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BREXIT AND SECURITISATION: THE RUBBER HITS THE ROAD[1]

The UK formally left the EU on 31 January 2020, but the Brexit implementation period delayed most of the practical effects of that until after 31 December 2020 ("**IP completion day**"). A month into the new regime, we examine how securitisation markets are changing in response to this new reality, offer solutions to some of the issues that have come up and identify key areas where market practice has yet to settle.

Key issues

- The end of the Brexit transition period resulted in a major shift in the regulatory environment affecting European securitisation markets.
- A great deal of work was done in the months leading up to 1 January to ensure the UK had a complete and operational regulatory framework.
- Markets have avoided major disruption but are still working through the implications of the new regulatory landscape.
- Current issues to deal with arise from transitional issues, the creation of separate EU and UK regimes, and from changes to the onshored UK Securitisation Regulation.
- The UK and EU Securitisation Regulations are likely to continue gradually to diverge, so market participants will need to keep monitoring both regimes on a continuous basis.

LEGISLATIVE BACKGROUND

Recent developments

As recently as the last few months of 2020, large areas of uncertainty remained in respect of how securitisation markets would operate after IP completion day. Thanks to hard work by regulators and good cooperation with various industry bodies, a great deal of progress was made before that deadline, however. This, in turn, has led to a much more complete and workable framework of onshored rules for operating a securitisation market in the UK.

Some of the key outputs were a series of statutory instruments cleaning up small but important bits of the main onshoring instrument for the Securitisation Regulation (e.g. replacing references to "exit day" with references to "IP completion day"), onshoring instruments relating to a large number of regulatory and implementing technical standards, transitional directions from both the Financial Conduct Authority and the Prudential Regulation Authority exercising their temporary transitional powers (the "**TTP**") in a very broad way, and guidance on the treatment of EU non-legislative materials that were not formally onshored by the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**"). The result of this approach was a UK framework that differed relatively little from the EU framework and – where there were differences – compliance with the new UK rules could in many cases be delayed until 31 March 2022.

The much anticipated EU-UK Trade and Cooperation Agreement signed on 30 December 2020 made little or no practical difference to these arrangements,

[1] A version of this client briefing is due to be published as a feature article in the March edition of the Journal of International Banking and Financial Law.

as it did not make any meaningful arrangements for cooperation in the area of financial services. These may be the subject of further agreement to be set out in a Memorandum of Understanding the EU and the UK are negotiating and aim to agree by March 2021 (the "**FS MoU**"), but the scope of any FS MoU is expected to be relatively limited and deal mainly with things like equivalence determinations (for which there is currently no legislative framework under the Securitisation Regulation in either jurisdiction).

The outcome of the above is a European market spanning two very similar but separate regulatory regimes in the EU and in the UK. We set out below a few of the key current differences between the regimes that may affect market participants' approaches to structuring and marketing their deals.

Key differences between the EU and the UK regimes

Simple, transparent and standardised (STS) securitisations

The first and most obvious difference between the regimes is to do with their approaches to STS. Each jurisdiction requires certain entities to be established within its own borders. The EU requires an EU originator, sponsor and SSPE (or issuer), whereas the UK requires only a UK originator and sponsor. This means that, in principle, it is not possible for a single transaction to achieve STS status in both jurisdictions. That said, the transitional provisions in the UK mean that any transaction listed by ESMA as STS for EU purposes will also receive STS treatment in the UK for those with securitisation exposures, provided that deal was notified to ESMA as being STS on or before 31 December 2022.

The reverse, however, is not true. Transactions that achieve STS status under the UK STS regime do not benefit from any transitional relief and will not be treated as STS by the EU. The result is that – at least for now – EU STS transactions have the competitive advantage of being eligible for STS treatment for those with securitisation exposures (and therefore lower capital charges) in both jurisdictions, where UK STS transactions do not.

Investment in third country transactions

One of the significant sources of uncertainty under the EU Securitisation Regulation since it was first implemented has been the so-called "5(1)(e)" problem. Under Article 5(1)(e) of the EU Securitisation Regulation, institutional investors are required to verify that the sell side has "where applicable" made available the information required by Article 7 of the EU Securitisation Regulation. Since this provision came into force, market participants have been seeking clarification about what this provision requires of investors investing in third country securitisations. A lack of official guidance has led to a range of differing compliance practices. On the most conservative end of the spectrum, some investors have been interpreting this as requiring them to check that third country originators are providing disclosure strictly according to EU standards. On the most permissive end of the spectrum, it has been interpreted as requiring nothing (because Article 7 is not "applicable" to third country sell-side entities), meaning that investing is allowed provided other aspects of Article 5 diligence can be met. A pragmatic middle ground approach has also emerged requiring substantial compliance in the light of the wider due diligence aims of Article 5. This uncertainty – and the accompanying diversity of compliance practices – remains in the EU post Brexit.

The UK, however, has sought to clarify the position. Under the UK regime, it is clear that UK institutional investors are only required to check strict

compliance with UK disclosure rules for reporting from UK sell-side entities. The new Article 5(1)(f) in the UK Securitisation Regulation makes clear that getting "substantially the same" reporting from third country entities is sufficient. This is a sensible and pragmatic approach. Moreover, while the meaning of "substantially the same" is not completely clear, there appears to be a consensus among English law securitisation practitioners that the EU and UK reporting requirements are currently sufficiently similar as to be considered "substantially the same" for these purposes.

The net result of this difference remains unclear. The UK rules are currently more certain, but could potentially prove less permissive than the EU rules (assuming the latter are resolved on the more permissive end of the scale). The possibility of the EU rules being clarified in a way that would make them more permissive is not outlandish – indeed, doing exactly this was one of the key recommendations of the High Level Forum on the Capital Markets Union[2], which means it may well be included in the legislative proposal contemplated by Article 46 of the EU Securitisation Regulation, which is due by 1 January 2022.

Sponsor definitions

Similar to the 5(1)(e) issue, the definition of "sponsor" has been the subject of considerable uncertainty in the EU for some time. More particularly, there has been a question of whether a third country investment firm was capable of being a sponsor under the EU Securitisation Regulation. Unlike the 5(1)(e) issue, this uncertainty has led to a fairly uniform market response – with the overwhelming majority of market participants appearing to take the conservative position of assuming that third country investment firms are not eligible to act as sponsors in the absence of official guidance to the contrary.

As with the 5(1)(e) issue, the UK chose to use the onshoring process under the Withdrawal Act to clarify the position. In the UK Securitisation Regulation, a sponsor is clearly defined to include in investment firm "whether located in the United Kingdom or in a third country".

The result of this difference is mainly to provide additional flexibility for UK institutional investors, who are able to recognise risk retention by a third country investment firm sponsor as valid for the purposes of their due diligence exercises. EU institutional investors on UK securitisation transactions, on the other hand, have a difficult call to make and have to take some regulatory compliance risk if they wish to invest in a securitisation with a third country investment firm sponsor as the risk retainer.

The TTP and other transitional relief

Finally, as a general matter, transitional Brexit relief came to an end in the EU on IP completion day. EU market participants were, from 1 January of this year, expected to begin treating the UK as a third country. A number of EU Member States made transitional arrangements specific to institutions located within their borders, but there is no general and expansive EU-wide transitional relief available after 31 December 2020.

Conversely, the UK has a wide range of transitional relief that continues to be available. Some of the reliefs are relatively short term. The TTP falls into this

[2] See p. 54 of the report (available here:https://ec.europa.eu/info/news/cmu-high-level-forum-final-report_en) where the HLF invites the Commission to "[a]llow an EU-regulated investor in third-country securitisations to determine whether it has received sufficient information to meet the requirements of Article 5 of Regulation (EU) 2017/ 2402 to carry out its due diligence obligation proportionate to the risk profile of such securitisation."

category, as it expires on 31 March 2022. Under the TTP, most regulatory requirements under the Securitisation Regulation can be met on the basis of complying with the "old" EU version of the obligation (e.g. reporting on EU templates rather than the new UK versions) until that date. The obligations excluded from this flexibility are generally excluded for practical reasons (e.g. applications for registration as a securitisation repository have to be done to the FCA on its form – an application to ESMA on its form cannot be substituted for that – for obvious reasons).

Other forms of transitional relief do not have set expiration dates and instead amount to grandfathering transactions done before a certain date; this is the case with STS treatment of EU transactions as described above.

In addition to those mentioned above, there are a number of other forms of transitional relief that do not specifically contemplate securitisation transactions but nonetheless help to smooth their path. These include the temporary permissions regime (which permits EU financial institutions who had relied on EU passports pre-Brexit to continue operating in the UK while they apply for UK authorisations), the financial services contracts regime (which assures the continuity of legacy financial contracts where a counterparty is no longer authorised in the UK post-Brexit) and transitional relief relating to the Benchmarks Regulation (which permits UK regulated entities to continue using EU-registered benchmarks for several years post Brexit), all of which play a role in avoiding cliff-edges for key elements of the financial infrastructure underpinning securitisation transactions. These reliefs are designed to wind down at different rates over a period of years, allowing sufficient time for UK market participants to adapt to the new realities.

MARKET RESPONSE

Despite this wide-ranging transitional relief – and not least because there is no EU equivalent to it – the market has already started to adapt. We set out below some of the practical ways in which the market is currently responding to the new regulatory landscape, as well as some of the consequences that arise from the existence of parallel, but very much separate, regimes.

Dual compliance

Not surprisingly, the UK and EU securitisation markets were and remain highly intertwined. While relatively few public transactions are cross-border in the sense of having sell-side entities (originators, sponsors and issuers/SSPEs) in both jurisdictions, it is common for EU investors to invest in UK transactions and *vice versa*. For that reason, many market participants are concerned to preserve the ability for investors in each jurisdiction to be able to invest in transactions offered from the other. As both the EU and UK's Securitisation Regulations have a system of sell-side obligations mirrored by a buy-side obligation to conduct due diligence to check compliance, this functionally means that sell-side entities are often asked to offer assurances in some form as to compliance with both regimes.

Dual compliance models

The responses from sell-side entities to these requests remain varied, and no market standard has yet emerged. The options for responses, however, typically take one of the following forms:

- *No assurance*: In this case, sell-side entities simply refuse to comment on whether they are complying with the regime that does not apply directly to them. This does not necessarily preclude investment from the other jurisdiction. In particular, UK investors with the benefit of the "substantially the same" standard described above may find it easier to invest in EU securitisations under these conditions than more conservative EU investors who do not have the benefit of that clarity. To some extent this reflects the pre-IP completion day approaches of EU and UK investors to investing in securitisations from third countries such as the US or Australia, particularly when those transactions were not specifically designed to be marketed to EU or UK investors.
- *Full dual compliance*: In this scenario, the sell-side entities comply with their home jurisdiction's regime and agree in the deal documentation effectively to comply with the other jurisdiction's requirements such that institutional investors in the other jurisdiction will be assured of being able to fulfil their regulatory due diligence obligations both at the time of initial investment and over time, even if the EU and UK regimes diverge.
- *Day 1 assurances*: This is a middle ground between the previous two options. With this approach, sell-side entities give a representation that their transaction complies with both regimes on day 1, but thereafter undertake only to comply with their home regime. To the extent the EU and UK regimes diverge after the deal has been sold, investors take the risk that that divergence may cause issues fulfilling their ongoing regulatory due diligence obligations.

A number of factors play a role in determining the approach taken on each transaction, including whether it is public or private, the overall strength of demand for the originator or sponsor's paper, the relative commercial strengths of the buy and sell sides on the transaction, originator governance concerns around the process for complying with two regimes, the extent to which the originator/sponsor expects anyway to have to comply with both regimes due to broader institutional factors, and the expected volume of investment from the relevant jurisdiction. From the limited market evidence available to date, all three approaches have been adopted and it remains far too early to call anything a market standard approach. Indeed, until the full range of types of originator – for example a private equity-backed portfolio financing or a large commercial bank regular issuer – have accessed the market post-IP completion day it will not be possible to make meaningful assertions as to the preferred market position and it may be the case that the market settles into a position of accepting that the standard varies depending on which type of originator is involved.

In all cases where any form of dual compliance is agreed, it is important in the documentation to take special care with the language employed, always remembering to distinguish between the regulatory obligations that apply directly to the sell-side entities on the one hand and obligations they are contracting into on the other. For example, references to complying with "all applicable laws" will not be sufficient, since the EU Securitisation Regulation is not "applicable" to a UK originator and *vice versa*.

Market participants will also need to consider carefully what type of comfort (e.g. risk retention analysis) they expect from the lawyers on the transaction. In general, lawyers qualified only in EU Member States will not feel able to comment on the application of the UK Securitisation Regulation. Conversely, English-qualified lawyers did not magically lose their knowledge of EU law on

1 January 2021, and many will feel able to give some degree of comfort on EU law matters, even without the involvement of continental colleagues – although this will generally not extend to the application of EU law in any specific Member State. There may be limitations to this kind of comfort – including questions of whether any such advice could remain privileged, for example. There may also be situations in which market participants want the extra assurance of advice endorsed by lawyers in the specific Member State(s) whose competent authorities are most relevant to their transactions. Thus far it would appear that many market participants on English law-governed transactions have been able to get comfortable on the basis of comfort provided solely by English lawyers.

Brexit risk factors

Up until IP completion day, most public transactions included some form of a Brexit risk factor. These had become relatively standardised, with a familiar menu of themes given a particular emphasis based on the specifics of the transaction. Following IP completion day, Brexit is a current practicality and no longer a source of possible future risk. It is therefore our view that standalone Brexit risk factors are no longer appropriate. Instead, tailored risk factors identifying any continuing issues for the specific transaction should be considered. In doing so, transaction parties should bear in mind that a number of the risks inherent in Brexit (e.g. change in law, political risk, risks of sovereign downgrades and counterparty risks) will already be covered in other standard risk factors included in securitisation offering documents. The best approach may be to enhance existing disclosure by, e.g. highlighting increased risks to cross-channel supply chains on auto securitisations, rather than including whole new risk factors.

Once again, it is too early for the market to have settled on an approach, but based on early evidence it would appear that the market is moving in the direction outlined above, with most transactions at least updating and severely cutting down on pre-IP completion day standalone Brexit risk factors, and a number have already dispensed with them entirely.

Securitisation repository reporting and Brexit

The issue of reporting to securitisation repositories has thus far been a slightly theoretical one. At the time of writing, no securitisation repository has yet been authorised in either the EU or the UK, despite the fact that the EU Securitisation Regulation has been applicable now for over 2 years. Nonetheless, grandfathering from the obligation to report to a repository applies only to pre-2019 transactions so there is now a large body of securitisations outstanding that contain language contemplating the need to immediately start reporting to a repository once one is authorised. In the run up to IP completion day (and since then) a certain number of market participants have defaulted to the idea that they should be reporting public transactions to securitisation repositories in both the EU and in the UK. From the point of view of strict legal requirements, this position will almost always be incorrect.

The obligation to report to a repository is limited to "public" securitisations, i.e. those securitisations where there is a regulatory obligation to publish a prospectus. Since securitisations are almost always offered on a wholesale (and therefore exempt) basis, functionally that obligation arises for securitisations only where there is an admission to trading on an EEA or UK

(as the case may be) regulated market. Accordingly, the obligation to report to a repository may arise in the UK or the EU, but virtually never in both.[3]

Indeed, because the jurisdictional reach of the EU and UK Securitisation Regulations generally only extends to sell-side entities established in the relevant jurisdiction, a number of transactions will not formally have the obligation to report to a repository in either jurisdiction, despite being admitted to trading on a regulated market. This will be true where a UK transaction (that is, where all of the sell-side entities are in the UK) is listed on a regulated market in the EU, a situation common for UK RMBS transactions. In this case, no obligation to publish a prospectus arises in the UK because there is no admission to trading in the UK. An obligation to publish a prospectus arises in the EU because of the admission to trading there, but the obligation to report to a repository that arises under the EU Securitisation Regulation does not have the territorial scope to extend to a UK entity. The same logic works in reverse, with EU sell-side entities and a UK listing, although this situation is much less common. It remains to be seen whether originators in this situation decide to use a securitisation repository in one jurisdiction or the other on a voluntary basis for investor-facing reasons or otherwise.

CONCLUSION

The markets are very much still adapting to the realities of Brexit, and no doubt further issues will arise, both from the existence of separate but near-identical regimes (as with repository reporting) and – gradually over time – from the divergence of the EU and UK Securitisation Regulation regimes.

It is apparent that the two regimes will diverge in some respects – indeed this has already begun as part of the onshoring process. Nevertheless, given their common roots in the EU Securitisation Regulation, we think it unlikely that the fundamental principles underlying the regimes will diverge considerably, even as the detailed implementation of those principles may move apart.

A few areas to note include the potential for differences in risk retention rules because the relevant technical stndards were not made by the EU in time to be onshored in the UK. In addition, the EU also has modifications to its Securitisation Regulation entering their final stages as part of the Capital Markets Recovery Package, which introduces rules better adapted for securitisations of non-performing exposures and an STS regime for synthetic securitisations. As at the time of writing, the UK has not indicated any intention to mirror these changes.

Finally, both the EU and the UK have legislated requirements to review their respective regimes by 1 January 2022. Based on the (admittedly limited) evidence available thus far, neither jurisdiction will be aiming for the regimes to diverge, but nor will they be trying especially hard to avoid that outcome. While the FS MoU may help with keeping the underlying principles of the regimes broadly aligned, it will continue to be necessary to monitor both the EU and the UK securitisation regulatory frameworks. Doing so will help ensure the requirements of both are met, thereby permitting the continued involvement of both EU and UK parties on the same securitisation transactions post-Brexit.

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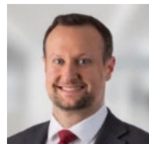
[3] This obligation to report to a repository in both the EU and in the UK would only happen in the very unusual case of a securitisation with a dual listing on two regulated markets, one in the EU and one in the UK – or in the even more unusual case of a non-exempt offer of securitisation paper to the public.

AUTHORS



Andrew Bryan
Knowledge Director

T +44 207006 2829
E andrew.bryan
@cliffordchance.com

Maggie Zhao
Partner

T +44 207006 2939
E maggie.zhao
@cliffordchance.com

CONTACTS

Timothy Cleary
Partner

T +44 207006 1449
E timothy.cleary
@cliffordchance.com

Jose Manuel Cuenca
Partner

T +34 91 590 7535
E josemanuel.cuenca
@cliffordchance.com

Lounia Czupper
Partner

T +32 2 533 5987
E lounia.czupper
@cliffordchance.com

Kevin Ingram
Partner

T +44 207006 2416
E kevin.ingram
@cliffordchance.com

Tineke Kothe
Senior Counsel

T +31 20 711 9146
E tineke.kothe
@cliffordchance.com

Oliver Kronat
Partner

T +49 69 7199 4575
E oliver.kronat
@cliffordchance.com

Jonathan Lewis
Partner

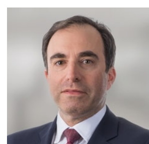
T +33 1 4405 5281
E jonathan.lewis
@cliffordchance.com

Jessica Littlewood
Partner

T +44 207006 2692
E jessica.littlewood
@cliffordchance.com

Emma Matebalavu
Partner

T +44 207006 4828
E emma.matebalavu
@cliffordchance.com



Simeon Radcliff
Partner

T +44 207006 2786
E simeon.radcliff
@cliffordchance.com

Tanja Svetina
Partner

T +39 02 8063 4375
E tanja.svetina
@cliffordchance.com

Christopher Walsh
Partner

T +44 207006 2811
E christopher.walsh
@cliffordchance.com

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www.cliffordchance.com

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