A never ending road

New aspects in the regulation of securitisation

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Introduction

A year ago, things were looking very uncertain and concerning for the world of securitisation and structured debt. The proposed new Basel and EU Solvency II capital rules looked like they were set to significantly increase capital charges for banks and insurers investing in securitisations. Moreover, CRA3 was introducing yet more disclosure requirements that appeared likely to be difficult to comply with and EU risk retention rules were changing yet again, with much of the flexibility in Article 122a and the CEBS Guidelines (later the EBA Guidelines) removed. Looking across the Atlantic, the markets were coming to grips with the Volcker Rule and what it was likely to mean for structured debt both in the US and elsewhere. Against this, there was improved mood music from policymakers and regulators about the importance of securitisation, but this was not being reflected in concrete regulatory response.

The picture this year is brighter, if still mixed. A range of official bodies have made clear their enthusiasm for the idea of "high quality" or "qualifying" securitisation as a building block for making the markets more hospitable to new securitisation issuance. The European Commission's flagship Capital Markets Union initiative includes the promotion of simple, transparent and standardised securitisation as a main policy objective in support of jobs, growth and the real economy. The new Basel securitisation framework is finalised and capital charges are increasing, but it looks like "qualifying" securitisation may reduce the impact of that blow. CRA3 disclosure obligations are onerous, but at least they are (so far as many public transactions are concerned) certain and manageable (albeit with some significant issues for a number of asset classes).

There is still a long list of developments in progress, though. Will ideas of qualifying securitisation be adjusted to allow inclusion of key product areas like ABCP conduits, typical CMBS and synthetics? Will capital rules create a level enough playing field for qualifying securitisation investments against other kinds of exposures to lure investors back into the markets? How will CRA3 disclosure obligations affect private transactions and asset classes where the nature of disclosure under CRA3 is misconceived? Will risk retention rules be adjusted to allow for mutual recognition and substituted compliance?

While the road of regulation on which securitisation market participants travel no longer seems quite so steep, it is still a winding and seemingly never ending one. We hope this latest publication in our New Beginnings series helps you to consider your journey along that road and to be properly equipped for the adventure!

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1. Capital Markets Union – the next big thing?

On 18 February 2015, the European Commission unveiled its long-expected plan to boost funding and growth across Europe by creating a Capital Markets Union (CMU) – a true single market for capital across the 28 EU member states.

The Commission's Green Paper on *Building a Capital Markets Union* aims to stimulate debate on the measures needed to identify and remove the many obstacles standing in the way of a deep and integrated single European capital market.

Two technical consultations, on "simple, transparent and standardised securitisation" and on the Prospectus Directive, were launched alongside the Green Paper. All three consultations closed on 13 May 2015 and the Commission is expected to move forward quickly, with concrete proposals to be published in the coming months.

What is the CMU and what are its main objectives?

Capital Markets Union is a flagship initiative of the European Commission that aims to create a single capital market. This would represent a significant step forward in the practical implementation of a long standing objective of the European Union: the free movement of capital. The CMU project is also a key part of the overall drive by the European Commission to boost jobs and growth.

The CMU initiatives are designed to strengthen cross-border capital flows, improve access to finance for businesses and infrastructure projects across Europe and diversify sources of credit. These component elements aim to reduce the cost of raising capital, particularly for SMEs, and lessen Europe's heavy dependence on the banking system in favour of a larger role for the capital markets in channelling financing to the real economy.

The European Commission's public consultations invited contributions from a broad spectrum of stakeholders as to the challenges facing the CMU project and how best to overcome them. Submissions were due by 13 May 2015 and the European Commission is currently in the process of preparing an Action Plan expected to be ready later in 2015, setting out the actions to be carried out over the next five years. A copy of Clifford Chance's response to the Green Paper is available on our website.

Key obstacles and areas of improvement

Section 2 of the Green Paper provides a preliminary analysis of some of the obstacles to the integration and development of the EU capital markets and identifies three key areas where it is necessary to overcome challenges:

- access to finance, including to risk capital, notably for SMEs
- the flow of institutional and retail investment into capital markets; and
- effectiveness of markets;

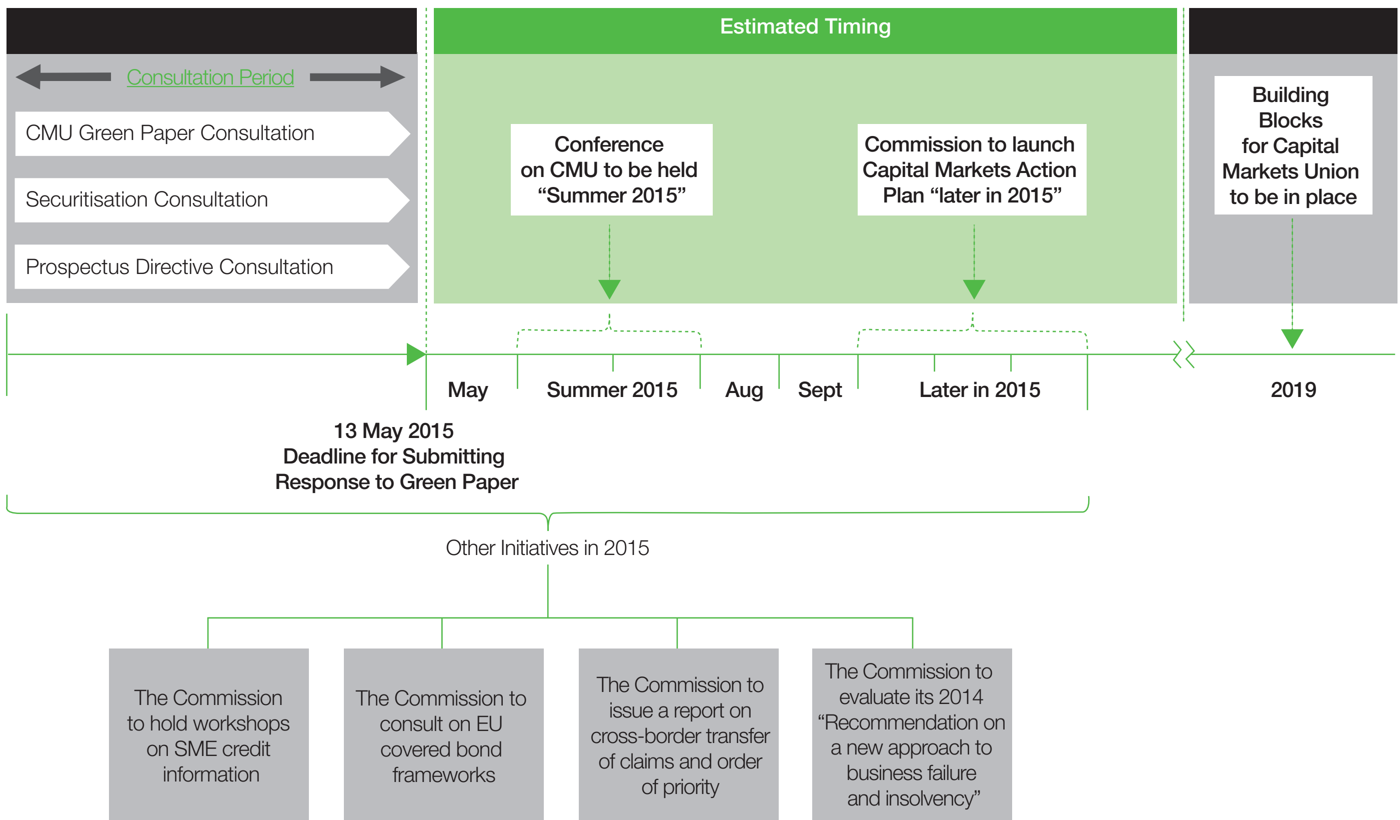
1. Access to finance, including to risk capital, notably for SMEs

Well-functioning equity and bond markets are among the fundamental objectives of the CMU project. In that context, the Green Paper discusses some of the barriers that have impeded access to capital markets, such as insufficient credit information in respect of SMEs, the cost of accessing public capital markets (e.g. the cost of preparing a prospectus, performing due diligence/verification and other complying with regulatory requirements), "short termism" on the part of investors and regulatory barriers which are common in new infrastructure investments.

To address the problems faced by SMEs relating to availability of credit information, the Green Paper suggests that banks should be encouraged to provide better feedback to SMEs whose credit applications are declined and to raise awareness of the alternative sources of funding that might be available. Another suggestion is to develop a simplified, common accounting standard, tailored to companies listed on markets such as multilateral trading facilities, which generally have less onerous listing and disclosure requirements than regulated markets.

The Green Paper further highlights the importance of establishing common

Implementation Timeline



standards and a common set of market rules, transparency on product features and consistent supervision and enforcement.

Finally, specific mention is made in the Green Paper of peer-to-peer lending and crowdfunding as a way of diversifying the sources of finance available within Europe. In this respect, feedback is sought on whether there are barriers to the development of appropriately regulated crowdfunding or peer-to-peer platforms, including on a cross-border basis.

2. The flow of institutional and retail investment into capital markets

The European Commission begins its review of this area by acknowledging the importance of attracting more institutional, retail and international investors to promote the diversification of funding sources.

The Green Paper analyses the role to be played by institutional investors – asset managers, pension funds and insurance companies, private equity and venture capital funds – and discusses some of the barriers that might be impeding investment from these institutions.

For asset managers, one such barrier is compliance costs, including the costs of setting up funds, becoming an authorised manager and selling across borders.

On the pensions front, the Green Paper considers whether the introduction of a standardised personal pension product across the EU, or removing barriers to cross-border access, would strengthen the single market in pension provision.

In response to calls for tailored treatment for infrastructure investments, the Green Paper seeks views on whether this should be included in future reviews of Solvency II and the CRD/CRR regime.

Private equity and venture capital funds are noted as providing valuable sources of funding, although significant barriers, such as the absence of an equity

investment culture, lack of credit and financial information, a fragmented market, and high costs mean that such markets often lack scale.

Furthermore, the Green Paper sought views on how private equity and venture capital might be further developed as alternative sources of finance. More particularly, the Commission wished to know whether changes are needed to the recently introduced EuVECA (European Venture Capital Funds Regulation) and EuSEF (European Social Entrepreneurship Fund) Regulations.

Finally, acknowledging the impact of new technology and business models, the Commission sought views on whether there are any significant barriers to entry for bank and non-bank direct lenders who often provide funding to start-ups and SMEs.

3. Effectiveness of markets

In order to achieve a larger, more integrated and deeper capital market it is necessary to overcome the barriers that are fragmenting European markets and holding back the development of various market segments. This is an extremely broad objective and the barriers are diverse, covering areas of company, insolvency and securities laws, and diverging tax treatments. As the European Commission acknowledges, tackling these issues will not be easy. We have already seen the degree of difficulty European authorities have encountered in attempting to harmonise insolvency law with the example of the EU Insolvency Regulation. Indeed, this first attempt at coordinating a European approach to insolvency acknowledges explicitly in Recital 11 that "as a result of widely differing substantive laws it is not practical to introduce insolvency proceedings with universal scope in the entire Community". Recital 11 goes on to acknowledge "widely differing laws on security interests" and different approaches to preferential creditors as hurdles. This may explain in part why the Commission's Green Paper says that "further analysis is needed to identify the scale of the challenge in each area and the appropriate solutions and degree of prioritisation". Taking on all of these areas will be challenging, to say the least.

Single rulebook

The single rulebook, developed over recent years through a number of key reforms, is seen as a major step forward, by creating a harmonised regulatory framework for European capital markets. However, it is noted that the practice of introducing superequivalent standards at national level, or "gold-plating", and divergent interpretation of the rules at national level persists and prevents many of the single rulebook's benefits from being fully realised. In this respect, the Commission proposes to work with Member States and the ESAs to ensure that financial regulation is correctly and consistently implemented and enforced.

Competition and barriers to entry

To support more efficient and well-functioning capital markets, the Commission aims to remove barriers to entry and assure access to financial market infrastructure. To this end, the Commission says it will continue to ensure that competition law is rigorously applied to avoid restrictions or distortions of competition.

Supervisory convergence

The Commission will review the functioning and operation of the ESAs with a view to improving regulatory convergence, seen as vital to establishing harmonised regulatory frameworks for capital markets. Accordingly, the Green Paper seeks views on whether the ESAs' current powers to ensure consistent supervision are sufficient and raises the question of whether they should be given additional powers if national regulatory regimes result in differing levels of investor protection, barriers to cross-border operation being erected or companies being discouraged from seeking finance in other Member States.

Data and reporting

The Green Paper goes on to discuss how the development of common data and reporting across the EU would assist the Capital Markets Union. It makes clear that if market-led efforts fail to deliver a consolidated tape which is easily accessible to market participants on a reasonable commercial basis, other options may be considered, including "entrusting the operation of a consolidated tape to a commercial entity".

Market infrastructure, collateral and securities law

The Green Paper refers to existing work in respect of the regulatory framework applying to market infrastructures. Collateral is mentioned as an area for improvement because the Commission believes that the fluidity of collateral in the EU is currently restricted. The Green Paper sought views on whether steps should be undertaken to facilitate an appropriately regulated flow of collateral throughout the EU and whether work should be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border.

On the securities law side, the Green Paper queries whether changes should be made to the laws relating to securities ownership, noting that legislation relating to investors' rights in securities differs across member states. The Green Paper investigated the

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feasibility of targeted changes to securities ownership rules that could materially contribute to more integrated capital markets, making it easier for investors to compare and assess the risks inherent in their investments.

The Commission has particularly prioritised achieving greater legal certainty in cross-border transfer of claims and their order of priority and plans to issue a report on this before the end of 2015. They hope that this will help to develop a pan-European market in securitisation and financial collateral arrangements and also facilitate other financial activities, such as factoring.

Company law and corporate governance

The Commission believes that further reforms to company law might be helpful in overcoming barriers to cross-border establishment and operation of companies. Accordingly, it discusses several obstacles arising from company law in the Green Paper, including those relating to corporate governance, protection of minority shareholders, cross-border mobility, restructurings and divergent national conflict-of-laws rules. The Green Paper sought views on these and other obstacles including possible solutions the Commission might implement.

Insolvency

Despite the challenges, the Commission wishes to revisit this area as it believes reducing divergences in national insolvency frameworks could contribute to the emergence of a pan-European equity and debt market by reducing uncertainty for investors. In 2014, the Commission adopted a recommendation on a new approach to business failure in which it urges member states to put in place early restructuring procedures and "second chance" provisions and to consider applying the principles to consumer over-indebtedness and bankruptcy. An evaluation of that recommendation is planned for 2015.

Taxation

The Green Paper solicited suggestions as to what tax-related barriers should be examined as a priority. A number of barriers are discussed in the Green Paper, including obstacles to cross-border investments such as pensions and life assurance products, due to distortions caused by different tax regimes across member states (e.g. to different types of market participants and to different types of financings). The effective use of incentives, such as R&D expenditure for innovative companies, is also discussed.

Technology

Finally the Green Paper notes that European and national company law has not kept pace with technological developments and that use of modern technology, e.g. electronic voting for shareholders and European-wide on-line registration of companies, could help reduce costs, ease administrative burdens and make cross-border communication more efficient. The Commission is interested in how the EU can best support the development of new technologies to benefit integrated and efficient capital markets.

Priorities for early action – quick wins

While the creation of the CMU is a long term project, requiring sustained effort over many years, the European Commission has identified some areas where progress could be made in the short term. The Green Paper outlines five priority actions, some of which were also identified in the "Investment Plan for Europe", published in November 2014.

These are: (i) helping small firms to raise funding and reach investors cross-border through a review of the current prospectus regime; (ii) widening the investor base for SMEs by improving the availability of credit information; (iii) encouraging direct investment in smaller businesses by supporting industry-led work to develop a pan European private placement regime; (iv) attracting investment in infrastructure and other long term projects by supporting the take up of new European long term investment funds (ELTIFs); and (v) promoting high quality securitisation and freeing up bank balance sheets to lend.

What is the role of securitisation in the CMU?

Securitisation features prominently in the CMU project.

Alongside the Green Paper, the European Commission launched a specific consultation on securitisation, seeking to develop an EU market for simple, transparent and standardised securitisation, which is an initiative that follows innovations from industry subsequently taken forward by the Bank of England, the ECB, the European Banking Authority and the BCBS-IOSCO Taskforce on Securitisation Markets. It aims to revive the securitisation markets while leaving behind the elements of unpredictability and opacity that contributed to the financial crisis.

Indeed, the consultation acknowledges the ongoing negative effect of the financial crisis on securitisation, with issuance in Europe amounting to €216 billion (most of which was retained) in 2014, compared with €594 billion in 2007 (most of which was placed) and notes

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that the US securitisation markets have recovered much more quickly that the European ones. Since the Commission does not plan to replicate the levels of official support for the securitisation markets that exist in the US, the consultation paper seeks other methods of encouraging their return.

The Commission is, however eager to emphasise that this "is not a return to the bad old days of the subprime market. Securitisation can help free up banks' balance sheets, allowing them to increase their lending to businesses and households" in the words of Commissioner Jonathan Hill, who has responsibility for Financial Stability, Financial Services and Capital Markets Union.

The idea is to formulate a set of generic rules to ensure simplicity, transparency and standardisation of securitisation instruments. Such a standardised system would create the conditions to encourage the new products and promote the availability of high quality information in relation to them. EU authorities are, however, likely to be extremely prudent because of the perceived role securitisation played in the crisis.

Securitisations that meet this new set of rules will likely benefit from more benign regulatory treatment, probably including more lenient risk weightings for securitisation assets held in the banking book.

Benefits for banks

Although one of the principal aims of the CMU is to diversify sources of finance to include nonbank sources of funding, the European Commission has been keen to emphasise that "*Capital Markets Union is about complementing the role of banks, not about displacing them. Europe's banking system will obviously continue to play a pivotal role in Europe's economy: it is very important to local communities; and it is at the heart of capital markets themselves*".

As banks are lenders to a significant proportion of the economy and act as intermediaries in capital markets, the hope is that they would benefit from a deeper integration of the single market for capital as this would mean fewer barriers to cross-border investments and an increase in the number and the amounts of transactions, both domestically and across the European Union. In addition, the European Commission believes that measures such as a framework for simple, transparent and standardised securitisations could provide scope for banks to lend more to the extent that they are able to transfer risks safely off their balance sheets.

The Commission is now acknowledging that, soundly structured, securitisation can be an important channel for diversifying funding sources and enabling a broader distribution of risk by removing part of the risk from the banks' balance sheets.

Securitisation can also provide additional investment opportunities by allowing banks to transfer assets to institutional investors to meet those investors' asset diversification, return and maturity needs.

Next steps

Reponses to the Green Paper and to the consultations on Securitisation and the Prospectus Directive were due on 13 May 2015.

A conference will be organised for the summer of 2015 and, taking into account the feedback from to the consultations, the European Commission will launch a Capital Markets Action Plan later in 2015.

In addition, work on a number of other initiatives, relating to various aspects of the Capital Markets Union project, are scheduled to take place in 2015. The European Commission plans to:

- hold workshops on SME credit information ;
- consult on the merits and potential shape of an EU covered bond framework and subsequently to present policy options;
- issue a report identifying the problems and possible solutions in relation to cross-border transfer of claims and the order of priority in cases such as insolvency; and
- evaluate their recommendation to Member States on a new approach to business failure and insolvency, which was issued in 2014.

The target is to have the building blocks of Capital Markets Union in place by 2019.

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2. Qualifying securitisation – the way forward?

A large number of regulatory initiatives affecting securitisation have come out in the last several years, most of which increase the regulatory burdens associated with securitisation transactions, generate uncertainty for transaction parties, or both. It is with some relief, then, that market participants have greeted proposals from policymakers and regulators to differentiate the securitisation markets by creating a class of "qualifying securitisations" that would benefit from a more benign regulatory environment and a generally more level playing field with other comparable forms of investment.

In this article, we explore the background to these proposals, the likely benefits and what kinds of transactions are likely to fall into the "qualifying" category. We also explore the situation of ABCP conduits, typical CMBS and synthetics, which are unlikely to qualify under current proposals but which might in future "come in from the cold".

General background

Participants in the securitisation markets are well aware of the serious consequences the financial crisis of 2007-08 had on those markets. Issuance dropped off precipitously for a variety of reasons and certain products such as arbitrage synthetic CLOs, CDO-squared and SIVs have never come back, and at this stage it looks unlikely they ever will – often for good reasons. It has not helped the recovery of the markets that wave after wave of new regulation has been brought in that generally make securitisation a less attractive product for all involved, even where well-intentioned. Bank, insurer and fund investors have all had risk retention and regulatory due diligence requirements imposed. Bank and insurance capital requirements in relation to securitisation investments are now being raised to levels so high it is a serious disincentive to investment. On the sell side, regulatory recognition of significant risk transfer has become very difficult to achieve and a plethora of often overlapping disclosure requirements have been introduced requiring publication of extremely detailed information in a variety of formats, at a variety of frequencies and in a variety of places. In addition, a number of legislative initiatives that are not particularly aimed at securitisation will nonetheless affect it, again generally making it more difficult, including bank recovery and resolution initiatives and new derivatives rules.

In that context it is not surprising that recovery of the securitisation markets has been slow. According to the Association for Financial Markets in Europe, annual securitisation issuance placed in the European markets was a laggardly €77.6 billion in 2014, compared to the pre-crisis peak of €477.6 billion. This is despite the fact that it was only a small number of securitisation products that had performed badly through the crisis. European RMBS, credit cards and other consumer ABS (which make up the majority of the European securitisation markets) all had default rates under 0.2% for the period from mid 2007 to the end of Q2 2014. SME securitisations had a very respectable default rate of 0.55% for the same period. CMBS, due largely to their maturity transformation features, had a default rate of 10.66% and made up just under 10% of the market. CDOs of ABS, on the other hand, had a catastrophic 41.08% default rate, but represented only 1.7% of the securitisation markets.

The fallout from the financial crisis caused securitisation to become something of a toxic brand as a whole, even though it was a small number of products, representing a very small proportion of the market, that were truly problematic.

As a result, industry considered the idea of trying to differentiate the market. By separating the universe of securitisation products into those that met certain standards (such as transparency, simplicity and standardisation) and the rest, the hope was that those products that had performed well could be revived. This idea originally manifested itself in the form of the Prime Collateralised Securities initiative, which assigned its first label in late 2012. PCS was established and remains an industry-led, not-for-profit scheme to certify that securities met certain criteria of "quality, transparency,

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simplicity and liquidity" and is restricted to certain asset classes.

Perhaps as a reaction to the generally slow pace of economic recovery following the crisis, various central banks, governments, and supranational and international authorities have recognised that anaemic issuance of securitisation instruments might be one of the brakes on growth and have become interested in reviving the securitisation markets.
The Bank of England (BoE), the European Central Bank (ECB), the European Banking Authority (EBA), the European Commission (EC), the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) have all consulted on some variation of a set of standards to differentiate the market.

Official sector expressions of interest in this topic started out referring to "high quality" securitisation with asset class-based distinctions, but have increasingly moved toward the idea that distinctions should be drawn along more neutral lines that are not asset class specific and don't suggest a specific limitation of risk or a particular level of credit quality. At this stage, a consensus between the official sector and market participants appears to be emerging around the idea of "qualifying securitisation" that meets standards of simplicity, transparency and standardisation or comparability.
Essentially, the idea is that "qualifying securitisation" should represent a belief that the risks of the transaction can be properly understood and accurately modelled based on the information made available to investors or prospective investors in the transaction. It should not be taken as an indication that the transaction is low or no risk. To do otherwise would be to eliminate the role of investors in assessing risk, deciding whether they are prepared to take it on, and at what price.

Why should I care?

All this is very interesting, but the question on most market participants' minds will, of course, be "Why do I care?" What does one get out of being a "qualifying securitisation" besides some very vague, general kudos?

Unfortunately, the answer at this stage is not clear. In today's market environment, taking into account the "toxic brand" of securitisation, of course, imprecise, general kudos are not to be sniffed at. A general positive attitude toward securitisation products would in itself be helpful in regenerating the market, but it's unlikely to be enough on its own.

The most likely outcome is that there will be more favourable regulatory treatment of qualifying securitisation. Again, precise answers are hard to come by at this early stage, but a number of possibilities look likely.

Capital treatment

The first is better capital treatment. This is already the case for insurance and reinsurance undertakings under Solvency II. An early version of the qualifying securitisation idea has been incorporated in the Solvency II Delegated Act, where investments in "Type 1" securitisations (that meet certain criteria) are subject to lower capital charges than "Type 2" securitisation (that do not). A similar approach looks likely to be set out for banks once European criteria for qualifying securitisation are adopted. The hope is that the criteria for insurance undertakings would then be revisited and harmonised with the general criteria adopted for securitisations by the European legislative authorities.

It is not clear the extent to which capital relief would be granted to banks for investments in securitisations, but the EBA consultation suggested that "the capital treatment proposed for the 'qualifying' framework should aim at limiting the extent of non-neutrality of capital charges." This suggests that the capital treatment for holding a securitisation exposure is unlikely to be identical to the capital treatment on the underlying loan, but that it may be quite close, and certainly closer than it currently is proposed to be under the Basel III Securitisation Framework (as to which, see the separate article in this collection). Given that high capital charges compared to other debt products are seen as one of the major impediments to a recovery of the European securitisation markets, this would be a significant help on its own.

There would, of course, be a question about how to square any changes in capital charges to Europe's Basel commitments, but this is by no means an unsolvable problem. For one thing, the BCBS has indicated that it plans to assess how the qualifying securitisation framework can be built into the Basel capital rules, which would mean there might be no need to deviate from the Basel commitments at all. In any case, both the EBA and the EC have suggested they may be willing to adopt a Europe-specific approach to bank capital that takes into account the improved understanding of risk associated with an investment in a qualifying securitisation.

Broader regulatory benefits

Improved capital treatment is probably the most important prospective regulatory benefit of being a qualifying securitisation, but it is by no means the only one.

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It has been suggested that the rules for qualifying as a Level 2B securitisation for purposes of the liquidity coverage requirement (LCR) – which already differentiate between types of securitisations – should be revisited and harmonised with the qualifying securitisation criteria. Accordingly, being a "qualifying securitisation" should mean a securitisation also qualifies for inclusion as a Level 2B high quality liquid asset for LCR purposes – possibly with additional "add-on" requirements also being set to reflect liquid assets requirements.

Likewise, certain modifications to the risk retention rules have been suggested that would only apply to qualifying securitisations. These would take the regulatory risk of non-compliance off of investors and thereby make it easier to invest in qualifying securitisation instruments. There may also be some form of alleviated regulatory due diligence for alternative investment fund managers, for example, who are subject to risk retention rules but do not have regulatory capital requirements (and accordingly cannot have capital penalties for breaches of risk retention requirements in the way that banks and insurers have).

What does a "qualifying securitisation" look like?

As mentioned above, a number of consultations have taken place on various incarnations of "qualifying securitisation". The BoE and ECB consulted jointly, followed by a consultation by the EBA, a joint consultation by the BCBS and IOSCO and most recently the EC confirmed that a framework for "simple, transparent and standardised" securitisation was a key part of its headline Capital Market Union project. These consultations have each been different, notably as to the level of detail in the criteria, but the general themes and categories of criteria are very similar.

Broadly, the proposals have suggested that any criteria eventually adopted should be modular in nature. As described above, regulators and legislators are intending (with the support of industry) to use the concept of qualifying securitisation for multiple purposes. Accordingly, while criteria should be harmonised, it is acknowledged that slightly different criteria will be appropriate for different applications. A securitisation instrument that is very high credit quality may be appropriate for a lower capital charge, for example, but liquidity will be more relevant for inclusion in the LCR liquidity buffer. It is therefore broadly intended to come up with a list of "core" criteria that all qualifying securitisation instruments will have to meet, but then acknowledge that there may be other "add-on" criteria imposed for specific purposes. Different proposals have approached this issue in different ways, and there is so far no clear consensus on which criteria would be core criteria on which would be add-on.

The categories of criteria have thus far been separated into simplicity, transparency and standardisation/comparability.

Simplicity

This category of criteria focuses on ensuring that deals are not so highly structured as to make it unreasonably difficult to model the risk being taken by an investor in the transaction. Accordingly, it includes the following types of criteria:

- **Exclusion of resecuritisations**: It is fairly obvious that piling one securitisation on top of another makes transactions more complex and makes it more difficult to accurately model the risk being taken by an investor in the resecuritisation. This criterion has been universal and uncontroversial in the consultations thus far. It is also reflective of the extremely poor historical performance of CDOs of ABS.
- **True sale**: The inclusion of "true sale" as a requirement has been consistent, but perhaps not very well articulated. It largely reflects a concern to ensure that the originator's credit is not a factor in assessing the securitisation instruments, which is universally accepted. That, however, could be achieved by an "asset isolation" requirement that might be met, e.g. by a synthetic securitisation with notes that are fully cash collateralised. The specific choice of "true sale" as a requirement probably reflects a suspicion of synthetic securitisations (discussed further below) and a concern to ensure that investors can "get their hands on the assets" in the event of an enforcement.
- **Asset homogeneity**: The precise content of this requirement varies, but the general theme is that only one "kind" of asset should be included in a transaction. One should not have to be an expert in multiple markets and the potential for correlation of risks between those markets in order to properly risk model a securitisation. To the extent that this relates to asset class, it is uncontroversial. Nobody is suggesting that residential mortgages and credit card receivables should be securitised in the same pool. But to the extent that homogeneity extends to currency or jurisdiction, it is less clear that this is appropriate. Currency risks can be hedged (indeed, another criterion requires that they be hedged), and some jurisdictions and asset classes might

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not be able to build up large enough pools to justify a securitisation if they had to stay within a single jurisdiction. In addition, a requirement for homogeneity of jurisdiction, at least within the EU, would seem to be contrary to the broader themes of the CMU project. It is also not justified based on the historical performance of, e.g. UK RMBS, (which routinely include both English and Scottish loans) or European SME loan securitisations (which often have loans in more than one jurisdiction to provide sufficient scale).

- **Exclusion of defaulted assets and credit-impaired obligors**: The principle behind this criterion is a good one, and the broad idea is widely accepted. It is much more complicated to assess the likely cash flows where the asset is already defaulted or where the obligor has a bad credit history than where the assets and obligors are in good standing. However, different industries and different jurisdictions have different ways of assessing the concept of "credit-impaired" and deciding when assets are "defaulted". Securitised credit card portfolios routinely include loans that are 90 days or more overdue as they are part of the over all bank (card issuer) portfolio and only exclude them from the portfolio when they are "charged off". Not so for residential mortgages or auto loans, where such loans are excluded from the portfolio being securitised. Likewise, it is easy to imagine an obligor being "credit-impaired" when it comes to a large residential mortgage loan, but being perfectly good credit for a comparatively small auto loan or a low-limit credit card. The devil, then, will be in the detail, and it will be important for the authorities to recognise these differences and allow sufficient flexibility when formulating the criteria.
- **Exclusion of refinancing risk**: Most proposed sets of criteria also contain an exclusion of securitisations that contain a significant element of maturity transformation and/or refinancing risk. This, of course, would exclude the structured investment vehicles popular in pre-crisis days, but also excludes many European CMBS transactions, which are typically backed by loans that have large balloon payments that will need to be refinanced at maturity.

Transparency

This category of criteria focuses on ensuring that enough information is provided to investors to ensure that they will be able to make an informed assessment of their (prospective) investments. The requirements broadly include:

- **Compliance with disclosure requirements**: Given the category, this is the most fundamental of the requirements. It is nonetheless somewhat controversial, largely because of questions around substituted compliance (which disclosure requirements need complying with) and because of the broad and intrusive nature of some disclosure requirements, including Article 8b of the EU's Credit Rating Agencies Regulation (as to which see the separate article on CRA3 disclosure requirements in this collection). This particularly affects private securitisation arrangements and those at the fringes of what one would normally think of as securitisation, but nonetheless falls within the regulatory definition of that term.
- **Investor access to transaction documents**: This is broadly uncontroversial and comes partly as a reaction to the difficulty some investors had when seeking to enforce their rights during the financial crisis because they could not lay hands on the documents under which their rights arose. The only real area of controversy in this respect is the specific stage at which documents are made available. In a European context, it will be quite difficult for transaction parties to make documents available prior to the date of issuance, as these are often being negotiated right up to that point. Conversely, some proposals suggest documents should be available during marketing of the transaction, which is closer to the current US market practice.
- **Listing**: Some proposals include a requirement that the transaction comply with the Prospectus Directive and/or have a public listing. This is controversial because it would effectively exclude all private arrangements, including asset-backed commercial paper. It also seems unnecessary as a "core" criterion in the light of other transparency-related criteria.
- **External verification of underlying assets**: This requirement would effectively formalise the existing market practice of having auditors or another independent party verify the pool tape against a sample of underlying loans to provide comfort as to the disclosure made to investors in any formal offering document. Market participants are broadly happy with this, though it would be awkward to apply in private scenarios where there would not necessarily be a formal offering document and, even if there was, it might not include asset-level disclosure.
- **Availability of loan-by-loan data**: This has been articulated in a number of ways and the underlying substance is broadly uncontroversial.

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Loan-by-loan data requirements have been imposed a number of ways over the last several years, and originators are used to complying with them. There is, however, an objection to imposing the same requirement separately in addition to a general requirement to comply with all applicable disclosure requirements. At least one of those disclosure requirements will normally be a requirement to provide loan-by-loan data. Where there is no such requirement this will normally represent a deliberate policy choice (e.g. because investors have direct access to the data or are not relying primarily on the underlying assets for repayment) and that policy choice should not be effectively displaced by a qualifying securitisation regime.

Standardisation/Comparability

The third and final category is in some ways a bit of a catch-all for other criteria, but is notionally supposed to make it easier to compare between securitisation transactions. These include:

- **Compliance with risk retention rules**: This is designed to help ensure a level playing field between securitisations and is broadly uncontroversial. Some issues arise, however, in respect of mutual recognition and substituted compliance. Despite the fact that they are designed to achieve broadly the same policy objectives, the US risk retention rules that will shortly become effective (as to which, see the separate article in this collection) are significantly different from the EU risk retention rules that have been in place for a number of years. The result of this is that it will not be straightforward for transactions to comply with both. Industry has suggested that compliance with any applicable set of risk retention rules ought to be sufficient for the purposes of being a qualifying securitisation, but it is not clear that recognition of third-country regimes will be adopted.
- **Restriction to standard/commonly encountered rates**: This is a requirement that interest rates used to determine payments in the securitisation should be based on commonly encountered market interest rates. This presumably facilitates comparison of rates because experienced investors will be used to modelling different commonly-encountered interest rates, and often the same underlying index will be used. This is broadly uncontentious, though it does raise the issue, especially for RMBS, of whether the originator's own standard variable rate (which underlies many mortgage loan interest rates) will be acceptable for these purposes. If not, then a large number of RMBS transactions would not be able to qualify – an outcome we understand the relevant regulators do not intend.
- **Hedging requirement**: Most proposals have a requirement that any interest rate and currency risks should be hedged or otherwise appropriately mitigated. This is paired with a requirement that derivatives should be used only for "genuine hedging" purposes. There are diverging views on whether the limitation of derivatives to "genuine hedging" would exclude synthetic securitisations, but the true sale requirement is obviously the bigger obstacle to synthetics qualifying.
- **Clear articulation of service providers' roles**: This is a somewhat vague requirement but it largely relates to ensuring investors will know what the various service providers (e.g. swap counterparty, servicer, trustee) are responsible for doing and providing, so far as possible, that those roles will always be filled appropriately. This means investors will be aware of any differences in roles and can largely ignore the risks associated with one or more service providers failing to carry out their role.

Who's in and who's out?

The criteria for qualifying securitisations are, of course, not asset class based. It is nonetheless possible to compare the criteria proposed with the asset class in the market and the transaction structures generally adopted in respect of them. Doing that exercise yields the result that residential mortgages, auto loans, credit card receivables and other forms of consumer lending should broadly be able to qualify (excluding sub-prime portfolios or portfolios including non-performing loans in all cases). In each case there are hurdles to qualification, but these vary depending on the asset class and the specific formulation of the proposals. Cash securitisations of SME loans are theoretically in the same category, but synthetic securitisations of SME loans are more common than cash securitisations at present so it remains to be seen how practically useful that will be.

It is equally clear that CDOs, re-securitisations, managed CLOs, and some others will be excluded.

It is therefore more interesting to focus on ABCP and conduits, CMBS and synthetic securitisations, which have all been excluded, but may in future be in a position to be included.

ABCP and conduits

ABCP and conduit transactions are unfortunately excluded from the proposed

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criteria. It is simply not possible for these arrangements to meet the kinds of criteria that are appropriate for term securitisations. What's more, an Association for Financial Markets in Europe survey suggests that applying the kind of transparency requirements imposed by the criteria would lead to a dramatic reduction in the use of these markets – the opposite of the outcome the authorities are hoping for. The problem is particularly acute from the authorities' perspective because these kinds of arrangements are a crucial tool for financing exactly the kind of credit they are hoping to encourage –trade receivables in particular.

Since the early proposals, authorities have started to acknowledge both the importance of ABCP conduits and the trade-related transactions they undertake, and that the criteria as proposed are inappropriate for them. There are early indications that the authorities intend to propose a solution (presumably in the form of separate, appropriate criteria), but no timeline has yet been proposed for that.

CMBS

CMBS is an interesting asset class from the perspective of qualifying securitisation because it is broadly capable of meeting the criteria set out in most of the proposals. It is also very much a "real economy" asset class that seems on its face to be consistent with the kind of finance that European authorities wish to encourage in that CMBS transactions finance real estate for use by businesses. Offices, hotels and shopping centres are common assets to be financed via CMBS.

That said, it has been excluded from the "good" side of the differentiation of the market right from the beginning. In the original PCS criteria, CMBS was excluded as an asset class and it still is today. The criterion that appears most frequently in proposals that would exclude CMBS is the prohibition on refinancing risk. Some US CMBS (that include more loans and that stagger their repayment profiles to a greater extent) might qualify based on the criteria as proposed by the BCBS-IOSCO consultation, but European CMBS (that have fewer loans and contain closely aligned repayment dates) would not.

At this stage, it's looking unlikely that most CMBS will be in a position to qualify in the short term. Certainly this asset class faces a difficult uphill battle with regulators. This is partly true because CMBS had a much higher default rate than most asset classes that look likely to qualify (10.66% from mid 2007 to the end of Q2 2014, where all others were 0.55% or below), and this is broadly understood to be due in part to the refinancing risk inherent in these structures.

Synthetic securitisations

While this is a securitisation technique, rather than an asset class, it is very clearly excluded by the criterion requiring true sale, which is universally included in the proposals. It is not, however, clear why all synthetic securitisations should be excluded. They are capable of meeting the vast majority of the proposed criteria in all of the proposals thus far. The regulators' justifiable reluctance to be seen to endorse a return of synthetic arbitrage CLOs could easily be addressed by a criterion requiring that synthetic CLOs be designed to assist with the originator's capital management. Concerns regarding isolation of the assets from the credit of the originator can be (and routinely are) addressed by collateralising the notes. Concerns relating to the investors being able to "get their hands on" the assets in an enforcement situation are equally obviated by collateralising the notes.

What is perhaps more important is that synthetic securitisation is a useful technique for securitising assets that are sometimes difficult to securitise via traditional techniques. Whether this is because of transfer restrictions on the underlying loans, costs or other reasons, many securitisations (of SME loans, for example) would be much more difficult (and perhaps even impossible in some cases) without the use of synthetic securitisation techniques. If the authorities' goal in establishing the qualifying securitisation framework is to revive the market in SME loan securitisations (among others), they may find they have come in wide of the mark until synthetic securitisations are allowed to qualify as well.

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Conclusion

The move towards differentiating the market in a manner that provides certain regulatory advantages to qualifying securitisations is a major and exciting development for the securitisation markets. It represents a sea change in official attitudes to securitisation. It may well help remove the "toxic brand" stigma associated with securitisation and spur the revival of markets that have been in the doldrums for the best part of a decade. Inevitably, some product areas will not qualify, and the impact of failing to qualify will likely vary depending on the specific circumstances. Synthetic securitisations, for example, may carry on (albeit at a lower level) because investors in synthetic securitisations largely do not have regulatory capital concerns. In other areas, investor bases may change, or alternative techniques for funding the same assets will be found.

Whatever the case, if the large amount of work that has already been done is to bear fruit, it must be implemented swiftly. In particular policymakers and regulators need to clarify in the very short term what caplital consequences will be associated with being "in" or being "out". Already the general level of securitisation expertise in the industry has begun to diminish as both investors and originators reduce the resources allocated to the product area in favour of other options that are lower cost, less stigmatised and subject to fewer regulatory burdens.

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3. Basel Securitisation Framework – reloaded

Background and purpose

On 11 December 2014, the Basel Committee published the final Basel III Document on the revisions to the securitisation framework, which governs banks' calculations of credit risk capital requirements for exposures in securitisation transactions. The final framework follows the two consultative documents from December 2012 and 2013, and contains the text of the revised framework that will replace the framework in Basel II (as amended) from January 2018.

The revised framework forms part of the Committee's broader Basel III agenda to reform regulatory standards for banks in response to the global financial crisis. In particular, the revised framework aims to reduce mechanistic reliance on external ratings, increase risk weights for highly-rated securitisation exposures and reduce risk weights for lower-rated senior securitisation exposures, thereby reducing the cliff effects inherent in the current securitisation framework. It also aims to enhance the risk sensitivity of the capital charges imposed by the framework.

The final framework largely follows the second consultative document from December 2013 in overall approach. However, in response to concerns raised by a number of market participants, the Committee has made a number of revisions and amendments in the final framework. These changes are discussed below along with the main elements of the revised framework.

Hierarchy of approaches

One of the most notable proposals of the Committee is to introduce a hierarchy of approaches for assigning capital requirements to securitisation exposures. This has been introduced to reduce the reliance on external ratings as well as to simplify and limit the number of approaches. No significant changes were made to the hierarchy of approaches as compared with the proposals contained in the second consultative document.

Approaches are organised in order of descending risk sensitivity (and therefore increasingly punitive nature). The idea is that the approach at the top of the hierarchy requires a large amount of information and gives credit to the bank (in the form of a lower capital charge) to the extent possible based on its detailed knowledge of the assets. Conversely, the approach at the bottom of the hierarchy requires very little information in order to assign a risk weight, but penalises the bank (in the form of a higher capital charge) for assuming risks it doesn't understand as well.

Wherever possible, therefore, banks would apply the Internal Ratings-Based Approach. Where that is not possible, they would apply the External Ratings-Based Approach. Where banks have insufficient information to apply either of those approaches, they would apply the Standardised Approach.

Use of the Internal Ratings-Based Approach would be required where banks have a suitable IRB model and sufficient information to estimate the IRB capital charge for the underlying pool if it had not been securitised. The use of the IRBA may, however be denied by the national supervisor where they lack confidence that this approach reflects the risk of the transactions. For example, this may be the case due to the structural features of the securitisation. The IRBA would reduce mechanistic reliance on external credit ratings and instead depend upon the transaction's credit enhancement level, tranche thickness, maturity and the calculation of expected losses. The explicit intention is for this approach to result in a lower capital requirement than the other approaches further down the hierarchy.

The External Ratings-Based Approach would be applied where the bank could not, for whatever reason, use the IRBA, and it is accordingly designed to produce slightly higher capital charges. The ERBA would require the bank to know the external or inferred credit rating of the tranche, its seniority in the capital structure, the thickness of non-senior tranches and the maturity of the tranche. Only one rating would be required in order to use this approach as opposed to the two required by the current framework. Finally, the Committee has reduced the risk weights for longer-maturity tranches assigned under the ERBA relative to those proposed in the second consultative document, a modification introduced to address concerns of potentially overstating maturity effects.

The Standardised Approach is intended to produce capital requirements that are slightly higher than under the IRBA but comparable to the ERBA, and is calculated on the basis of the weighted average capital charge for the underlying exposures in the pool with an uplift to reflect any deterioration in the underlying pool.

Where none of the above approaches can be used, a punitive risk weight of 1,250% is required to be assigned to the exposure.

Unfortunately, despite the Basel Committee's efforts, the capital changes for a given exposure do not always increase as you go down the hierarchy of approaches. This means that in some

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cases, it will actually be advantageous from a capital point of view for a bank to have less information and to avoid seeking permission to use the IRBA. This concern was identified by industry during the 2-year consultation process but never fully addressed.

Separately, an Internal Assessment Approach may also be used in the case of unrated exposures to ABCP programmes only. The Basel Committee on Banking Supervision may wish to consider allowing this approach to be applied to unrated securitisation exposures which are not funded through an ABCP conduit.

Mixed pools

As compared to the second consultative document, the final framework has been further developed in the context of mixed pools (where a bank is able to calculate IRB parameters for some but not all underlying exposures in a securitisation). A bank will only be able to use the IRBA where it is able to calculate the IRB inputs for at least 95% of the underlying exposures. Where a bank is unable to do so, it must use the other approaches lower in the hierarchy.

Maturity

With regard to exposures with longer maturities, the Committee continues to apply increased risk weights. The Committee intends that the tranche maturity input for the IRBA and ERBA approaches should have a five-year cap and a one year floor, and for this purpose has regard to the contractual or legal maturity.

In response to the second consultative document, a number of market participants commented that they view the use of legal maturity as too conservative an approach (as opposed to, for example the weighted average life of the assets). As a result, the Committee has agreed to apply a haircut in order to smooth the impact of maturity on capital charges where legal maturity is used. As opposed to being equal to legal final maturity, tranche maturity will equal one year plus 80% of the excess of legal final maturity over one year.

Maximum capital requirement

The Committee acknowledged in the second consultative document that the capital charges for a securitisation should be broadly consistent with the capital charges for the underlying pool, in particular senior tranches.

As such, the replacement text of the revised framework states that a bank using the IRBA for a senior securitisation exposure may apply a maximum capital requirement for the senior securitisation exposures it holds equal to the IRB capital requirement that would have been assessed against the underlying exposures had they not been securitised and assessed under the IRB framework. Similarly, in the context of the ERBA and Standardised Approach, the bank may apply a maximum capital requirement for the senior securitisation exposures it holds equal to the capital requirement that would have been assessed against the underlying exposures had they not been securitised.

In line with the above, the Committee has also confirmed that a bank should not be compelled to hold more capital after a securitisation than before.

Risk weight floor

Consistent with the second consultative document, no matter which approach is used, any securitisation exposure will have a risk weight floor of 15%. The original proposed floor was 20% before the Committee revised this downwards. A number of market participants had suggested a 10% floor, commenting that the 15% floor may still be too high as it still represents a substantial increase on the 7% floor under the current framework. Despite this, the floor remains at 15% in the final framework. Although where any maximum capital requirement in the context of senior tranches (as discussed above) is lower than the 15% floor rate due to applying a look through approach to the underlying exposures, the lower maximum capital requirement rate will apply.

Early amortisation provisions

As with the second consultative document, an originator or seller of assets into a securitisation which has early amortisation provisions will be unable to apply the securitisation framework to the sold assets where specific operational requirements are not met. This would mean that such assets would be assessed as if they were "on-balance sheet" for regulatory capital purposes. Where the operational requirements are met, the bank may exclude the exposures associated from the calculation of risk-weighted assets, but must still hold regulatory capital against securitisation exposures retained in connection with this transaction.

Resecuritisations

A resecuritisation exposure is a securitisation exposure in which the risk associated with the underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure. As a result of the Committee's view that resecuritisations

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are inherently difficult to model, only an adjusted version of the Standardised Approach can be used for resecuritisations. The adjusted version provides that resecuritisation exposures will be subject to a risk weight floor of 100% and risk weight and capital requirements caps will not apply.

Further, in response to previous comments from market participants, the revised wording provides that an exposure resulting from retranching of a securitisation exposure is not a resecuritisation if the bank is able to demonstrate that the cash flows to and from the bank could be replicated in all circumstances and conditions by an exposure to the securitisation of a pool of assets that contains no securitisation exposures.

Next steps

The revised framework will come into effect in January 2018. Concurrent with the revised framework, a number of consultations have been undertaken by various regulatory bodies, including the International Organization of Securities Commissions (IOSCO), the European Banking Authority and the Bank of England.

In particular, further work is being conducted jointly between the Basel Committee and IOSCO on establishing "Criteria for identifying simple, transparent and comparable securitisations" with a view to promoting the development of sustainable securitisation markets (as to which, see the separate article on qualifying securitisation in this collection). A consultative document with the proposed criteria has been issued, and the Basel Committee will consider how to incorporate such criteria into the revised framework over the course of 2015. These consultations will provide market participants with opportunities for dialogue with regulatory bodies on the interpretation and implementation of the revised framework.

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4. Risk retention – spot the difference

Articles 404-410 of the Capital Requirements Regulation (EU) No 575/2013 and the related regulatory technical standards (the "**CRR**") prohibit EU regulated credit institutions and investment firms from being exposed to the credit risk of a securitisation position unless certain risk retention and disclosure requirements are satisfied. Similar provisions now also apply to EU regulated alternative investment fund managers under Articles 50-56 of EU Regulation 231/2013 ("**AIFMR**") and in respect of EU regulated insurers and reinsurers under Articles 254-257 of Regulation (EU) 2015/35 ("**Solvency II**").

Despite some indication from regulators that the intention is for the three regulatory regimes to be interpreted consistently, certain differences have become apparent, particularly when contrasting Solvency II, which is administered by EIOPA, with the CRR and AIFMR, which are administered by the EBA and ESMA respectively and are more textually closely aligned. In this article we explore some of these differences and the approaches taken by originators in practice. We also consider other recent trends around risk retention that may be of interest to the market.

AIFMR and Solvency II – divergence from CRR and undertakings

A key area of divergence between the text of the CRR, AIFMR and Solvency II is the ability to consolidate risk retention within a supervisory group. Article 405(2) of the CRR allows the risk retention requirement to be satisfied on the basis of the consolidated situation of a parent credit institution, EU financial holding company or EU mixed financial holding company where it or one of its subsidiaries, as sponsor or originator (the definition of which includes an entity which is indirectly involved in the original agreement which created the exposure being securitised) securitises exposures from several credit institutions, investment firms or other financial institutions included in the scope of regulatory supervision of the parent or holding company. However, no equivalent consolidation provision is contained in either AIFMR or Solvency II. Although Article 56 of AIFMR provides that the provisions of Articles 50 to 55 shall be interpreted in a manner consistent with the "corresponding provisions" of the CRR, this is unlikely to provide sufficient scope to incorporate a new operating provision into AIFMR where there is no "corresponding provision". In our view, Article 56 is limited to aiding the interpretation of existing operating provisions only. The position under Solvency II is clear and generally even more inflexible as there is no provision authorising retention on a consolidated basis and no clause requiring interpretation consistent with either CRR or AIFMR.

This issue and other minor textual differences between the three regimes bring into focus the more general question as to the extent to which it is appropriate for the retaining entity on securitisation transactions to make covenants and representations as to compliance with AIFMR and Solvency II in addition to the CRR, particularly given the distinct possibility of further divergence between the three regimes in future, especially Solvency II. The arguments in favour of retaining entities agreeing to covenants to comply with the CRR are much stronger than for AIFMR and Solvency II. The CRR applies to EU regulated credit institutions and investment firms and in general will apply directly (not only in relation to risk retention) to the majority of originators on securitisation transactions in Europe. The retaining entity should therefore be familiar with the application of the detailed requirements of the CRR and have direct knowledge of the EBA as the European bank regulator. The retaining

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entity therefore has detailed knowledge and expertise as to the application of the CRR. It is well placed to determine what it needs to do to comply with the CRR and should be comfortable giving covenants as to compliance in the transaction documents.

Although the argument can be made that investors that are alternative investment funds “AIFs” or insurance or reinsurance undertakings (collectively, “insurers”) should benefit from an equivalent level of comfort in respect of their own regulatory regimes, this has to be considered in the wider context. In these situations, it is the investor, not the retaining entity, that has the greatest insight into the workings of the regulatory regime (whether AIFMR or Solvency II) and the relationship with the relevant regulatory authority. Accordingly, although the retaining entity must be clear as to the retention and disclosure obligations it is prepared to undertake, in many cases, it can be argued that it should be for the investor, not the retaining entity, to determine whether the retention and disclosure undertakings in the documentation, provided in the context of the CRR or on a generic basis, are sufficient for the purposes of AIFMR and Solvency II. It also seems reasonable for the relevant investor to take the risk of any change in approach between the CRR and its own regulatory regime, rather than placing this risk on the retaining entity, who is not regulated by that regulatory regime and has no control or bargaining power when it comes to consultations for future amendments or guidance.

Under current law, for the large majority of transactions, retention and disclosure obligations which comply with the CRR will be sufficient to comply with the retention requirements under AIFMR and Solvency II as well. Retaining entities will argue that the covenant to comply with the terms of the CRR should provide sufficient comfort to investors that are AIFs and insurers as well. We have, however, seen examples of retaining entities that are prepared to give covenants on compliance with AIFMR and Solvency II as well, in particular where the covenants are limited to the position under current law. In some instances, originators have undertaken to retain in accordance with the requirements of Solvency II (given the methods of retention are substantially similar to those in CRR and AIFMR) but that undertaking has not extended to other requirements, such as ongoing disclosure.

Parent company as originator – when can a parent be acquiring assets ‘for its own account’?

A parent company may be the retaining entity by virtue of being an ‘originator’ in its own right rather than by taking advantage of the consolidation provisions in the CRR. The definition of originator in the CRR (which also applies to AIFMR under Article 56 and Solvency II under its definitions provision) includes both: (i) an entity that is involved, directly or indirectly, in the original agreement which created the exposure; and (ii) an entity that purchases a third party’s exposures for its own account and then securitises them. The first limb provides a significant degree of flexibility for a parent or holding company to be designated as the retaining entity provided that entity is sufficiently involved in the origination process. The second limb of this definition requires further consideration particularly as to the meaning of the phrase ‘for its own account’. Thought has to be given as to whether the words ‘for its own account’ should be interpreted narrowly such as to preclude anything other than legal or beneficial title to the assets, or if a wider interpretation which could include a parent entity sometimes may be appropriate.

A key consideration on any portfolio acquisition will be the entity through which the portfolio will be acquired. On many transactions a special purpose vehicle will be established for the specific purpose of holding legal title to the assets. This may be preferable for a variety of legal, regulatory or administrative reasons at the time of the sale, these might include, for example, the requirements of local law pertaining to the assets and whether the portfolio is being acquired by a fund or via a REIT. Although it may be necessary or desirable for legal title to be held by a specific entity established for that purpose, different considerations may apply to risk retention, particularly if, for example, there may be a desire in future to reorganise the corporate group of the purchaser. Whether or not it can be argued that the parent company is purchasing the exposures ‘for its own account’ in such situations then becomes of relevance.

There is very little guidance on the meaning of the phrase ‘for its own account’. In our view, it is capable of extending beyond the holding of legal or beneficial title provided it can be shown that the true purchaser of the assets is the parent company. Whether or not the parent can be considered to be the purchaser of the assets would need to be determined on a case by case basis, however, we can identify certain key factors that are likely to be influential: (i) the degree of involvement of the parent entity in negotiating and executing the acquisition; (ii) whether it is

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strongly desirable or even necessary that title be held by a subsidiary for legal, regulatory or administrative purposes, for example, pursuant to the local law applicable to the underlying exposures or rules relating to the management and operation of the purchaser; (iii) whether the parent can be said to be merely 'booking' the trade through a subsidiary.

Establishing a strong nexus between defaults on the underlying portfolio and the economic impact on the parent will also be important. If the subsidiary that holds title to the assets being securitised is directly and wholly owned by the parent and does not carry on any business other than holding the assets there will be a clear, direct link between the performance of the assets and the value of the shares held by the parent in the subsidiary, such that any default on the assets will economically be 'passed-through' to the parent. This arrangement would need to be supported by covenants in the documentation as to ongoing ownership arrangements and business activities if it was to be relied on to support the parent company as retaining entity. The nexus between the holder of the assets and the parent would be much more difficult to establish if ownership was indirect (unless the intermediary companies were themselves shell entities) or if the subsidiary conducted other business which would dilute the otherwise pass-through nature of any defaults. To the extent there are any other arrangements in place between the parent and subsidiary that have the effect of placing the risk of default onto the parent these will also be relevant, for example, a limited recourse loan between parent and subsidiary dependent on the cashflows received by the subsidiary under the assets or some form of credit default swap arrangement. These arrangements are only likely to be helpful in support of the argument that the parent is the true purchaser of the assets if they are in place at the time of acquisition.

Where the parent is the retaining entity for the purposes of the regulation it may, in some situations, be possible for the parent to be the 'retaining entity' but for the retained assets to be held by its subsidiary as part of the purchase arrangements.

Method C: retention of randomly selected exposures

The CRR, AIFMR and Solvency II all provide for retention in the form of randomly selected exposures equivalent to no less than 5% of the nominal value of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination. This method of retention is used relatively rarely on securitisation transactions compared to the retention of the first loss tranche or a vertical slice of the exposures, which are much more common. It is therefore worth spending some time considering how the retention of randomly selected exposures would work in practice.

In our experience, where the portfolio of securitised exposures is being selected from a larger portfolio of eligible assets, originators have tended to randomly select the receivables to be securitised from the larger pool in an aggregate amount equal to 100 per cent. of the expected funding, as opposed to randomly selecting exposures equal to approximately 105.263 per cent. (being the number required to produce 100 per cent. of the expected funding after removing 5 per cent.) of the expected funding and then randomly de-selecting 5 per cent. of those to then provide 100 per cent. of the expected funding. From a risk and economic perspective the approaches deliver the same result and the former approach is simpler to explain from a disclosure perspective in the prospectus. A more significant issue that has arisen, however, is at what point in time the 5 per cent. retention will be sized, bearing in mind that this particular method of retention is only tested at the outset of the transaction.

It is common practice on securitisation transactions for a cut-off date to be established in respect of the portfolio as at which point the final pool is selected and the purchase price for the portfolio calculated based on the principal amount outstanding at that time. We shall call this date the 'final selection date'. The final selection date can range from being a couple of weeks to a few days prior to the closing date and either this date or an earlier (provisional) date will form the basis of the portfolio information in the prospectus. This approach is a sensible one in practice for a number of reasons: (i) it reflects the fact that there will always be a slight time lag in the systems of the servicer to process recent payments under the exposures or other actions taken in relation to the portfolio; (ii) to ensure certainty of execution - the selection of the pool needs to be established in advance to form the basis of the sizing and pricing of the subscription by investors and any retained piece; and (iii) the requirement that the retained exposures should not amortise any more quickly than the securitised loans means that after the

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final selection date the natural amortisation profile will be applicable to the retained as well as the securitised loans.

The practice of pricing and sizing the deal based on the size of the pool on the final selection date raises timing issues if the method of retention being used is the 'randomly selected exposures' method. One line of argument is that the 5% retention should be estimated in advance with the final calculation being determined on the closing date, taking into account the payment rate on both the securitised and retained exposures between the final selection date and the closing date of the transaction. This interpretation would, however, lead to uncertainty with regards to the assets being sold to the issuer and funded by investors. To cater for the possibility that the payment rate on the retained exposures may be slightly higher than on the securitised exposures, the retaining entity would either need to be prepared to incorporate a degree of headroom when calculating the size of the retention or some form of adjustment in the documentation to take place on, or shortly after, the closing date to remove or reassign back to the originator certain of the securitised exposures. This would appear to be unduly onerous and cause a significant degree of uncertainty given the unlikelihood of there being any material divergence in the performance of securitised and retained exposures during the relevant period.

In our view, it can be argued that calculating the size of the retention as at the final selection date would not only be more workable in practice but in most cases would also sit more comfortably within the spirit of the CRR. In making this assertion, we note that on the majority of securitisation transactions the issuer will take the risk of defaults on the securitised exposures and the benefit of any collections from the final selection date, not the closing date. Accordingly, from an economic and risk perspective, assuming the transaction closes, it is as if the assets were transferred on the final selection date and therefore appropriate that the size of the retention is also calculated on this date. To the extent there is any variation in the payment rate under the securitised exposures and retained exposures the issuer will take the benefit or risk of such variations accordingly.

This is an example of how the method of retention that is selected can impact on the size of the retention. We have highlighted this in other contexts in the past, particularly where the assets are being transferred at a discount, where retention of the nominal value of the securitised exposures under method (a) or (d) will require an increased amount of retention than retention by way of a vertical slice of each tranche of notes sold to investors. It is important to bear these differences in mind when considering the method of retention that will be used on the transaction.

Conclusion

We demonstrate above that although risk retention requirements have applied to securitisations for a number of years, new issues continue to arise and need to be explored. There is still a degree of uncertainty as to the application of these rules, particularly in the context of AIFMR and Solvency II and the risk that there will be further divergence between the three regimes is of general concern to the market. We would hope, however, that relevant authorities and investors will continue to work together to promote consistency and clear guidance on the application of each of the regimes in future.

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5. US risk retention – go your own way

Enacted in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") generally requires securitisers to retain at least five percent of the credit risk of any asset pool that is securitised and prohibits hedging or otherwise transferring such retained risk. The policy purpose of risk retention is to align the interests of those who originate assets that will be securitised and those who securitise those assets with the interests of investors in the resulting asset-backed securities (ABS). This risk retention requirement was not immediately effective when enacted in 2010, however, because Section 941 of the Dodd-Frank Act delegates the responsibility for implementing these risk retention requirements to a group of US federal regulators. This section also grants federal regulators discretion to craft exemptions for securitisations involving high-quality assets and specify permitted forms of risk retention.

US federal regulators released an initial proposal to implement credit risk retention in early 2011. During the public comment process, significant concerns were raised regarding the proposal's potential impact on lending activity. Revised implementing rules were proposed in August 2013 and final rules were adopted in October 2014.

Compliance obligations

Compliance with US risk retention requirements will be required as of 24 December 2015 for residential mortgage backed securities (RMBS) and one year later (24 December 2016) for all other types of ABS, unless an exemption is available. Any ABS issued before the applicable compliance date are not subject to these risk retention requirements. In contrast to the EU risk retention regulations, the US rules will not require a second layer of credit risk retention for pass-through re-securitisation transactions involving ABS for which credit risk has been retained in compliance with applicable US credit risk retention requirements.

While European risk retention requirements generally place the compliance burden on regulated ABS investors, US credit risk retention requirements are mandatory requirements of the securities laws which will apply directly to the sponsor of a securitisation and will need to be covered by standard no-contravention of law opinions. These requirements will apply to private placements in the United States as well as public offerings.

Retention by affiliates and third parties

A sponsor may elect to retain the required amount of credit risk indirectly through a consolidated, wholly-owned affiliate. In limited cases, a sponsor may also be able to meet its risk retention obligation by arranging for a third-party purchaser to retain the required amount of credit risk. Even when such risk is retained by a third party, however, the sponsor will remain responsible for ongoing compliance with the risk retention requirements.

Restrictions on hedging and risk transfers

Retained credit risk may not be hedged or otherwise transferred until the expiration of the relevant transfer and hedging restrictions. For all types of ABS other than RMBS, transfer and hedging restrictions will expire on the latest of:

- two years after the closing date of the securitisation;
- the date on which the total unpaid principal balance of the *securitised assets* that collateralise the securitisation is reduced to 33% of the original unpaid principal balance;
- the date on which the total unpaid principal obligations under the *ABS interests* issued in the securitisation is

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reduced to 33% of the original unpaid principal obligations.

For RMBS, the transfer and hedging restrictions will expire on the later of: (1) five years after the closing date for the securitisation; and (2) the date on which the total unpaid principal balance of the securitised assets is reduced to 25% of the original unpaid principal balance, but not later than seven years after the closing date. A limited exception to these transfer restrictions is available for CMBS risk retention involving eligible third-party purchasers.

Permitted forms of risk retention

Standard risk retention options

US risk retention requirements allow a sponsor to satisfy its risk retention obligation by retaining an eligible vertical interest, an eligible horizontal residual interest, or any combination thereof as long as the amount of the eligible vertical interest and the amount of the eligible horizontal residual interest combined is no less than five percent. The amount of the eligible vertical interest is equal to the percentage of each class of ABS interests issued in the securitisation transaction held by the sponsor as eligible vertical risk retention. The amount of eligible horizontal residual interest is equal to the fair value of the eligible horizontal residual interest divided by the fair value of all ABS interests issued in the securitisation transaction.

Any fair value determinations made in connection with the horizontal risk retention option would need to be made in accordance with US GAAP. Sponsors would be required to disclose key information about the methodologies and assumptions that they use to calculate the amount of their eligible horizontal residual interests in accordance with fair value standards. After considering comments, the federal regulators declined to modify the final rule to allow for calculation of fair value using the fair value measurement framework under local GAAP or IFRS for securitisation transactions where the sponsor is established outside the United States. The federal regulators believe the benefits to investors of being able to easily compare the fair value of risk retention in two separate issuances of ABS interests (regardless of where the sponsors are established) outweigh their estimate of the burden imposed on the sponsors by the requirement to use US GAAP methodology to determine fair value.

Alternative risk retention options for certain asset classes

The federal regulators have adopted tailored alternative risk retention options for specific types of asset classes. These alternatives, however, do not include any representative sample method similar to Method C of the EU risk retention rules. Commenters voiced concerns that the lack of a representative sample option could make it more difficult for global offerings of asset-backed securities originated outside the United States to be sold to investors in the United States.

It has been common in CMBS transactions for third-party purchasers to specifically negotiate the purchase of a first-loss position. In recognition of this market practice, the Dodd-Frank Act gave federal regulators authority to create third-party risk retention for CMBS transactions. As adopted in the final rules, either one or two (but no more than two) third-party purchasers are permitted to satisfy the risk retention requirement through the purchase of an eligible horizontal residual interest. If there are two third-party purchasers, neither third-party purchaser's losses may be subordinate to the other's losses.

In recognition of typical connections between third-party purchasers and special servicing rights in CMBS transactions, the final rules require the appointment of an Operating Advisor ("**OA**") for CMBS transactions that rely on the third-party risk retention option. The OA requirement provides a check on third-party purchasers by limiting their ability to manipulate cash flows through the exercise of the special servicing rights. The OA is required to be independent and will have the authority to recommend and call a vote for removal of the special servicer under certain conditions. In addition, the OA will be required to periodically report to investors and the issuer whether the special servicer is operating in compliance with any standards specified in the applicable transaction documents.

Exemptions from US credit risk retention requirements

Safe harbour for non-US transactions

In implementing the risk retention provisions of the Dodd-Frank Act, the federal agencies adopted a "safe harbour" provision for qualifying non-US transactions. Specifically, this provision excludes from US risk retention requirements transactions for which:

- neither the sponsor nor the issuing entity is chartered, incorporated or established under US law;
- no more than 10% of the value of all classes of ABS interests in the securitisation transaction are sold or transferred to US persons or for the account or benefit of US persons; and
- no more than 25% of the underlying assets underlying the ABS issue were acquired from a majority owned

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affiliates of the sponsor or issuing entity that is chartered, incorporated or organised under US law or from an unincorporated branch or office of the issuing entity that is located in the United States.

Some uncertainty remains about how this safe harbour will be applied in practice. In the near term, it would be prudent for market participants to seek advice regarding the availability of this safe harbour for Regulation S transactions that contemplate offshore offers to US persons.

This non-US transaction safe harbour is narrowly tailored to capture only those transactions in which the effects on US interests are sufficiently remote so as not to significantly impact US underwriting standards and risk management practices or the interests of US investors. The relatively narrow scope of the foreign safe harbour provision may have negative effect on non-US sponsors that seek US investors because they may need to satisfy risk retention requirements of two jurisdictions (their home country and the United States).

Qualified commercial loans

CLOs are subject to US risk retention requirements and CLO managers are considered to be the securitisers. The final rules provide an exemption for CLOs backed by qualifying commercial loan (QCLs). To qualify, the originator must determine that the borrower has satisfied the following numerical requirements for its two most recent fiscal years and is expected satisfy them in the next two fiscal years as well, based on reasonable projections:

- total liabilities ratio of 50% or less; calculated as the borrower's total liabilities divided by the sum of the borrower's total liabilities and equity, less the borrower's intangible assets;
- leverage ratio of 3.0:1.0 or less; and
- debt service coverage ratio ("**DSCR**") of 1.5 or greater; calculated as the borrower's EBITDA, as of the most recently completed fiscal year, divided by the sum of the borrower's annual payments for principal and interest on any debt obligation.

Calculation of each component of these QCL metrics must be made in accordance with US GAAP. A QCL will also need to meet the following criteria:

- a straight-line amortising payment;
- a fixed interest rate;
- a maximum five-year, fully amortising loan term;
- representations and warranties prohibiting additional indebtedness; and
- additional standards for QCLs that are backed by collateral, including lien perfection and collateral inspection.

Under the final rules, junior liens may collateralise a QCL. QCLs are also subject to certain evaluation, certification and repurchase conditions under the final rules.

Qualified commercial real estate loans

Under the final rules, the following criteria are required for a qualified commercial mortgage loan, referred to as a qualified commercial real estate ("**QCRE**") loan, which may be included in a CMBS transaction exempt from Dodd-Frank risk retention requirements:

- a 1.25 DSCR for loans made with respect to multifamily properties;
- for loans other than multifamily property loans, a 1.5 DSCR for leased QCRE loans; and
- a 1.7 DSCR for all other QCRE loans.
- The analysis of whether a loan is a QCRE loan is made with respect to the borrower and not limited to the underlying property. Loans with respect to properties with less than two years of operating history are, however, not eligible for QCRE loan status.

QCRE loans must also have the following characteristics:

- first-lien loan;
- ten-year minimum maturity;
- maximum LTV ratio of 65% with up to a 70% combined LTV ratio;
- a fixed interest rate (or convertible into a fixed rate via a specified derivative).

Interest-only loans or interest-only period loans will not qualify as QCRE loans. These loans are also subject to evaluation, certification and repurchase requirements.

Qualified residential mortgages

The Dodd-Frank Act generally provides for a qualified residential mortgage ("**QRM**") exemption for securitisations involving high-quality residential mortgages. While the statute required federal regulators to define this term as part of the implementation process, it provided that the QRM definition could be no broader than the definition of qualified mortgage ("**QM**") as defined in Section 129C of the US Truth in Lending Act ("**TILA**"). This means that regulators had the option to adopt a definition narrower than the QM definition. The final rules reflect a regulatory decision to instead exactly align the QRM definition with the QM definition (by cross-reference) to minimise the potential for future conflicts between the QRM standards for risk retention purposes and the QM standards adopted under TILA. In

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declining to grant a commenter's request to allow non-US originated transactions to benefit from the QRM exemption, the agencies noted that the application of this definition of QM to non-US originated transactions is limited by the statutory reference to the QM definition under TILA. While other categories of non-US originated loans may have trouble qualifying for potentially relevant risk retention exceptions as a practical matter, QRMs are the only category of qualifying loan exception for which federal regulators have indicated that their statutory authority to implement an exception is implicitly restricted to US-originated assets.

Qualifying re-securitisations

An exemption from US risk retention requirements will be available for qualifying re-securitisations if:

- the resulting ABS interests consist only of a single class and provides for a pass through of all principal and interest payments received on the underlying ABS interests (net of issuer expenses); and
- the underlying ABS interests were issued in compliance with US credit risk retention requirements or an applicable exemption.

Seasoned loans

The implementing rules also provide an exemption from risk retention for securitisations collateralized solely by servicing assets and seasoned loans that have not been modified since their origination or been delinquent for 30 days or more. For purposes of this exception, "seasoned loans" includes:

- residential mortgage loans that have been outstanding and performing for either: (1) the longer of five years or the period until the outstanding balance of the loan has been reduced to 25% of the original principal balance or (2) at least seven years; and
- any loan that is not a residential mortgage loan and that has been outstanding and performing for the longer of either: (1) two years; or (2) the period until the outstanding principal balance of the loan has been reduced to 33% of the original principal balance.

Qualified auto loans

Under the final rules, qualified auto loans ("QALs") included in an auto loan ABS transaction would be exempt from US credit risk retention requirements. To be considered a QAL, the following conditions must be met:

- a DTI ratio not in excess of 36% of a borrower's monthly gross income;
- a fixed interest rate and fixed interest payments;
- level monthly payments that fully amortise the loan over its term;
- compliance with applicable law for recording a lien on the title; and
- term that is the lesser of: (a) six years or (b) ten years less the vehicle's age.

Loans related to recreational vehicles, business vehicles and automobile leases are not eligible as QALs. QALs are also subject to evaluation, certification and repurchase requirements under the final rules.

Agency RMBS

US credit risk retention requirements will not apply to securitisations of residential mortgages underwritten by US government sponsored entities (GSEs) Fannie Mae and Freddie Mac. Such mortgages are fully guaranteed by these entities and backed by the full faith and credit of the US government. No equivalent exemption is available for RMBS involving residential mortgages backed by the full faith and credit of any non-US government.

Substituted compliance with non-US risk retention requirements not available

US federal regulators considered comments that requested establishment of a mutual recognition framework that would permit substituted compliance for ABS that complied with a comparable non-US risk retention regime. In declining to permit substituted compliance, these regulators noted that other non-US jurisdictions with risk retention requirements had generally not adopted mutual recognition frameworks. In addition, some non-US risk retention regimes recognise unfunded forms of risk retention, such as standby letters of credit, which US regulators do not believe provide sufficient alignment of incentives and have rejected as eligible forms of risk retention under the US framework.

Conclusion

The federal regulators designed the US credit risk retention requirements to incorporate sufficient flexibility with respect to forms of eligible risk retention to permit non-US sponsors seeking a significant US investor base to retain risk in a format that could satisfy applicable non-US and US regulatory requirements. Compliance with more than one set of risk retention requirements, especially in light of material differences, is likely to drive structural changes to securitisations both within and outside the United States and, in both cases, may require significant additional resources.

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6. CRA3 disclosure requirements – the worst yet to come?

The disclosure requirements under CRA3 have been hotly debated between market participants and regulators ever since the introduction of Article 8b, the provisions under which the requirements were introduced, in 2013. In that time, regulatory technical standards have come out that give form and substance to the disclosure obligations as they apply to certain asset classes in public transactions. The situation for other asset classes, and for private transactions, remains unclear and certain recent developments suggest that the worst may be yet to come.

In this article, we describe the disclosure obligations under CRA3 that have already been clarified, and provide an update on recent developments that give an indication of what may still be in store for the securitisation markets.

Background

Participants in the structured debt markets will by now be aware of the amendments (collectively known as CRA3) to the Credit Rating Agencies Regulation that came into effect in June 2013. In addition to the dual rating obligation and the obligation to consider appointing a smaller credit rating agency that industry has been living with for almost two years, CRA3 also introduced broad disclosure obligations in relation to structured finance instruments (being, broadly, a financial instrument or other asset resulting from a securitisation) ("**SFI**"). From 1 January 2017, where any of the issuer, originator or sponsor the SFI is established in the European Union, information will have to be disclosed via a publicly-accessible website to be established by ESMA (the "**SFIs website**").

The new disclosure obligations imposed under Article 8b have been the subject of much discussion since 2013 when the enabling legislation came into force, and in June 2014 the European Securities and Markets Authority ("**ESMA**") published its final draft regulatory technical standards (the "**RTS**") further elaborating on the precise nature of the disclosure obligations in respect of Article 8b for SFIs, backed by residential mortgages, commercial mortgages, loans to SMEs, auto loans, loans to consumers, credit card loans and leases to individuals or businesses. SFIs issued from 26 January 2015 which remain outstanding on 1 January 2017 will be caught by the disclosure requirements under the RTS. SFIs backed by other asset classes, by mixed pools or resulting from private and bilateral transactions are exempt from reporting obligations for the moment. The nature of any grandfathering in respect of these transactions remains uncertain.

Information and data to be reported under the RTS

The information to be reported under the RTS consists of:

- Loan level data, reported by way of the reporting templates for the relevant asset classes (residential mortgages, commercial mortgages, loans to SMEs, auto loans, loans to consumers, credit card loans and leases to individuals or businesses). This data is very similar to that already reported to European DataWarehouse for ECB eligible assets but is not identical.
- Where applicable, the final offering document or prospectus and transaction documents, including a detailed description of the waterfall of payments of the SFI and any other underlying documentation that is essential for the understanding of the transaction.
- Where a prospectus has not been drawn up in compliance with the Prospectus Directive, a transaction summary or overview of the main features of the SFI, including, amongst other things, the deal structure, the asset characteristics, cash flows, credit enhancement and liquidity support features, noteholder voting rights and the inter-relationship between secured creditors in a transaction.
- Investor reports, containing detailed information on, amongst other things, asset performance, cash flow allocation, a list of all triggers and their status, a list of all counterparties involved in a transaction, their role and their credit ratings and details of cash injected into the transaction by the originator/sponsor or utilisation of any liquidity or credit support and support provided by a third party.

Loan level data and investor reports are to be made available on a quarterly basis, in each case no later than one month following an interest payment date on the relevant SFI. The prospectus (or transaction

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summary where applicable) and relevant transaction documents must be made available "without delay" after the issuance of an SFI.

SFIs website

CRA3 specifies that the information required to be disclosed on SFIs (as detailed above) will be published on the SFIs website once set up by ESMA.

The RTS state that the technical reporting instructions concerning, among others, the transmission and the format of the files to be submitted by issuers, originators and sponsors will be communicated by ESMA on its website. These technical instructions are required to be published no later than 1 July 2016. This deadline is designed to ensure that issuers, originators and sponsors have sufficient time before reporting begins on 1 January 2017 to allow them to adapt and to develop adequate systems and procedures to ensure compliance.

Responsibility for provision of data

Responsibility for reporting data under CRA3 lies with the issuer, originator and sponsor, as applicable, on each transaction. However, the RTS is clear that one or more of them (and/or some third party) can be designated as the reporting entity (or reporting entities) to upload the required information to the SFIs website on behalf of all parties. The RTS clarifies however that responsibility for the reporting would remain with the issuer, originator and sponsor regardless of any such designation. The relevant designated entity must also be notified to ESMA "without undue delay" once the reporting obligations become live.

The relevant reporting entity is required under the RTS to store the files uploaded to the SFIs website in electronic form for at least five years. Where the reporting entity or any of the issuer, the originator or the sponsor (if different) identifies factual errors in the data that have been provided to the SFIs website there is a requirement that this corrected without undue delay. There are, interestingly, no dispute resolution provisions in the event these parties have a factual disagreement about the data required to be provided.

Implications for securitisation documentation

Although the market is still adapting to the (still evolving) disclosure obligations under CRA3, certain provisions have started to be included in underlying transaction documents for issuances of SFIs falling within the asset classes specified in the RTS.

As stated above, issuers, originators and/or sponsors on a particular transaction are able to designate one or more reporting entities for the purposes of CRA3, and there is an emerging practice to appoint the servicer (who is often also the originating entity) for that role. This is a sensible approach given the nature of some of the information to be reported such as loan level data which would normally be acquired during the loan origination process and will anyway be needed for the ongoing servicing of the assets.

Arrangers and managers have also, in some cases, begun requesting comfort that CRA3 disclosure obligations will be properly managed. As a result, there is an emerging practice on some transactions to include such comfort in the subscription agreement, in a standalone letter or in some other document, depending on the specific circumstances.

Recent developments

ESMA consultation and industry response

Now that the requirements of the RTS have become relatively clear (subject to the technical reporting instructions being published next year), ESMA has turned its attention to the SFI that are outside the scope of the RTS, and in particular those resulting from private and bilateral transactions. ESMA launched a consultation in March 2015 with two objectives: first to inform ESMA as it defines the terms "private" and "bilateral" which are as yet undefined in the RTS; and second to allow ESMA to assess whether the disclosure requirements currently contained in the RTS could be sensibly applied to SFIs of a private or bilateral nature or whether they should be adapted. Responses to the call for evidence issued as part of the ESMA consultation were due on 20 May 2015 and ESMA intends to take these into consideration when revising the RTS to cover private and bilateral SFIs.

Industry was naturally very interested in this call for evidence, given that a significant proportion of "securitisations" (as defined in the Capital Requirements Regulation) are non-public transactions that have therefore been subject to very limited (if any) public disclosure requirements to date. The potential requirement for public disclosure of detailed information relating to fundamentally private transactions has long been an area of concern for industry in respect of Article 8b. The broad thrust of industry's response to the ESMA call for evidence, therefore, was as follows:

- Private and/or bilateral transactions represent an important segment of the market and raise additional and heightened considerations from a disclosure perspective.
- Private transactions should be defined to mean transactions in respect of which no obligation arises under the EU Prospectus Directive to publish a prospectus.
- Private transactions should be further sub-divided into: private and supported, private and bilateral, private and intra-group, and private only.

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- Private and supported transactions would, broadly, be those that are supported in full or in part by credit enhancement or liquidity facilities provided by the sponsor or another EU-regulated institution. In respect of such transactions, industry has suggested that there should be a principles-based disclosure requirement, as well as specific requirements to entrench certain existing practices, including an information memorandum that describes the programme's legal structure and operative documents, and investor reports (on at least a monthly basis) setting out information about the transaction, the liquidity and credit support providers and the underlying transactions (consistent with established market practice).
- Private and bilateral transactions would be broadly defined as transactions with sophisticated institutional investors, where identification of investors will be possible throughout the life of the transaction and where there is no underwriting by an arranger. In respect of such transactions, industry has suggested that the disclosure requirements outlined in the RTS should not apply and instead a principles-based requirement should be implemented requiring that the issuer, originator and sponsor jointly should ensure that investors have access to "all materially relevant data" on the items referred to in CRA3. This approach would align the CRA3 requirements with the disclosure obligation which applies to credit institution and investment firm originators and sponsors under article 409 of the CRR.
- Private and intra-group transactions would be those where each of the investors is in the same group as an originator or sponsor of the securitisation, from either an accounting or prudential perspective. By definition these arrangements will not involve third party investors. For that reason, industry has suggested that a complete exemption should be provided, failing which a principles-based requirement (on the same basis as suggested above for private and bilateral transactions) should be adopted to provide sufficient flexibility.
- Private only transactions would be those that meet the definition of private but do not fall into any of the three more specific categories outlined above. In respect of such transactions, industry has requested that only the transaction documents and investor report requirements of the existing RTS should be applied, and the obligation to publicly disclose this information via the SFIs website should be disapplied. In addition, the general CRA3 disclosure obligation to provide investors with "all materially relevant data" should apply.

Although it is not yet clear to what extent feedback from the consultation process (and particularly the comments of industry summarised above) will inform the eventual position, it is hoped that a more limited disclosure obligation will apply in respect of private and/or bilateral SFIs. ESMA has acknowledged the confidential nature of many private or bilateral arrangements (referring in its consultation paper to "trade secrets" as an example), however it remains to be seen whether there will be any protection of the commercially sensitive elements of these transactions in the final detailed requirements.

Report of the Joint Committee of the European Supervisory Authorities

The latest development of note is the Joint Committee of the European Supervisory Authorities report published on 12 May 2015 (the "**Joint Committee Report**"). The Joint Committee Report is intended to be a wide-ranging review of the existing legislative and regulatory framework relating to securitisation (of which CRA3 is a part) with a specific focus on the consistency of due diligence and disclosure requirements. A number of recommendations are put forward in the Joint Committee Report, some of which would, if implemented, directly impact the disclosure obligations under CRA3.

In the industry response to ESMA's call for evidence on the subject of private and bilateral transactions, industry rightly set out some concerns with respect to a number of the recommendations set out in the Joint Committee Report. The report appears to single out securitisation and, if implemented, its recommendations could hinder the recovery of Europe's securitisation markets. This seems particularly unexpected in the context of the Capital Markets Union initiative of the European Commission, one of the main elements of which is a drive to revive European securitisation markets. While industry fully supports greater harmonisation and consistency, especially across different types of investors, there is a legitimate concern that securitisation market participants have not been consulted regarding the practical implementation of the Joint Committee Report's recommendations.

The Joint Committee Report seems the more unusual in that it comes so closely on the heels of the final RTS and that it recommends introducing further disclosure requirements that go beyond what we understand to be both the information that can be reasonably expected to be provided by an issuer or originator and beyond that which is reasonably required by investors. It is not yet clear whether these recommendations will be implemented (and if so in what form), but it is to be hoped that proper consultation will be conducted and the legitimate concerns raised by industry will be addressed before any further action is taken.

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7. US disclosure rules for ABS – an embarrassment of riches

During the fall of 2014, the U.S. Securities and Exchange Commission (the "**SEC**") adopted a number of rule amendments that affect the disclosure obligations of issuers offering asset-backed securities ("**ABS**") to U.S. investors. Specifically, the SEC adopted (1) Regulation AB II, a series of amendments to the disclosure-based rules contained in Regulation AB, the most prominent of which is the addition of detailed asset-level data to the disclosure requirements for SEC-registered ABS, (2) Rule 15Ga-2, which imposes requirements on issuers and underwriters of ABS to disclose the findings and conclusions of third party diligence reports and (3) Rule 17g-10, which requires third party due diligence service providers, such as accounting firms, to make certain representations to Nationally Recognised Statistical Rating Organisations ("**NRSRO**") regarding their due diligence reports. While issuers offering and selling ABS pursuant to transactions exempt from the registration requirements of the Securities Act of 1933, as amended (the "**Securities Act**") are not required to comply with the disclosure requirements of Regulation AB II, beginning 15 June 2015, *all* issuers and underwriters that offer ABS to U.S. investors will be required to comply with Rule 15Ga-2 and their due diligence service providers will be required to comply with Rule 17g-10. Non-U.S. issuers that privately place ABS into the U.S., while not required to strictly comply with Regulation AB or Regulation AB II, should nevertheless view the disclosure requirements contained therein as helpful guidance as to the materiality of specific asset-level disclosure data points.

Regulation AB II

Regulation AB II is an expansion and continuation of Regulation AB, the primary regulatory disclosure framework for SEC-registered ABS in the U.S., which the SEC originally adopted in December 2004. Regulation AB II implements provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), introduces new disclosure requirements, most prominently a requirement to provide detailed asset-level data varying by the asset type underlying the ABS, and contains forms and schedules geared toward standardising and expanding the information provided to investors about underlying assets in ABS. Issuers of SEC-registered ABS will be required to comply with these new requirements, which include ABS-specific registration forms (Form SF-1 and SF-3), beginning on 23 November 2015, except for the requirement to provide asset-level information, which will begin on 23 November 2016.

Asset-level disclosure

Regulation AB II will require asset-level disclosures for ABS registered with the SEC that is backed by:

- residential mortgage loans ("**RMBS**");
- commercial mortgage loans ("**CMBS**");
- auto loans and leases;
- debt securities; and
- resecuritisations of ABS.

No asset-level disclosure requirements have been adopted for ABS backed by equipment loans or leases, student loans, credit cards or floorplan loans, and an exemption is provided for resecuritisations of ABS issued prior to the compliance date.

Asset-level information will need to be provided in a standardised, tagged data

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format (eXtensible Mark-up Language, or XML). Schedule AL specifies the content of a required asset data file for each asset class to which asset-level disclosure applies. Although specific data requirements vary by asset class (for example, the SEC requires the disclosure of only 72 data points for auto loans while it requires 152 data points for CMBS), the new asset-level disclosures generally will include information about:

- the credit quality of obligors;
- the collateral related to each asset; and
- the cash flows related to a particular asset, such as the terms, expected payment amounts, and whether and how payment terms change over time.

Prospectus disclosure requirements

In addition, the SEC recently adopted amendments related to prospectus disclosure requirements for ABS offerings, including:

- expanded disclosure about transaction parties, including disclosure about a sponsor's retained economic interest in an ABS transaction and financial information about parties obligated to repurchase assets;
- statistical information regarding whether pool assets were originated in conformity with (or as exceptions to) disclosed underwriting/origination criteria, or modified after origination;
- a description of the provisions in the transaction agreements about modification of the terms of the underlying assets; and
- a requirement to file the transaction documents in connection with shelf takedowns by the date of the final prospectus.

Applicability of Regulation AB II to unregistered offerings

Regulation AB II in its original proposed form would have applied to both public and private offerings of ABS into the U.S. Although, as adopted, Regulation AB II does not apply to unregistered offerings, market participants generally regard disclosure regulation promulgated by the SEC, including Regulation AB, as important guidance for the preparation of offering memoranda for private offerings of securities, including offerings of ABS. U.S. federal securities law imposes significant disclosure obligations and potential liabilities on an issuer and other parties involved in offerings of securities to U.S. investors, whether offered and sold publicly or privately. Pursuant to Section 10(b) of the U.S. Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), and Rule 10b-5 promulgated thereunder, U.S. federal securities law imposes civil liability on issuers and other distribution participants for material misstatements and omissions contained in any offering document circulated to prospective investors or otherwise made (orally or in writing) in connection with any securities offering.

In its adopting release for Regulation AB II, the SEC expressed the view that investors needed access to more robust and standardised information about assets underlying particular ABS in order to make informed decisions. In the same release, however, the SEC also noted that many issuers of CMBS, RMBS and ABS backed by other assets types are already providing asset-level disclosure in compliance with disclosure frameworks developed by industry groups or, in the case of foreign issuers of ABS, disclosure regulations issued by domestic regulators.

While acknowledging that different asset types call for different disclosure, Regulation AB II reflects the SEC's view that investors would gain significant value from asset-level disclosure that's standardised by asset type. In light of the strongly held view of Mary Jo White, the chairwoman of the SEC, that the disclosure requirements of Regulation AB II address core issues related to the financial crisis, issuers of ABS into the U.S. that already provide asset-level disclosure in their offering documents should consider carefully the materiality of any specific data points that are called for by Regulation AB II's asset-level disclosure framework but not currently included in their offering documents. Issuers that do not currently provide asset-level disclosure should also consider carefully the materiality of such disclosure to their investors in light of the worldwide industry and regulatory trends calling for asset-level disclosure.

Disclosure requirements regarding third party due diligence reports

Effective 15 June 2015, Rule 15Ga-2 will require any issuer or underwriter of registered or unregistered ABS, as defined in the Exchange Act ("**Exchange Act-ABS**"), rated by a NRSRO to publicly file a Form ABS-15G on EDGAR, the SEC's electronic document retrieval system, in connection with any third party due diligence reports an issuer or underwriter obtains, which discloses the findings and conclusions of any such third-party due diligence report. In practice, this effective date means that the Form ABS-15G filing requirement will apply to relevant transactions that price on or after 12 June 2015. Form ABS-15G must be filed on EDGAR at least five business days prior to the first sale in the offering, but it need only be provided with

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respect to the initial rating of ABS (*i.e.,* not necessary in connection with subsequent rating activities). While this rule contemplates that a Form ABS-15G would be filed by either an issuer or an underwriter, we anticipate that it will become market practice for underwriters to expect issuers to bear the responsibility for filing these forms.

The Form ABS-15G disclosure may not merely summarise the third-party due diligence report; it must contain the actual findings and conclusions expressed therein. If the disclosure requirements have been met in the prospectus filed with the SEC (including attribution to the appropriate third-party), and the prospectus is publicly available at the time the Form ABS-15G is furnished by the issuer or underwriter, the Form may, however, refer to that section of the prospectus rather than providing the findings and conclusions once again in full.

A Form ABS-15G filing would not be required if an NRSRO engaged to provide an ABS credit rating provides the issuer or underwriter with a representation that it will publicly disclose the findings and conclusions of the relevant third-party due diligence report. If the issuer or underwriter reasonably relies on the NRSRO to make this disclosure and the NRSRO fails to do so in a timely manner, the issuer or underwriter will have until two business days prior to the first sale of such ABS to file a Form ABS-15G. A Form ABS-15G must be filed regardless of whether an NRSRO in fact uses the third-party due diligence report in its credit rating decision.

The necessity of this form with regard to pre-securitisation due diligence activities (*e.g.*, acquiring underlying assets from the originator or a third-party seller) is unclear. The regulation requires the filing of a Form ABS-15G in respect of "all third-party due diligence reports obtained by the issuer or underwriter, including interim reports, related to an offering of asset-backed securities."

Third-party due diligence reports

A "third-party due diligence report" for purposes of Rule 15Ga-2 and Form ABS-15G means any report that contains the findings and conclusions of any due diligence services performed by a third party. In this context, the meaning of "findings and conclusions" is currently the subject of discussion in the industry and remains open to interpretation. The conservative view is that each interim report (in its entirety) and the final report need to be disclosed. On the other end of the interpretive spectrum would be the disclosure of just a redacted final report. This would be done for two reasons: (1) there may be some privacy issues raised in connection with some of the information in these reports; and (2) much of the information in interim reports may be superseded by information in a final report.

For purposes of the definition of third-party due diligence report, "due diligence services" includes evaluations of any of the following:

1. the accuracy of the information or data about the assets provided, directly or indirectly, by the securitiser or originator of the assets;
2. whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria, or other requirements;
3. the value of collateral securing the assets;
4. whether the originator of the assets complied with federal, state, or local laws or regulations; or
5. any other factor or characteristic of the assets that would be material to the likelihood that the issuer of the asset-backed security will pay interest and principal in accordance with applicable terms and conditions.

The first four categories address the types of due diligence the SEC believes is typically conducted for offerings of RMBS, the primary area in which due diligence is conducted. The fifth category is a catch-all for other asset classes where such services may be performed in the future.

Whether a report issued by a custodian constitutes a "third-party due diligence report" is currently the subject of industry debate, especially with respect to seasoned loans (i.e., reports on what documents are missing).

Beginning 15 June 2015, Rule 17g-10 will require a third-party provider of due diligence services in connection with ABS offerings to U.S. investors to deliver a written certification on Form ABS Due Diligence-15E disclosing who paid for such services, a detailed description of the manner and scope of the due diligence services provided and a summary of the findings and conclusions of the due diligence. In practice, the effective date means that written certifications will need to be provided for due diligence services that are completed on or after 15 June 2015. There is some concern that this requirement would apply to third-party due diligence reports provided on or after 15 June 2015 in respect of a transaction that closed prior to this effective date, which may affect certain CLOs.

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Application to agreed-upon procedures performed by accounting firms

Some, but not all, services performed by accounting firms as agreed-upon procedures ("**AUP**") will be considered "due diligence" services. Those services that are not considered "due diligence" will not be subject to these rules. If the primary purpose of the service is to assist issuers and underwriters in verifying the accuracy of disclosures, the service will not be subject to the new rules. Examples of this type of service include performing procedures that tie information included in the offering documents to the loan tape or the financial statements, or recalculations of projections of future cash flows.

AUP services consisting of comparison by accountants of data on a loan tape to a sample of loan files are an example of a service that must be disclosed. This type of review is typically reflected in AUP letters that are delivered to underwriters or initial purchasers for ABS offerings, and can also be provided in connection with Rule 193 letters provided by accountants.

The SEC has acknowledged that accounting firms most likely will be reluctant to provide Rule 17g-10 certifications. As a result, the SEC will not object to including a description of the standards that govern the performance of AUP on Form ABS Due Diligence-15E.

Exemptions for non-U.S. transactions and municipal securities

The requirements of Rule 15Ga-2 will not apply to a non-U.S. offering of ABS where the following conditions are satisfied:

- the offering is not registered (and is not required to be registered) under the Securities Act;
- the issuer is not a "U.S. person"; and
- The security issued by the issuer will be offered and sold upon issuance, and any underwriter or arranger linked to the security will effect transactions of the security after issuance, only in transactions that occur outside the United States.

In addition, the requirement to file a Form ABS-15G will not apply to a municipal issuer of rated securities for private placements of ABS that are exempt from the registration requirements of the Securities Act. These municipal ABS offerings will, however, remain subject to the requirements under Section 15E(s)(4)(A) of the Exchange Act. Accordingly, these issuers will still need to make the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter publicly available – either by posting this information on a website maintained by the issuer or by voluntarily furnishing a Form ABS-15G on EDGAR.

Transaction considerations

Deal teams should be aware of the third-party due diligence report filing requirements, as the ABS-15G forms are due five days prior to the first sale. A failure to timely file a report may cause an inadvertent delay in the pricing of an offering. Filing on EDGAR, while simple and straightforward, requires at least 2-3 days of lead time for issuers that have not yet obtained the requisite passcodes and identifiers. In addition, issuers and underwriters will need to consider what, if any, provisions should be added to third-party due diligence service provider engagement letters to ensure that such parties comply with the new requirements, as well as the content and form of the disclosure to be included in the Form ABS-15G. In particular, issuers and underwriters should make sure that the confidentiality provisions in such engagement letters contain appropriate carve-outs to permit transaction parties to comply with the new regulations under the Dodd-Frank Act.

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8. Bank recovery and resolution – A narrow escape

One of the key pieces of financial stability legislation introduced by the UK government in the aftermath of the financial crisis of 2007-08 was the Banking Act 2009 (the "**Banking Act**"). It introduced wide-ranging new powers to promote the stability or orderly resolution of failing banks with the aim of preventing the kind of uncertainty and market disorder that followed the collapse of Lehman Brothers. More recently, the EU authorities have introduced the Bank Recovery and Resolution Directive (2014/59/EU) (the "**BRRD**"), which entered into force on 2 July 2014 and covers very similar ground, but with a wider geographic and substantive scope. Having just got to a point of comfortable coexistence with the existing regime, securitisation and covered bond market participants are now facing new uncertainties caused by the BRRD and the associated amendments to the Banking Act, which implements the BRRD for the UK and came into force in January 2015. The best publicised of these amendments are the ones relating to the bail-in power, which we discuss in more detail below.

Background

The Special Resolution Regime (SRR)

The SRR is the overall name for the various stabilisation and resolution powers given to HM Treasury and the Bank of England under Part 1 of the Banking Act.

In relation to relevant entities, the UK authorities now have a series of stabilisation powers, useable in advance of that entity's insolvency. These are in addition to the Bank Insolvency Procedure and the Bank Administration Procedure.

One of the important features that has recently changed in is geographical scope of these powers. As mentioned above, the Banking Act was initially a UK-specific response to the financial crisis. The SRR powers were accordingly not able to be exercised in relation to entities incorporated outside of the UK. With the recent changes made to the Banking Act as a consequence of the implementation of the BRRD, there is now greater harmonisation among European Union Member States, including mutual recognition of recovery and resolution measures, meaning, e.g. a UK bank's subsidiary in the Netherlands will in future be subject (via the Netherlands' implementation of the BRRD and associated recognition of UK measures) to Banking Act SRR powers. The Banking Act also provides for recognition of third country recovery and resolution measures in certain circumstances. The reach of Banking Act style powers, therefore, is now substantially wider than it used to be.

In addition, under the Banking Act as originally enacted, these powers applied only to banks and bank holding companies. Following the amendments made in the last few years, it now provides the UK authorities with the relevant powers to stabilise or resolve not only banks, but also building societies, systemically important investment firms, recognised CCPs, banking group companies and certain other entities.

The most important of these additions for the structured debt markets is clearly the addition of banking group companies (BGCs) which can now be the subject of SRR powers in order to assist with the stabilisation of the bank of whose group the BGC is a member. A BGC will, broadly, be any company that controls, is controlled by, or is under common control with, a bank (or other entity subject to the SRR). This is mainly an accounting test and is very similar (though not identical) to the test many securitisation originators have been working through in respect of their securitisation SPVs for EMIR consolidation purposes.

There are, however, a number of exceptions from that general definition of a BGC, including where the entity is a "covered bond vehicle" or a "securitisation company", which definitions are broadly intuitive. Unfortunately, however, even where an entity falls within one of these exceptions, it will nonetheless be a BGC (and thus subject to the SRR powers) if it is also an "investment firm" or a "financial institution".

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In practice, the "investment firm" category it is unlikely to be problematic. The definition of that term requires that the entity carry out MiFID services that no securitisation company or covered bond vehicle is likely to engage in.

The "financial institution" category is more problematic. That term includes any entity whose principal activity is any of a number of activities on a long list, which list includes both "lending" and "guarantees and commitments". Obviously, securitisation companies typically stand in the shoes of the originator (lender) under a number of credit agreements and covered bond vehicles exist largely to guarantee the obligations of the covered bond issuer.

It is nonetheless often possible to conclude that that securitisation companies and covered bond vehicles should escape the application of the SRR powers, but this analysis is nuanced and highly dependent on the specific facts.

Bail-in

Perhaps the most widely discussed new power in the Banking Act is the bail-in power, a power specifically required to be legislated under the BRRD. Under the bail-in option, the authorities have the ability, *inter alia*, to write down debt, write off debt or convert debt into equity, the whole to absorb losses and stabilise the entity or group. The exercise of these powers is subject to a general "no creditor worse off" rule, requiring that bail-in not put any creditor in a worse position than it would have been in under an insolvency. This means that equity holders should be written off before debt, subordinated debt holders should be bailed in before senior debt holders, etc. It is, however, unclear how helpful this would be in practice because of the complexity of analysing the alternative scenario of an insolvency, particularly when the entity concerned is not actually insolvent (as it would, by definition, not be when bail in – a pre-insolvency stabilisation power – is being used).

Various exemptions from the scope of the bail-in power are, however, available. First of all, in order for an entity's debt to be affected, that entity has to be subject to the SRR powers generally, i.e. it must be a bank, BGC, building society, investment firm, CCP, etc. Even where an entity is generally subject to the SRR powers, specific kinds of debt will be "excluded liabilities" and therefore not subject to bail-in (although at an entity level the SRR powers are still generally available). For purposes of the structured debt markets, the main useful category of "excluded liabilities" is secured liabilities.

Today's Banking Act – practical analysis

Securitisations

Taking the above background and applying it to a typical paradigm true sale securitisation structure with a bank originator, the main concern in relation to the Banking Act will be to ensure that the notes issued cannot be affected by the application of the SRR powers. The transaction being a securitisation, the notes themselves will be secured and therefore excluded liabilities, so there is no need to go through the full bail-in analysis. It remains only, therefore, to see whether the issuer can be affected by the SRR powers more broadly.

The issuer is likely to be a special purpose vehicle and therefore not in any category that would lead to the application of the SRR powers to the issuer in its own right. It will, however, potentially be subject to the application of the SRR powers to the extent that it is a BGC in relation to the originator. The following questions therefore arise:

a) Is the issuer in the same group as the originator? This will largely be an accounting analysis, but it will be helpful as a starting point to refer to the EMIR consolidation analysis that will need to have been done in order to determine the issuer's status as either an NFC+ or an NFC- for EMIR purposes.
   i. If the issuer is not in the same group as the originator, then the SRR powers will not apply to it and the analysis need not be taken any further.
   ii. If the issuer is in the same group as the originator, further information is required and the analysis must proceed as below.

b) If the issuer is in the same group as the originator, does it meet the definition of a "securitisation company"? This definition is aligned with the Taxation of Securitisation Regulations 2006, so the parties are likely to have carried out this analysis for tax purposes already.
   i. If the issuer is not a securitisation company, the SRR powers generally will apply, but the notes will not be subject to bail-in to the extent they are fully secured because they will be excluded liabilities.
   ii. If the issuer is a securitisation company, further information is required and the analysis must proceed as below.

c) If the issuer is a securitisation company, is it also an "investment firm" or a "financial institution"? As mentioned above, securitisation firms will almost never be investment firms. It is not entirely clear, but it will often

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be possible to conclude that issuers should not be considered financial institutions either, on the basis that their principal activity is not lending. Although they hold the rights of the lender in respect of many loans, they generally are not originating loans, providing further advances or otherwise engaging in the day-to-day activity one would associate with the term "lending". Further comfort can be derived from the fact that, in other contexts, the Financial Conduct Authority has given guidance that "lending" as described in the relevant legislation refers to origination of loans, and not to the mere holding of the lender's rights under a loan one has acquired from the original lender.

i. If the issuer is an investment firm or a financial institution, the SRR powers generally will apply, but the notes will not be subject to bail-in to the extent they are fully secured because they will be excluded liabilities.

ii. If the issuer is neither an investment firm nor a financial institution, it will be excluded from the definition of a BGC and will be entirely exempt from the SRR powers.

Covered bonds

In the case of a typical UK regulated covered bond, the BGC analysis above would be largely similar. The LLP that provides the guarantee would, of course, be in the same group as the bank issuer, since the bank issuer is a member of the LLP. The LLP would, however, almost certainly meet the definition of a "covered bond vehicle" and not be an "investment firm".

Whether the LLP would be a "financial institution" is, once again, a somewhat vexed question. If the LLP's "principal activity" were "guarantees and commitments", then that would bring the LLP into the definition of a financial institution. Providing the guarantee in respect of the covered bonds is, of course, a main function of the LLP on a covered bond transaction, but it may be possible to conclude that this should not be considered its only principal activity. One of the requirements to meet the definition of a "covered bond vehicle" is that the entity should acquire, own and manage assets making up the cover pool. There is a reasonable argument that the acquisition, ownership and management of those assets is also a principal activity of the LLP and therefore "guarantees and commitments" would not be the LLP's sole principal activity and the LLP could thereby escape the definition of a financial institution and the application of the SRR powers generally. Although not strictly a legal argument, this interpretation is supported by the fact that any other conclusion would nullify the entire purpose of providing the "covered bond vehicle" exemption from the definition of a BGC.

Even if the LLP is a financial institution, and therefore a BGC, it is likely that the covered bonds themselves would not be subject to being bailed in, insofar as the cover pool is sufficient to meet the obligations under them.

As mentioned above, certain types of debt will constitute "excluded liabilities" for the purposes of bail-in, and these excluded liabilities include any liability, so far as it is secured. Of course, standard regulated UK covered bonds are not, themselves, secured. They are guaranteed and that guarantee is secured on the cover pool. For these purposes, however, "secured" means secured against properly or rights, or otherwise covered by collateral arrangements. Although not directly secured in the traditional sense, the reference to collateral arrangements may well be wide enough to encompass the type of arrangements in place in respect of a covered bond. It seems likely that this will have been the intention, particularly given the very clear prohibition in the BRRD (of which the Banking Act is the UK implementation) against exercising bail-in powers in relation to "secured liabilities including covered bonds".

Conclusion

The BRRD and the Banking Act are one of several areas of new legislation that are not specifically intended to deal with structured debt, but nonetheless have a significant effect on it. While bank recovery and resolution legislation was always going to be of concern to securitisation and structured debt transaction parties, unfortunate legislative drafting at both the BRRD and Banking Act levels has resulted in difficulties that are perhaps more pronounced than they need have been in determining the precise nature and scope of the powers and their practical effect on structured debt transactions. It is to be hoped that future amendments will help to clarify some of the more difficult questions discussed above and that a developing body of practice will, in the interim, help to provide comfort to all market participants as to the nature of the bank-related risks they are taking when investing in securitisation products and covered bonds.

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9. Volcker Rule implementation – challenges for structured finance underwriters

In the period following the adoption by US federal regulators of regulations to implement the Volcker Rule (the "Implementing Regulations"), investment banks have been considering on a case-by-case basis whether the structured finance transactions they underwrite present compliance concerns with respect to this rule. In our experience, many structured finance issuers are eligible for a regulatory exemption or exception from the Volcker Rule. Underwriters are increasingly seeking assurances that an exemption is available or that the issuer is not within the scope of the Volcker Rule. Where the issuer has U.S. counsel (for example, if the securities are offered under Rule 144A), that assurance may take the form of a contractual representation and warranty from the issuer. In wholly non-U.S. transactions, where the issuer does not have U.S. counsel, market practice is coalescing on the provision of a memorandum from underwriter's US counsel as to the Volcker treatment of the issuer. If no such assurances can be provided, then transaction participants typically consider whether offering documentation should include disclosure regarding the possibility that the Volcker Rule could restrict banking entities from investing in the issuer's securities.

Background

The "Volcker Rule" is a new Section 13 to the Bank Holding Company Act of 1956 ("BHC Act") which was inserted by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). This provision applies to any "banking entities", which means, generally, any entity within the same group as a bank that has a U.S. branch or agency.

The Volcker Rule generally prohibits banking entities from:

- engaging in proprietary trading; or
- acquiring or retaining any ownership interest in, or sponsoring, certain types of funds, which can include structured finance issuers, unless an appropriate exemption is available.

The Volcker Rule also prohibits banking entities from engaging in "covered transactions" (under Section 23A of the US Federal Reserve Act) with a related sponsored, advised or managed covered fund or a covered fund that is offered as a permitted activity in connection with *bona fide* trust, fiduciary or investment advisory services. This prohibition is known as the "Super 23A" prohibition and mainly prevents banking entities from executing loans, derivatives and other transactions that would expose the banking entity to credit risk of a related covered fund.

The proprietary trading ban and the underwriting exception

The Volcker Rule's proprietary trading prohibition covers positions held in a "trading account," which is defined by the Implementing Regulations as any account that is used to take positions principally for the purpose of short-term resale, benefitting from short-term price movements, locking in short-term arbitrage profits, or hedging another trading account position. The Implementing Regulations provide a broad exception for underwriting activities from this ban on proprietary trading.

The underwriting exception requires verifiable compliance with a number of conditions, including that:

- the underwriting position of a banking entity's trading desk must be related to the banking entity's role as distributor of the securities that are subject to the underwriting activity;
- the amount and type of securities that the trading desk holds must be designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties; and

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- the banking entity must take reasonable efforts to reduce its position in the relevant securities within a reasonable period, taking into account the liquidity, maturity and depth of the market for the relevant securities.

In addition, the Implementing Regulations specify the features of compliance policies and procedures that a banking entity should have in place to ensure that it analyzes and tests its compliance with the conditions for this exemption. As this exception relates only to the proprietary trading ban of the Volcker Rule, the availability of additional regulatory relief must be considered if the securities proposed to be underwritten raise concerns regarding compliance with other aspects of the Volcker Rule.

Assuring compliance with covered fund related prohibitions

As originally postulated by Paul Volcker, the Volcker Rule was not aimed at securitisation or structured finance activities. However, the statutory definition of a "covered fund", and the scope of the Implementing Regulations make clear that securitisation issuers can be covered funds, and that banks' involvement with them is now highly regulated.

The definition of a "covered fund" set out in the Implementing Regulations includes an entity that relies on the exclusions from the definition of "investment company" provided in Sections 3(c)(1) and 3(c)(7) of the US Investment Company Act of 1940 (the "Investment Company Act"). These provisions were selected because they are commonly used by private equity and hedge funds, which were the original targets of the Volcker Rule. However, they were also commonly used by securitisation issuers (particularly 3(c)(7)), because they are generally based on the composition and status of the investors in the fund, and do not restrict the nature of assets or activities that a fund can acquire or undertake.

As stated above, the Volcker Rule prohibits banking entities from sponsoring or acquiring ownership interests in covered funds.

Potential causes for Volcker Rule compliance concerns

In structured finance transactions, circumstances where Volcker Rule compliance may become a concern include:

- the originator, underwriter, investment manager or any key investor is a banking entity subject to the Volcker Rule;
- the underwriter is affiliated with the sponsor of a securitisation;
- the issuer is a special purpose vehicle that holds a significant amount of investment securities or proposes to hold a significant amount of investment securities in the future that do not fully conform to the portfolio requirements of the Volcker Rule's exception for loan securitisations or meet another exemption or exclusion;
- the transaction involves an extension of credit to the issuer by a banking entity or a banking entity enters into a derivative transaction with the issuer.

For purposes of the Volcker Rule, to "sponsor" a fund means:

- to serve as a general partner, managing member, or trustee of the covered fund, or to serve as its commodity pool operator;
- in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of the fund; or
- to share with the fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

An ownership interest includes not only traditional equity interests, but also any security that receives income from the issuer on a pass-through basis and any security that entitles the holder to participate in the selection or replacement of certain managers (including investment managers) of the issuer, other than upon an event of default. Banking entities are therefore significantly restricted in the nature of structured finance securities they can hold, and underwriters are limited in the securities they can sell to such banking entities. As a result, underwriters have begun to ask for assurances that an exemption or exception from the Volcker Rule would apply to them.

As we mention above, when a sponsor or issuer has engaged US counsel to advise on the transaction, the assurances may be provided by the issuer in the form of representations and warranties in the underwriting agreement.

However, non-US offerings by non-US issuers are often executed without involving US counsel. In those circumstances, US counsel would not be engaged to advise the issuer with respect to representations and warranties regarding the applicability of

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the Volcker Rule as part of the transaction documentation, and the issuer could not give those representations and warranties on an informed basis. Consequently, it is becoming market practice for underwriters to engage special US counsel to provide a memorandum confirming the basis on which the issuer complies with, or is exempt from, the Volcker Rule.

A variety of exclusions from the definition of covered fund may be applicable to structured finance transactions, often depending on the types of assets being securitised.

Alternate exemptions from the Investment Company Act

An issuer would not be considered to be a "covered fund" for purposes of the Volcker Rule if it could rely on an exclusion or exemption from the definition of "investment company" under the Investment Company Act *other than* the exclusions set forth in Sections 3(c)(1) and 3(c)(7). Accordingly, if the issuer is eligible to rely on an alternate exemption from the definition of "investment company" under the Investment Company Act, the underwriters of the issuer's securities would not face "covered fund" related compliance concerns under the Volcker Rule. Two exemptions on which structured finance vehicles often rely are found in Section 3(c)(5) of the Investment Company Act.

Mortgage ABS. RMBS or CMBS issuers may qualify for the exception found in Section 3(c)(5)(C) of the Investment Company Act. Under this exception, an issuer would not be an investment company for purposes of the Investment Company Act if that issuer "is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and … is primarily engaged in … purchasing or otherwise acquiring mortgages and other liens on and interests in real property". Whether an issuer qualifies for this exception depends almost entirely on the composition of the issuer's portfolio of assets. The "primarily engaged" requirement of Section 3(c)(5)(C) means that the issuer's portfolio should have the following composition:

- mortgages and other liens on, and interests in, real estate ("qualifying interests") are at least 55% of the issuer's total assets;
- other real estate-type interests are at least 25% of the issuer's total assets (or less, to the extent that qualifying interests exceed 55% of the total); and
- miscellaneous investments are no more than 20% of the issuer's total assets.

Accordingly, to qualify for this exception, the fair value of an issuer's portfolio of mortgage loans should exceed 55% of the fair value of the issuer's total assets throughout the life of the financing, and the fair value of any miscellaneous investments should not exceed 20% of the fair value of the issuer's total assets.

A qualifying interest is an asset that represents an actual interest in real estate or is a loan or lien fully secured by real estate. An asset that is the functional equivalent of, and that provides the same economic experience as, a direct investment in real estate or a loan or lien fully secured by real estate, may be considered a qualifying interest for Section 3(c)(5)(C) purposes.

Non-mortgage ABS. Many types of non-mortgage structured finance transactions, including auto loan or credit card transactions, can rely on the exception found in Section 3(c)(5)(A) of the Investment Company Act. Under this exception, an issuer would not be an investment company if it "is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and … is primarily engaged in … [p]urchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services".

Redeemable securities not eligible. Redeemable securities would not qualify for any exemption provided under Section 3(c)(5) of the Investment Company Act. Section 2(a)(32) of the Investment Company Act defines a "redeemable security" as "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." As a result, if the securities are redeemable without any significant restrictions at the option of the holders, this exemption would not be available. Provisions permitting the issuer to redeem the securities in certain circumstances would, however, not cause the securities to be treated as redeemable securities for these purposes.

Volcker Rule exemption for loan securitisations

To the extent that an alternate Investment Company Act exemption is not available, structured finance underwriters may be able to instead rely on the "loan securitisation" exemption provided in the Implementing Regulations. This exemption excludes structured finance

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vehicles that meet specified conditions of the loan securitisation exemption from the definition of covered fund. A "loan securitisation" is defined as an issuing entity for asset-backed securities that meets the conditions of the rule and the holdings of which are comprised solely of:

- loans (this is a defined term that includes any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative);
- rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to holders of such securities or (ii) related or incidental to purchasing or otherwise acquiring and holding the loans, provided that each asset is a permitted security meeting specified requirements;
- interest rate or foreign exchange derivatives that meet specified requirements; and
- special units of beneficial interest and collateral certificates that meet specified requirements.

A loan securitisation must own the loans to be securitised directly and not through a synthetic exposure, such as a credit default swap. In addition, to qualify for this exemption, the issuer's portfolio of underlying assets must not contain any of the following impermissible assets:

- any security, including an asset-backed security, or any interest in an equity or debt security;
- any derivative; or
- any commodity forward contract.

For these purposes, "impermissible assets" does not include:

- investments in high-quality, highly liquid, short-term investments whose maturity corresponds to the securitisation's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities;
- securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities (*i.e.*, securities received in bankruptcy in exchange for loans); and
- interest rate or foreign exchange derivatives that meet the following requirements: (1) the written terms of the derivative directly relate to the loans, the asset-backed securities, or the servicing assets; and (2) the derivatives reduce the interest rate and/or foreign exchange risks related to the loans, the asset-backed securities, or the contractual rights or the servicing assets.

Any derivatives held by a loan securitisation must be related to the types of risks associated with the underlying assets and may not be derivatives designed to supplement income based on general economic scenarios, income management or unrelated risks, such as credit default swaps.

The limited scope of eligible assets in the loan securitisation exemption has significantly altered the CLO market, where transactions are structured either to meet the relatively exacting requirements of Investment Company Act Rule 3a-7 (and thereby obviate the need to rely on either 3(c)(1) or 3(c)(7)), meaning the issuer would not be a covered fund, or to avoid investment in corporate bonds and other securities (and thereby fit the criteria for the loan securitisation exemption from the Volcker Rule).

Material conflicts or high risk strategies. The Implementing Regulations provide that the loan securitisation exemption (and other exemptions provided under the Volcker Rule) would be disallowed to a banking entity with respect to a particular issue of securities if the investment in the securities:

- involves or results in a "material conflict of interest" between the banking entity and its clients, customers or counterparties; or
- results, directly or indirectly, in a material exposure by it to a "high-risk asset" or a "high-risk trading strategy".

For purposes of the Volcker Rule, a "material conflict of interest" would exist if the transaction or activity at issue would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions or activity. The Implementing Regulations would permit circumstances in which conflicts of interest were mitigated by making clear, timely and effective disclosure or, in certain cases, by implementing information barriers. For these purposes, a "high-risk trading strategy" means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. In our experience, the practical effect of these provisions is minimal because transactions falling within its ambit are exceedingly rare, for good and obvious reasons.

The SOTUS Exemption

If none of the above described exceptions apply, non-US structured

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finance underwriters may be able to instead rely on the solely outside the United States, or "SOTUS", exemption provided by the Implementing Regulations.

This exemption permits certain non-U.S. banking entities to have an ownership interest in, or sponsor, a "covered fund" that is *organised and offered solely outside the United States*.

The SOTUS exemption provides relief to a limited subset of non- U.S. banking entities and must therefore be evaluated on an entity-by-entity basis. It is only available to banking entities that are not (1) organised under U.S. law or (2) directly or indirectly controlled by a banking entity that is organised under U.S. law. In addition, the non- U.S. banking entity must exceed specified U.S. bank regulatory thresholds regarding the relative size of its non- U.S. business (in broad terms, its total assets or revenues outside the United States should be greater than its total assets or revenues inside the United States).

This exemption also requires that the non-U.S. banking entity and any relevant personnel that makes the decision to sponsor or acquire or retain any ownership interest in the issuer not be located in the United States, and not be controlled directly or indirectly by, a banking entity that is located in the United States. Its investment in the issuer, including any transaction arising from risk-mitigating hedging related to an ownership interest, should not be accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organised under U.S. laws. Furthermore, no financing for its sponsorship of the issuer or purchase of the securities may be provided, directly or indirectly, by any branch or affiliate that is located in the United States or organised under U.S. laws.

A non-US banking entity seeking to rely on the SOTUS exemption may not engage in an offering of ownership interests that targets residents of the United States. If intends to resell the securities, it should only offer for sale and resell the securities to purchasers who are not "U.S. persons" (as defined in Regulation S). This marketing restriction only applies to the particular non-U.S. banking entity in connection with its own activities with respect to covered funds. The U.S. Federal Reserve Board has clarified that the SOTUS exemption is available to qualified non-U.S. banking entities with respect to funds in which there are U.S. investors as the result of marketing or selling activities of unaffiliated third parties.

Disclosure

Issuers that are not banking entities but possibly are "covered funds" for purposes of the Volcker Rule are not expected to be responsible for policing whether the banking entities that buy their securities are doing so in compliance with the Volcker Rule. In other words, a "covered fund" issuer would not be expected to implement transfer restrictions on its securities to prevent transfers to banking entities that are subject to the Volcker Rule.

These issuers should consider, however, whether they are providing sufficient disclosure in their offering materials to permit potential investors that are banking entities to comply with the Volcker Rule. To the extent that the securities are offered to U.S. investors, U.S. federal securities law imposes civil liability on issuers, underwriters and other distribution participants for material misstatements and omissions contained in any offering document circulated to prospective investors or otherwise made (orally or in writing) in connection with any securities offering. For these purposes, a misstatement or omission is considered material if disclosure of the misstated or omitted fact would be viewed by a reasonable person as having altered the total mix of information available.

Depending on the facts and circumstances of a particular offering, that an issuer may be considered to be a "covered fund" for purposes of the Volcker Rule, which would restrict banking entities from owning the issuer's securities, may be considered material information that would be prudent to include in the offering materials provided to potential investors.

Conclusion

Most structured finance underwriters are banking entities subject to the Volcker Rule. Since the Volcker Rule's implementing regulations were adopted in December 2013, structured finance underwriters have been evaluating on a case-by-case basis whether the transactions they underwrite present Volcker Rule compliance issues. Often they request assurances that exemptive relief would apply to them in the form of a contractual representation and warranty in the underwriting agreement or in the form of a memorandum from underwriter's U.S. counsel. Depending on relevant facts and circumstances, if no such assurances can be given, disclosure may need to be included in the offering documentation regarding the Volcker Rule's potential impact on the offering.

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10. Securitisation swaps – recent regulatory developments and challenges ahead

It is almost seven years since the height of the crisis which engulfed global financial markets in September 2008. During those seven years, regulators around the world have responded with many reforms, and a particular target of those reforms has been the global derivatives industry. While these reforms have not been primarily directed at securitisation swaps, they are, nevertheless, having a significant impact on such swaps, and are likely to have even more of an impact in the years ahead.

This article discusses the EMIR reforms which apply in the EU, analysing the impact which those reforms have for securitisation swaps, and some of the resulting challenges and difficulties.

EMIR and securitisation swaps

Within the EU, the regulatory reforms impacting on the derivatives industry are primarily to be found in the European Market Infrastructure Regulation (Regulation (EU) No 648/2012, commonly referred to as "EMIR") and the various secondary measures which have been introduced pursuant thereto. Most of these reforms have been devised primarily with traditional over-the-counter (OTC) derivatives in mind. However, they apply to all OTC derivatives, and thus also apply to swaps entered into by securitisation issuers in connection with securitisation transactions. Many of these regulations also apply to swaps entered into in connection with covered bonds, although some important differences do apply.

Flow market derivatives, such as vanilla interest rate swaps, currency swaps and credit default swaps, are characterised by being both highly standardised and high volume, where it is common for parties to have many outstanding transactions between them at any point in time. It is, therefore, unsurprising that when these rules are applied to more bespoke derivative transactions, such as securitisation swaps, difficulties can arise.

Securitisation swaps are highly bespoke instruments. The terms of the transaction are usually tailored to meet the specific features of the securitisation to which they relate, thus departing from the more standard form contracts seen in the flow market. For example, whereas most flow market interest rate swaps will have a fixed notional amount which applies for the life of the swap, or a pre-determined notional amount profile that is agreed at the outset, in many securitisation swaps, the notional amount will be linked either to the outstanding balance of the notes, or to the performing balance of the underlying asset pool backing the notes, and, accordingly, may fluctuate unpredictably over the life of the transaction. Because of this, pricing and trading securitisation swaps requires a detailed knowledge of the underlying asset portfolio and the broader terms of the securitisation transaction. This is very different from the way in which market makers price more standard OTC derivatives.

The nature of securitisation issuers as special purpose vehicles also has an impact on the number of transactions they enter into. Most securitisation issuers will only enter into a small number of transactions at the time the notes are issued, and will not subsequently enter into any additional swaps or even amend those existing swaps. Even in the case of programme issuers, they will only enter into a limited number of swaps in connection with each issue. This is a reflection of the fact that securitisation issuers have only limited assets, and are bound by covenants to apply those assets in specific, pre-defined ways, meaning they have no flexibility to change the way they deal with their assets over the life of a transaction. This is very different from the situation with financial or corporate entities, or even investment funds, which may enter into numerous OTC derivatives on a continuous basis.

When assessing the impact the EMIR reforms have on securitisation swaps, the reforms can be classified into two broad categories. The first category can be described as administrative or process-related, and are reforms designed primarily to ensure that parties have accurate records of the transactions which they enter into and procedures in place to identify and resolve any discrepancies between them as to the terms of those transactions. The second category are those which are designed to reduce or mitigate the counterparty risk associated with derivative transactions. While the first category of reforms has

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now largely bedded down, the regulators are still formulating many of the rules to give effect to the second category.

Classification of transaction parties

Before considering the impact of the various EMIR regulations on securitisation swaps, it is useful to pause to consider how EMIR classifies entities, which in turn determines to what extent the various rules apply to a swap transaction. Broadly-speaking, EMIR divides entities in two ways. First, there is a division between EU entities and non-EU entities (referred to as third country entities, or TCEs). EU entities are then divided into one of three categories for the purpose for determining whether or not they are subject to the various rules. The first of these categories is financial counterparties, such as banks. In practice, the hedge counterparty entering into a swap with a securitisation issuer will almost always be a financial counterparty. Entities which are not financial counterparties are referred to as non-financial counterparties (NFCs), and are in turn sub-divided into what are termed NFC+ and NFC– entities, depending on whether the aggregate notional amount of derivative transactions which they enter into exceeds a particular threshold (often referred to as the clearing threshold). However, determining whether or not an entity has entered into transactions which exceed the clearing threshold is not as straightforward as it may initially appear, for two reasons described below. TCEs are similarly divided into entities equivalent to financial counterparties, NFC+s or NFC-s. As discussed below, however it is not always the case that the various rules apply to a TCE in the same way as they apply to an equivalent EU entity.

First, in calculating the aggregate notional amount of derivative transactions, hedging transactions should be excluded. While the precise definition of what constitutes a hedging transaction is complex, in most cases, the types of swaps entered into by securitisation issuers are likely to fall within this definition.

Secondly, and more difficult, it is not just the aggregate notional amount of non-hedging derivative transactions entered into by the entity itself which needs to be considered, but also non-hedging derivative transactions entered into by other members of the group to which the entity belongs. For this purpose, an entity can belong to the same group as another entity if one entity is in a position to exercise dominant influence or control over the other entity, or if a third entity is in a position to exercise dominant influence on control over both entities. This is essentially an accounting determination rather than the determination that would apply for many other regulatory purposes. This presents an issue for many securitisation issuers because, while it will usually be established as an "orphan" SPV, it is not uncommon for such entities to be consolidated with the originator bank or another institution for accounting reasons on the basis that that other institution does have dominant influence or control over the issuer. Whether this is the case can also change over the life of a transaction as, for example, noteholders change or the structure of other entities in the group changes. Thus, while it may be relatively easy to conclude that a securitisation issuer would be a NFC– when viewed on a standalone basis, it is much more difficult to reach this conclusion if the issuer forms part of a larger corporate group. It is also possible that, even if an issuer is a NFC– at the time it enters into a transaction, it may subsequently become a NFC+, and thus become subject to a higher level of regulation.

A further complication arises in the case of TCEs. While such entities are not generally themselves subject to EMIR, to the extent that the hedge counterparty is an EU entity, the rules will still apply. However, there is inconsistency in how the various rules under EMIR apply to transactions with TCEs. While in most cases parties are required to comply with the level of regulation which would apply if the TCE were established in the EU (and was therefore either a NFC+ or NFC–), this is not always the case. In particular, as discussed in more detail below, in the case of the mandatory margining rules, EU entities which are financial counterparties or NFC+s are required to exchange margin with *all* TCEs, regardless of whether the TCE in question would be classified as a NFC+ or NFC– entity if it was established in the EU.

It is likely that this group test, and how it applies to TCEs, will be one of the issues considered during the review of EMIR which is to be undertaken later this year (2015). Whether this results in any reforms, and if so whether those reforms provide some form of relief for securitisation issuers, remains to be seen.

The first category – administrative and procedural requirements

As noted above, the first category of EMIR reforms are essentially administrative and process-related, and comprise the following: (i) a requirement for timely confirmation of transactions, (ii) procedures for reconciling portfolios of transactions, (iii) procedures for identifying and resolving disputes, (iv) procedures for compression of portfolios of transactions and (v) transaction reporting.

Of these, the compression rules are unlikely to be relevant for most

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securitisation swaps, as they only apply where there are in excess of 500 transactions outstanding between the parties.

The requirement for portfolio reconciliation requires the exchange of portfolio information between the parties on a periodic basis, which for most securitisations will be either annually (where the issuer is a NFC–) or quarterly (where the issuer is a NFC+). In most cases this should not be onerous given the small number of swaps which the issuer will enter into, and the fact that the terms of those swaps are unlikely to change over the life of the transaction. However, corporate service providers responsible for managing SPVs do need either to have systems in place to carry out this reconciliation, or appoint a third party to do so on the issuer's behalf. The element of these reconciliation requirements which is most likely to cause an issue is the requirement that the parties exchange mark-to-market valuations of the transactions. Although this requirement only applies where the issuer is a NFC+, it may nevertheless be difficult for the issuer to calculate this mark-to-market value, and in many cases it may need to appoint a third party to do this calculation on its behalf.

The dispute resolution procedures are usually addressed by inserting provisions into the swap documentation setting out how the parties will go about resolving any disputes should they arise.

The transaction reporting requirements can present a challenge for securitisation issuers, because in order to report transactions it is necessary for an entity to have a relationship with a trade repository. This has timing and cost implications, particularly for an entity which is only ever likely to enter into a very small number of transactions. However, the practice which is largely developing in the market is for issuers to delegate responsibility for reporting to the hedge counterparty, and most hedge counterparties are now willing to provide that service.

Finally, the requirement for timely confirmation of transactions can present some challenges. In many securitisations, the swaps are "priced" at the same time as the pricing of the notes, which will usually occur a period of time before the closing date of the notes. Traditionally, this "pricing" would not actually result in a binding transaction coming into place between the issuer and the hedge counterparty. Rather, the swap would only actually be entered into at closing, even though the rates that will apply will be those that were determined at the time of pricing. This reflects the fact that, particularly for a standalone issuer, part of the analysis underpinning the bankruptcy remoteness of the issuer rests on the fact that it has not entered into transactions prior to the closing date.

However, where the hedge counterparty books the swap in its system at the time of pricing, the requirement for timely confirmation means that the documentation for the swap needs to be executed (and become effective) soon after the transaction is booked – within one or two business days depending on whether the issuer is a NFC+ or NFC–. This represents a departure from the conventional approach described above.

The second category – mitigating counterparty credit risk

We turn now to the second category of reforms, being those designed to reduce or mitigate the counterparty risk associated with derivative transactions. There are two broad planks to these reforms: (i) the clearing obligation and (ii) mandatory margining requirement for swaps which are not subject to the clearing obligation. Both these reforms have the potential to have significant impact on securitisation swaps, although the extent to which they will apply is likely to vary considerably from transaction to transaction.

The clearing obligation

The policy objective underpinning the clearing obligation is to require as many derivative transactions as possible to be cleared through a central counterparty so as to replace the counterparty risk with exposure to the clearing house. Clearing houses across the EU have been establishing offerings to facilitate clearing of of such transactions, but this is a process which takes time, and not all transactions will ultimately be capable of being cleared. As clearing houses become capable of clearing a particular type of transaction, the regulators may make an order extending the clearing obligation to that type of transaction. Once that occurs, any transactions of that type must be cleared through a clearing house unless one of the parties to that transaction is a NFC– or, in the case of TCEs, would be a NFC– if it was established in the EU.

In practice, whether or not the clearing obligation applies to a particular transaction actually involves a two-step analysis. The approach taken by ESMA is to define a category of derivatives which are subject to the clearing obligation by reference to a small number of variables, resulting in a relatively broad category. However, not all transactions which fall within these broad categories will actually be capable of being cleared by a clearing

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house, as the clearing house will generally impose tighter parameters for the transactions it will accept for clearing than those which define the category itself. Thus, it is only those transactions which form part of a category of transactions which ESMA has declared are subject to the clearing obligation *and* which a central counterparty will accept for clearing which need to be cleared.

For the time being, the effect of this is that most securitisation swaps are unlikely to be subject to the clearing obligation for either or both of the following the reasons. First, if the issuer is a NFC– (or a TCE which would be a NFC– if it was established in the EU), then it will not be subject to the clearing obligation, although that would change if the issuer was subsequently become a NFC+ (or equivalent to a NFC+), even if that was merely the result of transactions entered into by other entities within the same group.

Secondly, most securitisation swaps contain bespoke features which mean that they would not be accepted by any clearing house at the present time. While this could change in the future, there is no indication that it is likely to do so imminently. Nevertheless, if this did change at some point during the life of a swap, and the issuer was a NFC+, it would become necessary to clear the swap.

At this time, no securitisation swaps in the European market are structured in a way that would make it possible for them to be cleared through a central counterparty. Doing so would present a number of significant challenges, not only to the terms of the swaps themselves, but also to the broader structural framework that underpins securitisation. The only way in which a securitisation swap could be cleared would be by the hedge counterparty agreeing to clear the swap on the issuer's behalf. However, the model by which this occurs under EMIR is a "riskless principal" model, under which the issuer would be required to cover the hedge counterparty for all costs and obligations which it incurs to the clearing house in connection with that swap. Whether a hedge counterparty would be willing to clear the swap on the issuer's behalf, while also agreeing to the standard limited recourse and non-petition provisions which are central to establishing the bankruptcy remoteness of the issuer (and which are inconsistent with the "riskless principal" model) remains to be seen – not least because doing so is likely to have significant implications for the regulatory capital treatment of the swap for the hedge counterparty. Similarly, under the "riskless principal" model, the hedge counterparty would only be obliged to perform its obligations to the issuer to the extent that the clearing house performs its obligation to the hedge counterparty. Whether the rating agencies would be willing to accept this limitation, or whether they would require the hedge counterparty to continue to perform, even in the case of a clearing house default, also remains to be seen. Finally, and at a purely practical level, as collateral would need to be provided to the clearing house in connection with the swaps, and the issuer is unlikely to have eligible collateral available for this purpose, that collateral would need to be provided, either by the hedge counterparty itself, or by a third party, which would introduce an additional cost into the securitisation.

The only alternative would be to terminate the swap, which would leave the issuer unhedged, or to amend the swap in some way so that it was no longer subject to the clearing obligation. Terminating or amending a securitisation swap in this way would, however, be difficult, due to the restrictive covenants which apply in most securitisations, as well as the fact that the issuer would not have access to the collateral which it would need to provide for posting to a clearing house in connection with the swap.

Margining

More likely to be an issue for securitisation swaps are the mandatory margining rules. These rules will apply to all OTC derivatives which are not cleared through a central counterparty, unless one of the parties to that that derivative is a NFC–. In contrast with the clearing obligation, however, for the purpose of these draft rules, only entities established in an EU member state can be classified as a NFC–. Thus, in the case of entities established outside the EU, they will be subject to the margining rules regardless of the notional amount of derivatives they enter into.

At time of writing, the mandatory margining rules are still in draft form, and have been subject to extensive comment from across the financial industry. However, if they were to be implemented in their present form, where the issuer is either a NFC+ or a TCE, the transaction would be subject to the mandatory margining rules and both parties would be required to exchange mark-to-market variation margin. In addition, if the aggregate notional amount of transactions outstanding between the parties exceeds a particular threshold, the parties will also be required to exchange initial margin. The collateral eligible to be provided as initial or variation margin is essentially limited to high quality liquid cash and securities.

As noted above, most of the EMIR rules

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have been devised with the high volume flow market in mind, and do not apply particularly well to securitisation swaps. In the case of the administrative and process-related requirements this is largely a case of parties complying with rules even though they do not appear to offer much benefit in the context of securitisation swaps. In the case of mandatory margining, however the failure of the rules to take into account the specific nature and features of securitisation swaps means that, if the rules were implemented in their current draft form, many securitisations would simply be unable to comply with them.

The key difficulty is, of course, that securitisation issuers do not have access to eligible collateral to post as margin. Thus, in order to be able to post margin, the issuer would need access to some form of collateral facility or arrangement to give it access to such eligible collateral, which would introduce an additional cost into the securitisation. It is also unclear how requiring the issuer to post margin which is provided through such an arrangement would actually provide any net benefit to the financial system, as it would simply replace the hedge counterparty's exposure to the issuer with the collateral liquidity facility having what is essentially exactly the same exposure to the issuer.

What the draft mandatory margining rules fail to take into account, however, is that securitisation swaps already contain features which mitigate counterparty risk for both parties. First, in the case of the hedge counterparty's exposure to the issuer, the hedge counterparty is a already a secured party, ranking either senior to or *pari passu* with the noteholders in the issuer's payment waterfall. Thus, although the hedge counterparty is not receiving cash or securities collateral, it is nevertheless secured on the portfolio of assets which are the subject of the securitisation.

Secondly, in the case of the issuer's exposure to the hedge counterparty, standard rating agency criteria include rating requirements for the hedge counterparty, and obligations to post collateral if the hedge counterparty is downgraded below a particular threshold. If the hedge counterparty is further downgraded below a second, and lower, threshold, then it is obliged to procure a guarantee of its obligations under the swap or transfer the swap to a replacement hedge counterparty which does have the required rating. These requirements, and in particular the requirement for the hedge counterparty to transfer the swap to a replacement entity upon a second downgrade, are arguably better suited to the nature of securitisations than merely requiring the parties to exchange variation margin as contemplated under the draft rules. This is because the rating agency requirements are designed to avoid the issuer ever facing a defaulting hedge counterparty. In contrast, the mandatory margining rules would simply mean that upon a default by the hedge counterparty, the issuer would be able to apply the collateral against any termination amount payable by the hedge counterparty. This would then leave the issuer with the need to find a replacement swap counterparty to avoid being unhedged. As the issuer is usually a SPV, it will have limited ability to find such a replacement without the assistance of an arranger, which may not always be available.

It is unfortunate that the draft margining rules do not take these features into account, particularly given that, in recent years, a market has developed for the transfer of securitisation swaps from hedge counterparties that have been downgraded, thus providing evidence of the efficacy of the rating agency approach.

This is also unfortunate given that the draft margining rules do provide an exemption from the requirement for a covered bond entity to post collateral to a hedge counterparty provided it satisfies certain conditions that are very similar to the features of securitisation swaps described above. Given the similarity between covered bond swaps and securitisation swaps, and the similar funding purposes served by covered bonds and securitisation, this different regulatory treatment creates an un-level playing field between these two key wholesale funding strategies. Once again, it remains to be seen whether this inconsistency will be addressed as part of the review of EMIR to occur in 2015.

Representations as to NFC status

Given the significance of the classification of the issuer as a NFC+ or NFC– (or, where the issuer is a TCE, as an entity that would be a NFC+ or NFC– if it was established in the EU), many hedge counterparties require the issuer to make a representation to that effect. In most cases, this representation is based on a form which has been formulated by ISDA, and which can be adopted by the parties incorporating the terms of what is referred to as the "NFC Protocol" into the swap documentation.

However, the NFC Protocol also contains an additional termination right for the hedge counterparty if the issuer ceases to be a NFC–, and the parties fail or are unable to comply with any clearing requirements or other risk

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mitigation techniques (of which the most likely to be problematic are the mandatory margining requirements). Including this termination right is inconsistent with the general restrictions which apply to the termination of securitisation swaps which are required by rating agencies and which are necessary to minimise the risk of the swap terminating while the notes are still outstanding, thereby leaving the issuer unhedged. No clear consensus has yet developed in the market as to whether this termination right is included. In some ways, it is similar to a right to terminate for illegality, which does generally apply to securitisation swaps. The similarities are particularly pronounced at the moment because the rules for mandatory margining are still being developed, and therefore whether or not the parties would be able to comply with those rules should the issuer become a NFC+ is difficult to assess. It remains to be seen whether this termination right will become common once those rules have been finalised.

Conclusion

Although primarily devised for the flow market, the EMIR regulatory reforms for OTC derivatives also apply to securitisation swaps. Some of these reforms are primarily administrative or process-related and it is relatively easy for securitisation swaps to comply with those rules. However, other reforms such as the clearing obligation and mandatory margining rules cannot be complied with within current securitisation frameworks. Currently, it is unlikely that the clearing obligation applies to any existing securitisation swaps, and the margining rules are still in draft form, but this will change over time. While these rules would only apply to securitisation issuers which are NFC+s and, in the case of the margining rules, TCEs, the difficulty of determining that an issuer is definitely (and will remain) a NFC– means that, once the rules do apply, they will pose significant challenges for securitisations that seem unnecessary and unjustified at a policy level.

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Acknowledgements

We would like to thank the following people for their contributions to this publication:

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Timothy Cleary
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Robert Gross
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Kevin Ingram
Kathryn James
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J201505150047237