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THE EU SECURITIZATION REGULATION – CONSIDERATIONS FOR US ISSUERS, ORIGINATORS AND SPONSORS

The European Union (**EU**) Securitization Regulation (the "**Securitization Regulation**"), which replaces previously sectoral securitization rules and provides a harmonized regime, took effect on January 1, 2019. Unlike the US securitization rules, EU law continues to impose significant compliance obligations on certain EU regulated entities that invest in securitizations. As a result, US securitizers offering asset-backed securities to EU institutional investors may be indirectly affected by the Securitization Regulation's requirements.

We have recently published a briefing that provides a detailed overview of this new regime, which is available here, as well as a briefing that discusses application of this new regime in more detail, which is available here. In this briefing, we consider the main elements of the Securitization Regulation relevant to US issuers, originators and sponsors, and what compliance under the Securitization Regulation would mean for their transactions.

Key issues

- Harmonized EU securitization regulation became effective on January 1, 2019 and imposes compliance obligations on additional types of EU institutional investors in securitizations.
- There is a continuing debate on whether EU institutional investors are required to ensure non-EU institutions are complying with the Article 7 transparency requirements.
- Currently, significant portions of the Securitization Regulation (including the risk retention, due diligence and the transparency requirements) fully apply to all branches and affiliates of EU banks and investment firms world-wide, on a consolidated basis.

BACKGROUND AND SCOPE

The Securitization Regulation repeals the main securitization provisions in sectoral legislation applicable to banks (the Capital Requirements Regulation, or "**CRR**"), insurers (Solvency II) and fund managers (the Alternative Investment Fund Managers Directive regime and, collectively, the "**Old Securitization Framework**"). It replaces those provisions with a new regime applicable to all institutional investors (which now includes UCITS and pension funds) and originator/sponsor-type entities (whether or not regulated). In addition, it introduces the concept of a "simple, transparent and standardised" (or "**STS**") securitization, and STS securitizations will receive better regulatory treatment than other securitizations.

For purposes of the Securitization Regulation, a "securitization" is a transaction involving tranched credit exposure to an asset or pool of assets. A "securitization position" is an exposure to a securitization, but does not have to be in the form of a security. Equivalent US regulations, by contrast, apply only when asset-backed securities are issued and do not include tranching among the criteria used to determine which transactions are regulated as securitizations. To the extent that a transaction does not involve multiple tranches of asset-backed securities, it could be regulated as a securitization for US regulatory purposes but would not be considered in-scope for purposes of the Securitization Regulation. Furthermore, certain asset-backed credit arrangements not involving the issuance of securities may be considered securitizations for purposes of the EU regime but not the US regime.

Unlike any of the prior securitization rules that it replaces, the Securitization Regulation provides that originators, sponsors, original lenders and issuers will be subject to severe penalties (including fines of up to 10% of annual net turnover on a consolidated basis) for non-compliance. Furthermore, as a result of concurrent amendments to other provisions of the CRR, these securitization rules now appear to apply fully to all branches and affiliates of EU banks and investment firms world-wide, on a consolidated basis.

The Securitization Regulation applies to transactions where securitization positions are created on or after January 1, 2019 and generally does not apply to pre-existing securitizations unless new securities are issued, or new securitization positions are created on or after January 1, 2019.

CONSIDERING THE SECURITIZATION REGULATION IN THE CONTEXT OF NON-EU TRANSACTIONS

When is compliance required?

The jurisdictional scope of the Securitization Regulation is not formally limited and defined. Since it was officially published in December 2017, however, the market appears to have developed a consensus that the jurisdictional application of the Securitization Regulation should be thought about in terms of transaction parties rather than transactions. The Securitization Regulation will need to be considered where any party to a transaction (notably, originator, sponsor, original lender, issuer or investor) is in-scope. A party is in-scope if it is subject to supervision by a national regulator designated under Article 29 of the Securitization Regulation. Because this is a market consensus approach, rather than an approach set out in the text, a certain amount of uncertainty remains. This is a matter that has been repeatedly raised with regulators by industry representatives and it is hoped that it will be resolved by guidance in one form or another, although it is the view of some regulators that the jurisdictional application is a matter for the primary legislators and not something that can be resolved through a regulatory interpretation.

Expanded definition of EU institutional investors

Article 1(2) of the Securitization Regulation states that the Securitization Regulation applies to institutional investors. The term "institutional investor" is defined in Article 2(12) by reference to entities that are defined in, or fall under, certain EU Regulations that only apply to EU investors. It therefore seems clear that only institutional investors that are established or located in the EU ("**EU institutional investors**") will be required to comply with the Securitization Regulation with respect to their investment activities.

The universe of institutional investors has been significantly expanded by the Securitization Regulation to include new investor classes not previously subject to any securitization related obligations. The Old Securitization Framework only applied to EU-regulated banks (including investment firms), EU-regulated insurers (including reinsurers) and alternative investment fund managers ("**AIFMs**") either established in the EU or with a full EU passport. Under the Securitization Regulation, three additional investor categories are now also in-scope:

- EU pension funds (and the investment managers who manage their assets);
- UCITS funds (whether self-directed or UCITS management companies); and
- non-EU AIFMs that manage and/or market alternative investment funds in the EU (even when they are only marketing into the EU on a private placement basis using so-called "Article 42 registrations")[1].

Direct application of the Securitization Regulation to non-EU originators, sponsors, original lenders or issuers

The Securitization Regulation subjects an originator, sponsor, original lender or issuer involved in a securitization to a raft of obligations regardless of whether they are regulated entities. In general, these obligations will only apply directly where the relevant entity is established in the EU.

There is no requirement (direct or indirect) on any non-EU originator, sponsor, original lender or issuer to comply with the Securitization Regulation if:

- each of the originator, sponsor, original lender or issuer is established and located outside the EU; and
- no EU institutional investor invests in the exposures created by that securitization.

When no EU nexus is envisaged for a transaction, transaction participants should include appropriate disclosure and disclaimers in the relevant offering documents to make clear to all investors that their transaction has not been structured to comply with the Securitization Regulation.

The Securitization Regulation requires EU institutional investors to confirm as part of their regulatory due diligence that any securitization transaction in which they invest complies with relevant requirements. As a result, the

[1] Clarification has been sought from ESMA as to whether the definition of "institutional investor" covers any marketing or only marketing based on an AIFMD passport. Until such a clarification is issued, many large non-EU AIFMs are assuming that any marketing, including marketing in reliance on the Article 42 registrations, would be sufficient to bring them into scope.

Securitization Regulation may apply indirectly to non-EU entities to the extent securitization positions are offered to EU institutional investors, as discussed further below.

Voluntary compliance by originators, sponsors, original lenders or issuers

If a US originator, sponsor, original lender or issuer plans to sell securitization exposures to EU institutional investors, these US entities would be indirectly required to comply with the Securitization Regulation, because EU institutional investors are subject to due diligence requirements under Article 5 of the Securitization Regulation. These require EU institutional investors to confirm that any originator, sponsor, original lender or issuer involved in a securitization has complied with specified provisions of the Securitization Regulation – prior to investing in a securitization and on an ongoing basis. Accordingly, US originators, sponsors, original lenders and issuers need to consider the impact of the Securitization Regulation when deciding whether to market to EU institutional investors. Historically, some non-EU originators, sponsors and original lenders voluntarily complied with the Old Securitization Framework in order to make their securitization exposures eligible for purchase by the EU investor base.

Article 5(1) requires institutional investors to verify that:

- originators or original lenders "established in a third country" grant all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes as detailed in the Securitization Regulation;
- the originator, sponsor or original lender will retain, on an ongoing basis, a material net economic interest of not less than 5% in the securitization, determined in accordance with Article 6, and the risk retention is disclosed to institutional investors; and
- the originator, sponsor or issuer has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article (discussed further below).

The next issue to consider is the exact scope of the obligations imposed by the Securitization Regulation on non-EU originators, original lenders, sponsors or issuers – this is where there is currently some debate and uncertainty in the market.

Application on a consolidated basis

The amendments to the CRR that accompanied the Securitization Regulation require EU-established credit institutions and investment firms to apply a significant portion of the Securitization Regulation on a consolidated basis. These include the risk retention, transparency and due diligence obligations discussed above, as well as a prohibition on any resecuritizations (i.e. any securitization of securitization exposures). Together, they represent a very significant expansion of a previously manageable rule that mainly affected diligence obligations. Although there appears to be a political agreement to amend this rule in a way that would largely reinstate the *status quo ante*, the problematic version currently applies. Until the amendments are finally adopted and become effective (which is potentially several months away), this rule puts EU banks and investment firms with securitization operations (including trading activity) in the US and other non-EU countries in a difficult position, and entities that are part of an EU banking group will still need to take special care when engaging in securitization activities, even where there is no other EU nexus to the transaction.

In practical terms, we expect most institutions will choose to engage with their principal prudential regulators and seek comfort that they can rely on the fact that the current version of the rule was never intended (as evidenced by the political agreement to change it), and carry on largely with business as usual. However, there is no assurance that this comfort will be provided.

What does compliance under the Securitization Regulation actually mean for a US transaction?

Risk retention – Article 6

A US originator, sponsor or original lender seeking to market securitization exposures to EU institutional investors would need to comply with the risk retention obligations set out in Article 6. This Article broadly requires the relevant entity to retain on an ongoing basis 5% risk retention in the transaction. Pursuant to Article 5(1)(d), an EU institutional investor would not be able to invest in any non-EU transaction unless the risk retention obligations set out in Article 6 are complied with and disclosed to the institutional investor (see below).

The risk retention level of 5% and the five retention methods under the old regime remain largely unchanged under the Securitization Regulation, so the 5% risk retention rule under the Securitization Regulation will be familiar to most active US originators and sponsors.

Transparency and disclosure requirements – Article 7

Arguably the most significant change under the Securitization Regulation for the "sell-side" is the introduction of Article 7, which requires EU originators, sponsors and issuers to comply with extensive transparency and disclosure obligations (the "**Transparency Requirements**"). It includes the following enhanced reporting requirements:

- *Providing key underlying documentation to investors pre-pricing*: Originators, sponsors and issuers must make available all underlying documentation that is essential for understanding the transaction, including a prospectus (or where there is no prospectus, a transaction summary) prior to a transaction being priced and must designate amongst themselves one entity to fulfil the disclosure requirements (the "**reporting entity**") and who is the primary point of contact in respect of the Transparency Requirements.
- *Asset-level disclosure and investor reports:* Originators, sponsors and issuers must provide asset-level portfolio disclosure and investor reports (in each case using prescribed templates) on an ongoing basis. These templates have yet to be finalized, although on February 1, 2019, the

European Securities and Markets Authority ("**ESMA**") published revised draft regulatory technical standards which contain the latest draft reporting templates[2] (the "**Revised RTS**"). This is the latest development following ESMA's controversial announcement that private securitization transactions would have to report in substantially the same format (including line-by-line disclosure templates for loan-level data and investor reporting) as public securitizations.

- *Inside information and significant events*: Any inside information relating to the securitization that the reporting entity is obliged to make public under the Market Abuse Regulation, and significant events for transactions which are subject to the Market Abuse Regulation regime will also need to be reported under Article 7. The Revised RTS attempts to clarify the applicability of the "inside information" and "significant event" templates to reduce market confusion about when each is to be used.

In addition, public transactions (i.e. where a prospectus is required to be published under the Prospectus Directive) are required to disclose information to a regulated securitization repository or (where no such repository exists) on a website meeting certain prescribed standards. Private transactions have slightly more leeway, in that there is no prescribed mechanism for disclosure provided that investors, competent authorities and, upon request, potential investors can access information.

As a result of the more prescriptive requirements under Article 7, one of the key interpretive issues for both EU institutional investors seeking to invest in US securitizations, and US originators, sponsors and issuers seeking to market securitizations to EU institutional investors is the extent to which US transactions must comply with the Article 7 disclosure and reporting requirements as a result of the application of Article 5(1) to EU institutional investors. Unfortunately, the application of the Transparency Requirements to EU institutional investors regarding non-EU entities is not settled, and this is discussed further below.

To what extent do the Article 7 disclosure and reporting requirements apply to US transactions?

Article 5(1)(e) of the Securitization Regulation ties together:

- the obligations of EU institutional investors to conduct due diligence under Article 5; and
- the obligations of originators, sponsors and issuers to provide information to investors under Article 7.

The interpretation of this provision is therefore central to any analysis of the applicability of Article 7 to non-EU transactions. The text of Article 5(1)(e) states that institutional investors must verify that "an originator, sponsor or issuer has, *where applicable* [emphasis added], made available the information required by Article 7 in accordance with the frequency and

2 See https://www.esma.europa.eu/sites/default/files/library/esma33-128-600_securitization_disclosure_technical_standards-esma_opinion.pdf

modalities provided for in that Article." The use of the words "where applicable" in Article 5(1)(e) has been interpreted in different ways by market participants, which has led to divergent views as to whether Article 7 applies to non-EU transactions.

There also appears to be some uncertainty as to what compliance would entail for non-EU transactions, assuming that Article 7 applies. That is, whether a non-EU transaction would:

- have to follow the Article 7 requirements in their entirety, including with respect to the form and content of the reports; or
- be able to comply by providing the information that investors would need to verify pursuant to the due diligence requirements of Article 5, while not complying with the technical requirements of Article 7, such as the form of the reports.

This uncertainty has been made particularly acute by the position of ESMA that both private and public (i.e. listed on an EU main exchange) transactions need to use prescribed data templates; the issue would be less of a concern if the templates only applied to public transactions. In the absence of guidance and clarification from the regulators, the market has yet to adopt a consensus approach on these issues.

The textual interpretations of Article 5(1)(e)

Some have argued that the use of the words "where applicable" in Article 5(1)(e) can be textually interpreted to mean that Article 7 is not applicable to non-EU originators, sponsors or issuers at all (the "**first textual interpretation**"). The basis for this argument is that EU institutional investors:

- need not check that Article 7 disclosure obligations are complied with by non-EU originators, sponsors and issuers, because these entities would technically be outside the jurisdiction of the EU and therefore not subject to the Securitization Regulation itself (subject to the consolidation issue mentioned above); and
- are only required to verify compliance with Article 7 by entities to which Article 7 actually applies (i.e. originators, sponsors or issuers established in the EU) rather than in all cases.

This interpretation effectively excludes US and other non-EU entities from needing to comply with the Article 7 due diligence and reporting requirements, even when the transaction is being marketed to EU institutional investors.

The other textual interpretation of the "where applicable" wording in Article 5(1)(e) is that it simply clarifies that an EU institutional investor must determine the type of information that it would need to receive from the originator, sponsor or issuer in order to evidence its compliance with the Article 5 due diligence requirements, because the Article 7 requirements differ between private and public transactions and for specific asset classes. Market participants who favor this interpretation are of the view that non-EU originators, sponsors or original lenders would indirectly be caught by Article 7 as long as there are EU institutional investors in their transactions, because EU institutional investors would ultimately only be able to invest in securitizations that comply with the Article 7 transparency requirements.

Considering the policy impact of the first textual interpretation

Although an argument can certainly be made using the first textual interpretation that EU investors are not required to due diligence non-EU securitizations, this would seem to be at odds with the policy objectives of the diligence obligations and the Securitization Regulation in general.

The underlying policies cited in the recitals to the Securitization Regulation include:

- the need to ensure that EU investors are subject to proportionate due diligence requirements (so that they could properly assess the risks and make an informed assessment on the creditworthiness of a given securitization instrument);
- enhancing market transparency; and
- revitalizing the European securitization market.

With these policy objectives in mind, it seems unlikely that the regulators and policymakers intended the Securitization Regulation to be interpreted in such a way as to allow an EU investor to undertake less than the required due diligence and obtain less disclosure on non-EU securitizations than would be required for an investment in an EU securitization of the same type of asset. The first textual interpretation also pre-supposes that the national regulators who have supervisory oversight over EU institutional investors would accept a reduced level of due diligence by EU institutional investors in respect of non-EU securitizations. As we know, EU investors did suffer significant losses on securitizations by non-EU originators during the 2008 global financial crisis.

On the other hand, it is also clear that the fields for data templates were not designed for data from non-EU originators. This points again to the main policy issue being the position of ESMA that the templates must be used for all transactions whether private or public. If private (i.e. not listed on a main EU exchange) transactions did not need to use prescribed templates, the different policy considerations could be reconciled by non-EU originators being required to provide enough information to EU investors to enable them to undertake their required due diligence but not require use of prescribed methods for private deals which are problematic for non-EU originators to provide.

Practical approach and next steps

Although clarification has been sought from the authorities, this process will undoubtedly take time. Due to the political nature of the Securitization Regulation, we do not expect that the European Supervisory Authorities (ESMA, the European Banking Authority and the European Insurance and Occupational Pensions Authority, collectively the "**ESAs**") will provide substantial formal guidance without first carefully considering the wider policy implications of doing so. Even if the ESAs or national regulators issue guidance, it would be non-binding in nature as neither the ESAs (individually or collectively) nor the national regulators have the power to suspend the application of the regulation or issue US-style "no action" letters. It is also unlikely that any person affected would ultimately look for the point to be clarified judicially by the Court of Justice of the European Union.

Market participants should therefore take an informed, pragmatic view when considering which approach to adopt. An investor that is directly impacted by Article 5 should make a considered assessment regarding its overall approach to compliance with the Article 5 requirements with respect to non-EU transactions, in consultation with its internal compliance/legal functions, and where appropriate, external advisors and national regulators, because the investor will ultimately need to be confident that it has complied with its own due diligence requirements prior to investing in any non-EU transactions. Non-EU originators, original lenders and sponsors will need to balance two opposing considerations when structuring their transactions:

- the ability for EU institutional investors to acquire and hold the securitized exposures (which could be an issue of secondary market transferability, even where the securitized exposures will initially be marketed to investors that are not EU institutional investors); and
- potential operational challenges to demonstrating compliance with Article 7 of the Securitization Regulation.

Regardless of the specific circumstances of a transaction, EU institutional investors will need to have internal policies regarding how they approach compliance to demonstrate that they have considered the issues and adopted a consistent, reasoned approach. This will be helpful in demonstrating good faith and due diligence should regulators seek to challenge whatever approach is eventually taken with respect to diligencing compliance with the Transparency Requirements. US originators, original lenders and sponsors will therefore find that their own approach to the Article 7 transparency requirements may be dictated largely by their investors and potentially made subject to contractual as opposed to regulatory obligations.

Conclusion

The Securitization Regulation has significantly expanded the universe of entities subject to the EU securitization rules and correspondingly the universe of transactions that will need to conform. Unfortunately, this expansion in scope has been accompanied by uncertainty as a result of the new framework becoming effective well before all necessary secondary regulations were complete and before ambiguous provisions in the Securitization Regulation could be clarified by regulators and policymakers. We remain hopeful that more clarity will develop in the coming months as market participants develop consensus approaches, and regulators and policymakers take steps to finalize key elements of the regime that remain incomplete.

For the time being, market participants (whether on the buy-side or sell-side) should take an informed, pragmatic view and consider the changes introduced by the Securitization Regulation in the context of individual transactions and also on a broader organizational level, and should put in place robust compliance processes for in-scope securitizations and internal written policies which set out a consistent approach to assessing whether compliance is necessary.

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