EU Commission Report on the Functioning of the EU Securitisation Regulation – Considerations for the CLO Market

By Dasha Sobornova, Deborah M. Festa, Ezra Zahabi, Sarah H. Mischner and Andrew W. Keller

5 December 2022

Key Points:

- The European Commission ("EU Commission") has published its report on the functioning of the EU Securitisation Regulation which contains the EU Commission's assessment of a number of key aspects of the regulation.
- The main impact for the collateralized loan obligation (CLO) market is the extraterritorial reach of the investor due diligence requirements around reporting.
- The EU Commission has directed the European Securities and Markets Authority (ESMA) to (1) review and simplify the current form of the reporting templates and (2) create a separate set of reporting templates for private securitisations, which will apply to virtually all European Union (EU) and United States (US) CLOs.

On 10 October 2022, the EU Commission has published a report[1] addressed to the European Parliament and Council on the functioning of the EU Securitisation Regulation (EU SR)[2] pursuant to its obligation under Article 46 of the EU SR (the "Report"). The EU Commission's views carry significant weight since it was the driving force behind the concept, and the text, of the EU SR.

Investor Due Diligence Requirements in Relation to Non-EU Transactions

Article 5(1)(e) of the EU SR requires EU investors to verify "where applicable" that certain disclosures and periodic reports required by Article 7 of the EU SR have been provided (and will be provided on an ongoing basis), however whether or not this requirement extends to transactions where neither the issuer nor the retention holder is an EU entity remained unclear until now. In the absence of any guidance from the EU regulators, the market has formed a view that this requirement was not applicable to non-EU transactions, and therefore, EU investors could invest in US CLOs where just the usual trustee reports are provided to all investors.

In the Report, the EU Commission confirms that the legislative intent behind Article 5(1)(e) was to ensure that all EU investors receive the same information in order to allow them to perform proper due diligence before making an investment decision, and so it was not appropriate to interpret Article 5(1)(e) in a way that allows to "[differentiate] the scope of the information to be provided depending on whether the securitisation is issued by EU entities or by entities based in third-countries"[3]. This gives a clear message to the market that any new US CLOs will have to provide the Article 7 reporting in order to be considered EU SR compliant. US CLO managers with active EU platforms will be able to capitalise on the operational arrangements already in place for their EU deals and minimise any additional cost and time required to set up the Article 7 reporting for their future US transactions. It may allow such managers to attract more EU investors in the short term if they are able to make the necessary arrangements ahead of their competitors that do not operate in Europe and therefore may take longer to get fully set up.

The EU Commission also notes in the Report that the market has interpreted the requirements of Article 5(1)(e) differently, but does not provide a view on whether live deals that have followed the market view should be grandfathered. Even though the clarification provided by the EU Commission is not new law, but rather a confirmation of the intent behind the current law, it creates a new sense of uncertainty for EU investors that are holding positions in US CLOs issued since January 2019 when the EU SR came into force.

The Report confirms the EU Commission's view that, despite Article 5(1)(e) being phrased to apply to (the originator, sponsor or SSPE) "where applicable", the obligation applies to non-EU entities. The EU Commission separately confirmed its view that the requirements under Article 5 apply also to non-EU AIFMs marketing funds to investors in the EU.

The investor due diligence requirements for all relevant investors are contained in Article 5 of the EU SR, and in some cases reflected in sectoral legislation. For example, the Alternative Investment Fund Managers Directive (AIFMD)[4] provides that where an Alternative Investment Fund Managers (AIFM)[5] is exposed to a securitisation that no longer meets the requirements provided for in the EU SR, it shall act in the best interest of the investors and "take corrective action, if appropriate". This means that AIFMs have certain discretion with respect to this issue. We expect that AIFMs will be considering a number of factors in connection with each holding affected by the EU Commission's statements in the Report, from the availability of alternative investment options to the recent performance of the portfolio underpinning every affected investment. There is no similar discretion expressly offered to credit institutions under the Capital Requirements Regulation (CRR)[6]. Generally speaking, where a regulatory authority considers an investor to have breached the requirements under the EU SR, it may impose penalties, including fines or restitution orders to make whole clients or investors who have suffered loss as a result of a breach.

Each type of EU investor that is subject to the EU SR should review their portfolios and consider the best option to address this issue in each case.

Live US CLO Transactions

The EU Commission's statement is problematic for any live US CLOs. Any EU investor looking to invest in a US CLO needs to satisfy its due diligence obligations before purchasing the notes as well as on an ongoing basis. Article 7 requires that the asset level and investor reports are provided on the required templates for each payment date since the start of the transaction[7] and also requires certain information to be provided *before* pricing the transaction (mainly transaction documents in the near final draft form)[8]. We expect that virtually all existing US CLOs marketed to EU investors prior to the date of the Report would have relied on the market interpretation of Article 5(1)(e) which means that these Article 7 requirements would not have been followed.

Whilst US CLO managers are not under a direct legal obligation to provide the Article 7 reporting[9], some managers are now exploring the possibility of making such reporting available for their live deals. This will provide some comfort to EU investors already invested in such deals, but ultimately it is for those investors to determine whether it will be appropriate to continue holding such investments. This specific point has not been addressed by the EU Commission in the Report or confirmed by any EU regulator to date.

Any new EU investor looking to invest in existing US CLO transactions needs to verify that the asset level and investor reports have been provided on the required templates for each payment date since the start of the transaction, which, again, is unlikely to be the case. This means that any new EU investors are unlikely to be able to satisfy their EU SR due diligence requirements in respect of such deals.

Reporting Templates Update and New Private Securitisation Reporting Templates

The Report sets out the EU Commission's views on the content and usability of the reporting templates. The EU Commission acknowledges that some of the asset level reporting fields are difficult to complete and that some of the information is unnecessary and does not help investors in assessing their potential investments. The EU Commission has invited ESMA to review the templates and directed it to consider potentially deleting problematic fields or amending them in order to align the templates with the investors' needs[10]. This is a welcomed move, although there is no clear guidance as to the timing of this review or when the new templates are likely to become effective.

The Report contains a separate section discussing "private securitisations". Whilst this term is not defined in the EU SR, the distinction between private and public securitisations becomes important in the context of the Article 7 reporting. A securitisation is considered "private" if no prospectus has been drawn up in compliance with the EU Prospectus Regulation[11]. US and European CLO transactions are usually structured in a way that exempts them from the requirement to produce a EU Prospectus Regulation compliant prospectus, which makes them private transactions for the purposes of the EU SR. Currently the same set of reporting templates applies to private and public securitisations; however, in the Report the EU Commission invites ESMA to draw up a set of templates specifically for private securitisation transactions[12]. The market participants have advocated for simplified reporting templates for some time now so this is a positive development. As with the updates to the current templates, the EU Commission did not set a deadline for ESMA to draft these new templates.

For US CLO managers that intend to market to EU investors, this means that the operational arrangements being put in place in order to provide the Article 7 reporting will need to be updated in the future, and potentially more than once if ESMA simplifies the current templates before drafting the private securitisation templates. Whilst this will create additional operational burdens in the future, the cost is unlikely to be significant once the initial set-up is affected.

Divergence Between the EU and UK Investor Due Diligence Requirements Around Reporting

As the United Kingdom (UK) investors are no longer subject to the EU SR[13], the EU Commission's views in the Reports are not directly applicable. The UK SR imposes different investor due diligence requirements around reporting depending on whether the issuer and the retention holder of a securitisation are established in the UK[14] or in a third country[15] (including any EU member state).

As widely discussed in the market, the UK version of these investor due diligence requirements is also problematic and gives rise to some uncertainty. Whilst the UK regulators will have regard to any EU non-legislative materials[16], such as the Report, His Majesty's Treasury (the "HM Treasury") has produced an equivalent report pursuant to its obligation under Article 46 of the UK SR[17] in which it has stated that it and the UK regulators will seek to clarify what kind of disclosures are required for securitisations where the issuer and the retention holders are established outside of the UK, which may suggest that the full template reporting[18] will not be required in order for a transaction to be considered UK SR compliant. This means that the two regimes may diverge on this point in the future, and, if so, CLO managers will have to ensure that each group of investors is provided with the relevant information and reporting.

Conclusion

The views of the EU Commission on the investor due diligence requirements around reporting (Article 5(1)(e) of the EU SR) provide much needed clarity, but its interpretation of this requirement is not what the market participants were hoping for. The EU Commission has effectively disagreed with the market view, which has in turn put EU investors holding notes in live US CLOs in an uncertain position. It also means that US CLO managers

will have additional administrative and operational burdens, which some may decide not to take on if the benefits cannot outweigh the time and cost required.

Whilst one of the main aims of the EU SR is to protect EU investors and ensure that they carefully consider any potential investment, by the EU Commission's own admission the immediate effect of its comments in the Report is that for the time being these investors are cut off from a number of markets, which puts them at a competitive disadvantage when looking to diversify their portfolios or improve yield. The prospect of simplified reporting templates (and separate private securitisation templates) goes some way to soften the blow, but it remains to be seen how quickly ESMA will respond with its proposals, and how many US CLO managers will be prepared to take on the additional obligations to attract EU investors.

If you have questions about this client alert, please contact any Akin lawyer or advisor below:

Dasha Sobornova
dasha.sobornova@akingump.com
+44 20.7661.5486

Deborah M. Festa
dfesta@akingump.com
+1 310.229.1030

Ezra Zahabi
ezra.zahabi@akingump.com
+44 20.7661.5367

Sara H. Mischner
smischner@akingump.com
+1 212.872.8048

Andrew W. Keller
akeller@akingump.com
+1 310.229.1020

[1] The Report can be found here: **https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2022:517:FIN**

[2] 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, as amended.

[3] para 11.2 (*Buy-side obligations – availability of disclosures*) of the Report, the EU Commission's assessment section.

[4] 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.

[5] The Report contains a separate section on AIFM investors at para 11.3 (*Buy-side obligations – AIFM investors*).

[6] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012.

[7] See Art 7(1) of the EU SR – "information…shall be made available simultaneously each quarter at the latest one month after the due date for the payment of interest…".

[8] See Art 7(1) of the EU SR regarding which information needs to be provided before pricing.

[9] Whist the EU Commission did not explicitly confirm this interpretation, this is clear from its comments at para 11.1 (*Sell-side obligations*) of the Report, the EU Commission's assessment section.

[10] para 5 (*Due diligence and transparency*) of the Report, the EU Commission's assessment section

[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] para 6.2 (*Sufficient Information for investors and supervisors on private securitisations?*) of the Report, the EU Commission's assessment section

[13] UK investors are subject to the provisions of the EU SR, as it forms part of UK domestic law by virtue of the European Union (Withdrawal) Act 2018, as amended by the Securitisation (Amendment) (EU Exit) Regulations 2019 and as further amended (the "**UK SR**").

[14] See Article 5(1)(e) of the UK Securitisation Regulation

[15] See Article 5(1)(f) of the UK Securitisation Regulation

[16] FCA's statement "Brexit: our approach to EU non-legislative materials" can be found here: **https://www.fca.org.uk/publication/corporate/brexit-our-approach-to-eu-non-legislative-materials.pdf**

[17] HM Treasury's "Review of the Securitisation Regulation: Report and call for evidence response" can be found here: **https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1040038/Securitisation_Regulation_Review.pdf**

[18] UK reporting templates largely track the EU SR reporting templates, and can be found here: **https://www.handbook.fca.org.uk/techstandards/SR/2020/reg_del_2020_1224_oj.pdf**