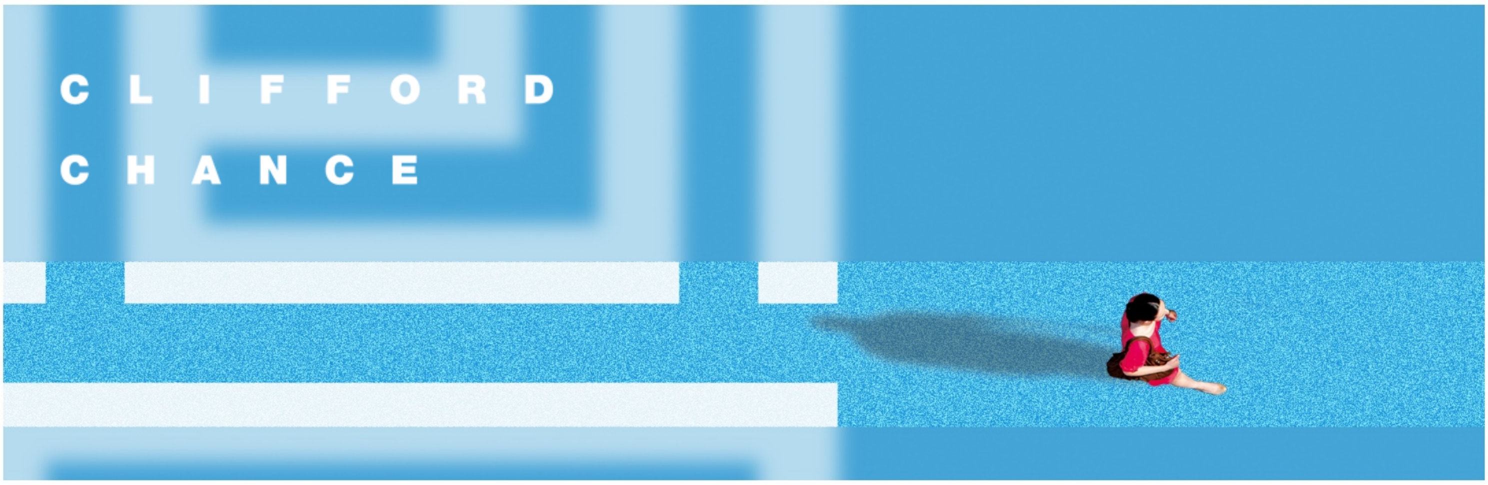

THE REGULATORY LANDSCAPE OF BREXIT FOR CLOs: WHERE TO FROM HERE?

The UK's vote to leave the EU has raised questions across the financial markets and answers are only beginning to trickle through. For CLO market participants – and UK-based collateral managers in particular – the biggest legal concerns are regulatory, mainly around MiFID authorisation and risk retention. In this briefing we review the issues facing the CLO market as a result of the Brexit vote and discuss why, for the moment, the best bet is probably to wait and see.

Key issues

- MiFID authorisations and risk retention are the two biggest Brexit issues for European CLO industry
- The Securitisation Regulation and expected changes to MiFID add to Brexit uncertainty
- There are various potential solutions to the above issues, but immediate action is best limited to reviewing documentation to check the degree of flexibility
- Documentation for new transactions should provide for flexibility
- A premature change in retention structure on existing deals is likely inconsistent with current EU risk retention

WHAT'S HAPPENED?

From a purely legal perspective, nothing has happened yet following the referendum. The vote to leave the EU in the referendum on 23 June 2016 was advisory. So while the political landscape has transformed almost beyond recognition, the legal landscape remains unchanged.

The certainty, however, ends there. There is extremely limited visibility at this point about when legal change will come - other than that it is likely to take several years - and what it will look like when it does. It is even possible (though it seems unlikely) it will never come.

MIFID AND PASSPORTING

The first issue for CLO managers is regarding the management of the asset pool. Depending on the jurisdictions involved and the contents of the asset portfolio, certain MiFID authorisations may be required in order to manage the portfolio. Notably, the delivery of discretionary investment services can trigger licensing requirements in the place of "delivery" of the service (i.e. where the "client" is). This means that the management of CLOs with bond buckets will become problematic in those jurisdictions of incorporation of the SPV which treat such CLO management as being carried on in their jurisdiction. UK managers will not be able to continue to rely on the MiFID passporting into such a jurisdiction of their UK licence.

Examples

Interestingly, for the two main SPV jurisdictions for European CLOs - Ireland and The Netherlands - there is a difference in the approach to licensing of MiFID management activities.

Whilst the Dutch regulator treats management of the portfolio of a Dutch SPV as licensable activity in The Netherlands, the Irish approach - for the moment - is that management is carried on from the location of the manager, and so local Irish licensing requirements are not triggered merely by managing the portfolio of an Irish CLO vehicle.

Should CLO managers be looking at Irish SPVs more to avoid the requirement for the manager to be MiFID authorised? Probably not.

The Irish route

Moving existing vehicles to a new jurisdiction is not a trivial exercise and the gains are in any case uncertain - partly because it is possible that the differences in local regimes will not persist for very long. The introduction of MiFID2 in January 2018 will bring with it a cross-border regime which allows firms from "equivalent" non-EU jurisdictions to provide services into the EU under a registration system. If the UK is held to be such an "equivalent" non-EU jurisdiction, then the regulatory position in the Netherlands and Ireland for access by UK firms could become the same. Additionally, Irish SPVs have limitations on their ability directly to invest in loans in some European jurisdictions (such as Belgium or Spain).

Dutch exemption

Further, there are other ways of dealing with the potential problems posed by Brexit. Even assuming passporting is lost upon the UK's exit from the EU, the Dutch regime already has a helpful exemption for non-EU entities to rely on in the form of a third-country regime used by some US collateral managers. The Netherlands may decide to extend the third-country regime currently used by some US collateral managers to UK-based collateral managers.

Sub-delegation

Another option would be sub-delegation. Those collateral managers who already have authorised entities in other EU countries could consider sub-delegating the functions that require MiFID authorisation. It may be possible for groups without such an entity to set one up, but it will be important to weigh up the advantages and disadvantages of this approach in each individual case, since other factors such as cost, long review times and risk retention arrangements need to be taken into account as well.

Dutch "reverse enquiry"

A final option that has been mooted in the market is the use of the so-called "reverse enquiry" route in the Netherlands, but we consider its use impractical for new origination because the representations required to use this route will not normally be feasible to be given by the parties.

Conclusion

Overall, it is likely that a number of solutions will be available to UK collateral managers who need MiFID authorisation post-Brexit. That said, it will take time to work out which options work best - not least because of ongoing regulatory change within the continuing EU. It is likely that some form of ongoing relationship agreement will be reached with the EU, and this might include rights to conduct cross-border business on a passport-like basis. Failing that, the availability of the third country regime or the ability to sub-delegate to an EU entity provide options. The most appropriate approach for any individual collateral manager is a question of their specific circumstances, but in most cases the best approach for the moment may be to let the dust settle a bit more before making any big moves.

RISK RETENTION

In addition to needing MiFID authorisation for the reasons discussed above, most existing European CLO managers will need it for risk retention purposes.

This is because the majority of European CLOs done on the "CLO 2.0" model are structured to rely on a MiFID-authorised "sponsor" retaining risk for the purposes of European risk retention rules. This leaves the obvious question of what happens to CLOs with European regulated investors (on whom the burden of risk retention compliance falls) once their sponsor is no longer eligible as a sponsor to retain risk under EU rules?

The starting point is Article 407 of the Capital Requirements Regulation, and its corresponding provisions in Solvency II (for insurers) and the AIFM Regulation (for alternative investment fund managers). In these provisions, sanctions are imposed on investors who become exposed to a non-compliant securitisation by their "negligence or omission". So even assuming that there is no grandfathering for existing transactions, it seems unlikely existing investors would be sanctioned for investing in a securitisation that became non-compliant as a direct result of Brexit. After all, the transaction would hardly have become non-compliant by the investor's "negligence or omission".

Nonetheless, if there is no grandfathering of existing transactions, there would be powerful disincentives for European regulated investors to invest in UK-sponsored CLOs after Brexit, reducing demand and prices, and increasing volatility.

Solutions

So what is to be done?

The "originator" solution

A number of CLOs in the market use the originator model, where either the manager purchases a certain number of the exposures before selling them to the CLO vehicle or an SSPE origination platform is used. This route is already used by a number of US managers who do not have MiFID authorisations and being an "originator" doesn't require any particular regulatory status.

For new transactions, use of the originator route would certainly be a feasible method of future-proofing, though it does not come without its own challenges. There are difficult waters to navigate around the proportion of assets the manager needs to originate, the length of time the manager must hold those assets on its balance sheet and the extent of permissible "engineering" around the acquisition and holding of those assets.

For existing transactions, the challenges are even greater. Even where the sponsor was also theoretically an "originator" at the time the transaction was established, the nature of the risk retention rules is rigid. Investors are required to diligence the retention structure at the time of investment to ensure compliance, meaning that the retention structure cannot normally be changed after the transaction is established absent exceptional circumstances. Indeed, the regulatory technical standards in force under the CRR provide precisely this.

While Brexit is certainly exceptional, at this stage, it would be difficult to argue that "exceptional circumstances" exist that have an effect on risk retention. After all, from a legal point of view, nothing has happened yet. So while "in-flight" changes to the originator model might be possible, probably with regulator blessing, once Brexit takes effect, it would be premature - and probably inconsistent with existing risk retention rules - to try to make such an adjustment now.

Retention on a consolidated basis

In a limited number of cases, collateral managers may also be able to take advantage of the provisions of the CRR that permit retention on a consolidated basis. This may be a possibility where the manager's group structure will continue to contain an EU parent and the undertaking was to retain on a consolidated basis with that parent.

Conclusion

Based on the above, it once again seems as though a "wait and see" approach is appropriate. While nobody can say what the legal landscape will look like at the time Brexit becomes effective or thereafter, two things do seem certain:

(i) any attempt to do an "in-flight" move from the sponsor to the originator model before legal changes have happened is open to challenge, may end up being unnecessary due to passporting or grandfathering arrangements; and

(ii) to the extent passporting or grandfathering arrangements put in place at the time do not assist, Brexit becoming legally effective will most likely be regarded by regulators as "exceptional circumstances" allowing for changes to the retention structure at the time when they're needed.

THE SECURITISATION REGULATION

In addition to the analysis above based on existing law, there are of course significant changes to EU regulation of securitisation in the pipeline that should not be ignored. Proposals include putting the risk retention duty directly on the originator, original lender or sponsor, the creation of a category of "simple, transparent and standardised" securitisations that would benefit from more benign regulatory treatment, and extensive and detailed disclosure obligations. It is likely that the Brexit vote will not prevent the EU Securitisation Regulation being passed in due course, although the exact provisions of the regulation will need to be agreed.

Some have mooted more extreme changes as part of the approval process, such as raising the level of risk retention to 20% and requiring extensive disclosure from investors as well as from originators and sponsors. These are less likely to be enacted.

NEXT STEPS

So what can managers do right now? As we say above, the best advice is probably to wait and see. There is potential for the cards to fall in any number of ways, meaning a high risk that any move to anticipate the coming changes could be wasted effort - or even make things worse.

That said, there are a few practical things that can usefully be checked in existing deal documentation, so that managers are aware of their options once the picture becomes a bit clearer. These include:

- whether the power for the manager to sub-delegate management services is broad enough to allow sub-delegation to an authorised entity;
- whether there is an ability for the manager to resign on the basis it has lost the right to carry out its duties as a result of a change in law (most deals would already have this);
- whether there are issuer substitution provisions allowingfor a relatively straightforward change of issuer jurisdiction; and
- what amendment provisions are in place - and in particular what amendments are possible without investor consent - to check the level of flexibility to deal with unexpected changes.

Similar considerations will be relevant for new deals. While there is no need to immediately change CLO vehicle jurisdictions or transfer management functions to other entities, it is possible to be better prepared by hard-wiring a degree of flexibility into transactions.

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