional investors may decline to invest in non-EU CLOs, unless the non-EU issuer, originator, or sponsor of such a CLO assumes the obligation to make Article 7 information and reports available.

Japan Financial Services Agency Amendments to Capital Adequacy Requirements for Banks and Other Regulated Financial Institutions with Respect to Securitisations

General

In December 2018 and January 2019, the Financial Services Agency of Japan ("JFSA") published proposed amendments to the JFSA's notices on standards for banks and certain other entities regulated by the JFSA (collectively, the "JFSA Regulated Investors") to determine capital adequacy.[3] These proposed amendments were published in final form in March 2019 with additional guidance in the form of frequently asked questions ("FAQs") and responses to public comments (together with the FAQs and the final form of amendments, the "FSA CA Amendments").[4]

Application of FSA CA Amendments

The FSA CA Amendments impose punitive regulatory capital risk weighting charges upon a JFSA Regulated Investor's[5] investments in securitisations (a "Securitisation Investment") unless:

i. the JFSA Regulated Investor has established a system for obtaining information regarding the comprehensive risk profiles, assets and structure of the Securitisation Investment in a prescribed manner (the "JFSA CA Securitisation Information Requirements");[6] and

ii. either (A) the originator, or another permitted entity, such as the originator's parent company or an arranger that was sufficiently involved in the organisation of the Securitisation Investment (a "JCA Risk Retention Holder"), retains (i) an equal portion of each tranche issued in the securitisation (a "Vertical Interest"), the total amount of which is not less than 5 per cent of the aggregate exposure to the assets underlying the securitisation (the "Securitisation Assets"), (ii) an interest in the most junior tranche issued in the securitisation (a "Horizontal Interest"), the total amount of which is not less than 5 per cent of the aggregate exposure to the Securitisation Assets, or (iii) a combination of a Vertical Interest and a Horizontal Interest, the total amount of which is not less than 5 per cent of the aggregate exposure to the Securitisation Assets, if the most junior tranche in the securitisation is less than 5 per cent of the aggregate exposure to the Securitisation Assets and the JCA Risk Retention Holder retains 100 per cent of the most junior tranche (the "JCA Risk Retention Interest"),[7] or (B) the JFSA Regulated Investor acquiring the Securitisation Investment determines that the Securitisation Assets were not inappropriately originated.[8]

Under the FSA CA Amendments, a JCA Risk Retention Holder may not hedge its JCA Risk Retention Interest.[9]

The JFSA provided guidance in the form of FAQs and responses to public comments with respect to the determination of whether the assets underlying a securitisation were not inappropriately originated. The FAQs also described alternative forms of credit risk retention, such as the random selection of the underlying assets for the Securitisation Investment from a pool of assets continuously retained by the originator.[10] If no JCA Risk Retention Holder acquires and retains a JCA Risk Retention Interest, and the originator does not otherwise retain credit risk pursuant to a permitted alternative credit risk retention method, then, in order to avoid a punitive regulatory risk weighting capital charge in connection with the Securitisation Investment, a JFSA Regulated Investor must perform a detailed analysis of the Securitisation Assets to determine whether the Securitisation Assets were not inappropriately originated. If the Securitisation Assets are loans, including loans purchased in the open market by a CLO, the JFSA Regulated Investor may perform an analysis of whether the Securitisation Assets were not inappropriately originated by reviewing objective materials to assess (1) the originator's underwriting criteria, (2) covenants for creditor protection, (3) the collateral and terms of the Securitisation Assets, and (4) the ability to collect claims on the Securitisation Assets.[11]

Effect of FSA CA Amendments on Securitisation Investments

Participants in the securitisation markets expect the FSA CA Amendments to result in increased diligence requests from JFSA Regulated Investors, even if a JCA Risk Retention Holder retains a JCA Risk Retention Interest in an amount sufficient to satisfy the JFSA's capital adequacy standards. The criteria for determining that Securitisation Assets for different types of Securitisation Investments were not inappropriately originated are likely to evolve over time for different categories of Securitisation Assets. In addition, the JFSA CA Securitisation Information Requirements will likely result in additional investor reporting requirements on a continuing basis, and it remains to be seen whether this additional reporting will impose a material administrative burden on CLO managers and trustees or conflict with confidentiality requirements.

The FSA CA Amendments do not say that a majority-owned affiliate may satisfy applicable risk retention holding requirements in the same way that a majority-owned affiliate may satisfy credit risk retention requirements under the final rule ("U.S. Risk Retention Rules") implementing Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank

Act"). However, originators might be able to satisfy risk retention holding requirements under both the FSA CA Amendments and the Securitisation Regulation, and depending on their ownership, these also may be majority-owned affiliates for purposes of the U.S. Risk Retention Rules. If a majority-owned affiliate acquires a risk retention interest under the U.S. Risk Retention Rules, but not as a permitted JCA Risk Retention Holder, a JFSA Regulated Investor could separately consider this as a factor when performing its analysis of whether the Securitisation Assets were not inappropriately originated.

In 2018, the U.S. Risk Retention Rules were determined by U.S. courts not to be applicable to collateral managers of "open-market CLOs";[12] and, even though the U.S. Risk Retention Rules remain in effect for Securitisation Investments issued by other types of structured finance entities, including the category of CLOs referred to as balance sheet CLOs, the sponsors of those structured finance transactions to which the U.S. Risk Retention Rules still apply may prefer to retain a risk retention interest through a majority-owned affiliate. Because several JFSA Regulated Investors have been important participants in the U.S. CLO market, very often as anchor investors in the highest rated tranches, it would be beneficial for a market standard to develop for loans "not inappropriately originated".

Impact of the Volcker Rule on CLOs

General

Section 619 of the Dodd-Frank Act (commonly referred to as the "Volcker Rule")[13] prohibits a "banking entity"[14] from acquiring or retaining an "ownership interest"[15] in, or "sponsoring", any "covered fund".[16] Five U.S. federal "bank" regulatory agencies (the SEC, CFTC, Federal Reserve, FDIC and OCC, collectively, the "Agencies") adopted regulations in December 2013 implementing the Volcker Rule (the "Final Rule"),[17] which are now in effect. The Final Rule aims to promote safety and soundness in the financial system by restricting commercial banks and affiliates from engaging in risky investment banking activity.

The Final Rule excludes certain investments that would otherwise fall under the Volcker Rule's purview based on the rationale that such investments pose low risks to commercial bank depositor funds and, in fact, benefit capital markets. One such exclusion carves out a loan securitisation that does not hold securities (other than short-term cash equivalents and securities received *in lieu* of debts previously contracted with respect to the loans) or structured products (other than an interest rate or foreign exchange derivative that directly relates to the underlying loans) in its portfolio ("Loan Securitisation Exclusion")[18] from the definition of "covered fund", therefore permitting banking entities to invest in securities issued by these loan securitisations. Many CLOs qualify for the Loan Securitisation Exclusion by eliminating or restricting the issuer's ability to purchase high-yield bonds and other debt instruments (including, for example, letters of credit) that may not meet the definition of a "loan" under the Volcker Rule.

If a CLO does not qualify for the Loan Securitisation Exclusion, it can avoid treatment as a "covered fund" under the Volcker Rule by qualifying for the Rule 3a-7 exemption from registering with the U.S. Securities and Exchange Commission under the Investment Company Act of 1940 (the "1940 Act"), instead of the exemption under Section 3(c)(7) of the 1940 Act, which CLOs typically utilise. Rule 3a-7 imposes restrictions on the manager's discretion in managing the portfolio of loans, making the exemption unavailable to many actively managed CLOs.

Banking entities may be permitted to invest in the debt issued by CLOs that are "covered funds" and that do not qualify for the Loan Securitisation Exclusion by structuring the debt in which these entities invest such that it does not meet the definition of "ownership interest" under the Volcker Rule. These debt classes would not have the right to vote to remove or replace the CLO manager.

Banking entities cannot own notes or equity issued by a CLO that does not qualify for one of the above discussed exemptions. U.S. congressmen, banks and industry associations have lobbied the bank regulatory agencies to revise the Final Rule so that it does not affect bank ownership of CLO notes or at least grandfathers CLOs that were transacted prior to 2014. The Structured Finance Industry Group ("SFIG"), the trade industry advocacy group focused on the structured finance and securitisation markets, also criticised the complexity of the rule, citing burdensome costs associated with determining the impact of the Final Rule on securitisations.[19] In response to calls to simplify and tailor compliance requirements under the Volcker Rule, the Agencies proposed revisions to the Final Rule in July 2018.

Notice of Proposed Rulemaking Revising the Final Rule

On July 17, 2018, the Agencies issued a notice of proposed revisions ("Notice")[20] to the Final Rule and requested comments on the same. The Agencies also solicited feedback from the industry on securitisations in Questions 176–180 in the Notice. Question 176 focused on the Final Rule's "covered fund" definition exclusions, including the Loan Securitisation Exclusion, and asked how the Agencies could make the provisions more effective or modify the exclusions to address concerns about how they work in practice. Questions 177–178 focused specifically on the loan securitisation exclusion and the types of assets a CLO should be permitted to hold while qualifying for the Loan Securitisation Exclusion. Questions 179–180 focused on the definition of "ownership interests" in the context of loan securitisations and specifically asked about concerns that such interests include "other similar interests" in addition to equity and partnership interests.

Industry Reaction to the Notice

SFIG and other industry participants submitted comment letters in response to the Notice. SFIG in particular detailed three primary issues that proposed revisions should address in the rule: (1) the definition of a "covered fund" captures vehicles not targeted by the purpose of the Volcker Rule; (2) the Loan Securitisation Exclusion fails to facilitate many common securitisation structures; and (3) the definition of "ownership interest" is too broad and ambiguous.[21]

A final revised Volcker Rule is expected by the end of the year. However, the Agencies may re-propose the rule before issuing a final rule.

The LSTA Decision and CBOs

The U.S. Risk Retention Rules were issued in 2014 and became effective on December 24, 2016 with respect to asset-backed securities collateralised by assets other than residential mortgages. Except with respect to asset-backed securities transactions that satisfy certain exemptions, the U.S. Risk Retention Rules generally require one of the "sponsors" (or its majority-owned affiliate) of the asset-backed securities to retain not less than 5 per cent of the credit risk of the assets collateralising asset-backed securities. Under the U.S. Risk Retention Rules, a "sponsor" is a person who organises and initiates a securitisation transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. The sponsor (or its majority-owned affiliate) is generally prohibited from directly or indirectly eliminating or reducing such credit risk by hedging or otherwise transferring the retained credit risk.[22]

The regulators charged with implementing the U.S. Risk Retention Rules indicated in the adopting release that with respect to open-market CLO transactions, where a collateral manager, among other things, selects assets for a securitisation issuer to purchase from a variety of different sellers, they would view the collateral manager of a CLO to be the sponsor. A recent decision of the U.S. Court of Appeals for the D.C. Circuit held, however, that the U.S. Risk Retention Rules do not apply to collateral managers of open-market CLOs ("Appellate Court Ruling"). The Appellate Court Ruling was based in part on the understanding that in an open-market CLO, the collateral manager does not actually originate or hold any of the securitised assets at any point but rather directs the securitisation issuer to purchase them from market participants.[23]

The Appellate Court Ruling only discussed in limited detail the characteristics of an open-market CLO and did not address securitisations in which the assets are not syndicated bank loans. Therefore, there is uncertainty as to how a relevant governmental authority would apply the Appellate Court Ruling to collateralised bond obligation ("CBO") transactions where the assets include corporate bonds. We believe, however, that if the underlying factors that formed the basis of the Appellate Court Ruling are present in a securitisation transaction, then the nature of the underlying assets should not be dispositive. In other words, if a CBO transaction would otherwise meet the open-market CLO criteria described in the Appellate Court Ruling but for the fact that the underlying assets are not loans but are instead corporate bonds, the CBO manager should not be deemed to be the sponsor of the CBO required to comply with the U.S. Risk Retention Rules.

Conclusion

Regulations imposed with respect to investments in securitisations have generally been intended to ensure that securitised assets are properly and purposefully originated. However, even if the goals of the regulators are generally consistent, navigating the securitisation market (and the CLO market in particular) has become much more complex in recent years because of the different approaches adopted by regulators for different jurisdictions. This has caused some issuers to avoid certain markets altogether. At least for the near future, it appears unlikely that the different jurisdictions will harmonise their regulations.

Endnotes

1. Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No. 648/2012.
2. For a summary of the prior rule, see Craig Stein & Paul N Watterson, Jr., CLO 3.0: The Impact of Regulations, *The International Comparative Legal Guide to: Securitisation 2014* (7th ed.), at 9.
3. The proposed amendments to the notices may be found at https://www.fsa.go.jp/news/30/ginkou/20181228_3.html and https://www.fsa.go.jp/news/30/ginkou/20190109_1.html.
4. The final versions are available at https://www.fsa.go.jp/news/30/ginkou/20190315-1.html.
5. Article 248(3) of the Notice of the Financial Services Agency No. 19 of 2006 ("Notice"). For convenience we refer in these endnotes only to the notice applicable to banks as an example, although a separate notice is published for other types of JFSA Regulated Investors.
6. Article 248(1) of the Notice.
7. Article 248(3) of the Notice.
8. Article 248(3) of the Notice.
9. Article 248(3) of the Notice.
10. Article 248-Q2(1) of the FAQs.
11. Article 248-Q2(2) of the FAQs.
12. *Loan Syndications and Trading Ass'n v. SEC*, No. 17-5004 (D.C. Cir. February 9, 2018).
13. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 619 (2010).
14. The term "banking entity" means any insured depository institution, any company that controls an insured depository institution, or that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.
15. The term "ownership interest" includes equity or partnership interests and "other similar interests". The term "other similar interests" includes, without limitation, certain specified characteristics including a right to select or remove a manager of a covered fund, share in the income, gains or profits of a fund or to otherwise possess economic rights similar to that of an equity holder.
16. The term "covered fund" includes any issuer that would be an investment company as defined in the Investment Company Act of 1940 (the "1940 Act") but for Sections 3(c)(1) or 3(c)(7) of the 1940 Act and that is not otherwise excluded from the definition of covered fund under the Volcker Rule.
17. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5808 (January 31, 2014).
18. The Final Rule specifically exempts loan securitisations that are asset-backed securities whose assets are comprised solely of loans, "servicing" assets, and interest or foreign exchange derivatives that directly relate to the underlying loans.
19. Letter by the Structured Finance Industry Group, September 21, 2017 at 2.
20. Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 137 (July 17, 2018).
21. Letter by the Structured Finance Industry Group, October 17, 2018 at 2–3.
22. See Craig Stein & Paul N Watterson, Jr., CLOs and Risk Retention, *The International Comparative Legal Guide to: Securitisation 2015* (8th ed.), at 8.
23. *Id.*

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