

C L I F F O R D

C H A N C E



SURVEYING THE SCENE:
ISSUES FOR THE GLOBAL
SECURITISATION MARKETS

FOREWORD

At this time last year, our focus – and that of the securitisation markets generally – was very much on regulation and its effects on the future of the markets. The European Union’s ambitious Capital Markets Union project promised much, even as changes to capital weights continued to threaten the viability of European markets. On the American side, changes to regulation were settling down and causing less market dislocation than initially feared.

In the months that followed, events changed the narrative and focus of market participants dramatically. The UK voted in a referendum to leave the European Union, Donald Trump was elected President of the United States and oil prices rose back to hover firmly around \$50/barrel thanks in part to the revitalisation of OPEC. The US Federal Funds Rate rose 50 bps to 1%, meanwhile the Bank of England and European Central Banks extended their quantitative easing programmes into 2017.

All this has left securitisation markets to operate in a very different geopolitical and macroeconomic environment to last year. Accordingly, this year’s publication covers the major changes in regulation while adding more of a market focus – our attempt to survey the current scene and take stock. We look at the impact of major events such as Brexit, but also more granular market developments, such as the ways commercial market participants are engaging with trustees to amend deals and the differences in due diligence practice between the EU and the United States. We consider changes by deal type (including evolutions in warehousing transactions and synthetic securitisations) as well as by geography (such as the state of the Asia-Pacific securitisation markets).

Inevitably, events will also continue to have an effect on regulation, and regulation is still a major issue for the securitisation markets. The European Commission’s Capital Markets Union project continues to progress, with political agreement on the new Securitisation Regulation expected shortly after this publication goes to print. On the American side of the Atlantic, significant reforms of financial regulation have been trailed by President Trump and his administration, and we examine the directions these might take.

Of course every business occupies a different vantage point on the landscape, and will have its own scene to survey. We hope the issues we consider in this publication are of help to you in situating yourself and your business in the right place.



Kevin Ingram

Partner, on behalf of the
International Structured Debt Group

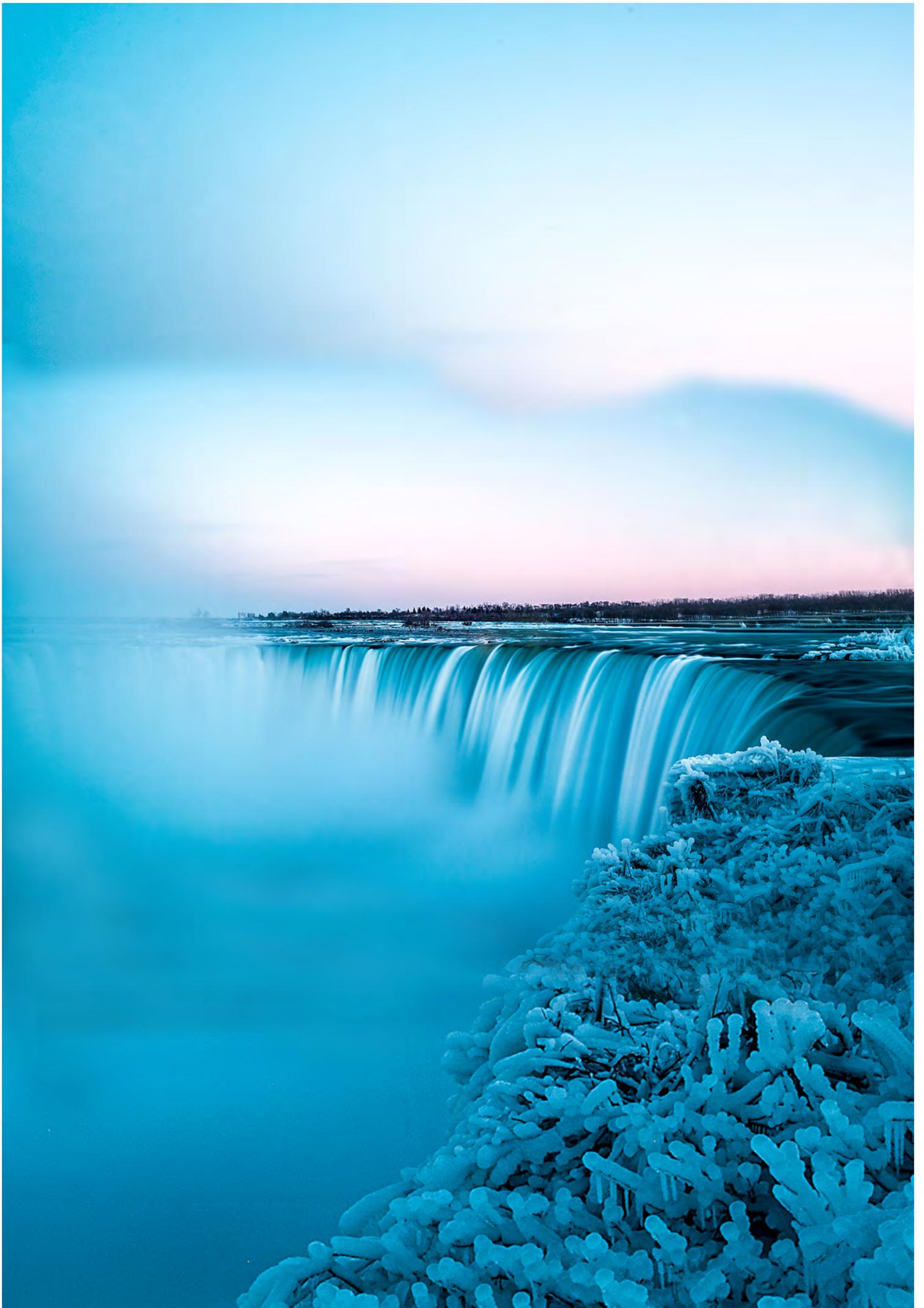


Andrew E. Bryan

Senior PSL – Structured Debt

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THE EU SECURITISATION REGULATION: A LIGHT AT THE END OF THE TUNNEL

The path of an EU regulation is long and winding – that of the Securitisation Regulation perhaps more than most. Even as this publication goes to print in late May 2017, while political agreement is expected imminently, there remains a possibility it may not materialise at all; that is despite the countless thousands of hours devoted to it by the public, private and third sectors alike over the last several years. In this article we take a look at the major features of the proposed Securitisation Regulation, what it seeks to achieve and some of the important areas of concern where the outcome of both the political and technical discussions should be watched closely by the market.

Background and general overview

Many of the ideas that eventually found their way into the proposed Securitisation Regulation can be traced back to industry initiatives from 2011-12 designed to show that securitisation was not the bogeyman it was made out to be in the wake of the 2007-08 financial crisis. Even so, it wasn't until a May 2014 consultation by the Bank of England and European Central Bank that official sector enthusiasm began to build in earnest. It took over a year and several more consultations before the European Commission proposed the Securitisation Regulation in late September 2015. Almost two years on from the formal proposal, political agreement on the regulation still has not been reached. Indeed, the Commission, Council and Parliament have at times seemed oceans apart on key issues. Political agreement finally seems likely shortly after this publication goes to press – but at this stage there are rumblings that one or two key disagreements may yet derail the whole process. So what is all the fuss about?

The main purposes of the Securitisation Regulation have remained constant since it was formally proposed by the European Commission. At its base, the Securitisation Regulation is intended to

be a shot in the arm for European securitisation markets and one of the flagship parts of the Capital Markets Union project. It is intended to set out a Europe-wide framework for securitisation, uniform across sectors and geographies, that will encourage new entrants to the market on both the buy and sell sides, unlocking new sources of funding and helping to lessen Europe's dependence on bank funding.

In aid of those objectives, the Securitisation Regulation introduces a category of “simple, transparent and standardised” or “STS” securitisation marked out for more benign regulatory treatment than other securitisations. Compared to other securitisations, this will include lower risk weightings for bank capital purposes and is expected to also include better insurance capital treatment, and more favourable treatment as high quality liquid assets for purposes of the liquidity coverage ratio.

In addition to introducing the concept of STS securitisation, the Securitisation Regulation will repeal and replace the securitisation provisions in sectoral legislation such as the Capital Requirements Regulation (affecting credit institutions and investment firms), the Alternative Investment Fund Managers Directive (affecting fund managers) and

Solvency II (affecting insurance and reinsurance undertakings). By repealing and replacing these provisions – along with transparency rules in the Credit Rating Agencies Regulation – the Securitisation Regulation will eliminate the mostly minor differences in the risk retention and due diligence requirements between sectors. It will also better align the disclosure requirements on the sell side with the due diligence requirements on the buy side. At the same time, it will level the playing field on the buy side by ensuring the same due diligence obligations apply to all institutional investors including those hitherto not affected by securitisation-specific rules, such as UCITS funds.

The big issues – and what to watch for

So far, so uncontroversial, you might think. The introduction of STS securitisation is novel, but extensively consulted upon and – once the principle is agreed – the details are very technical. The rest of the regulation appeared, at first blush, to consist of ironing out technical differences that would mainly have bothered securitisation professionals, but few others – although the Commission did take the opportunity to introduce a few significant substantive changes that had been moving up the agenda for a while. These consisted of

things like introducing a direct obligation on originators, sponsors and original lenders for risk retention (rather than it remaining solely the obligation of regulated investors to check) and closing a perceived loophole that allowed the creation of special purpose vehicle retainers. These were both areas where industry was largely on board, and few others seemed likely to object.

But object they did, though not necessarily to the changes proposed by the Commission. While the Council largely agreed with the Commission's proposal and ran with it, the Parliament had their own ideas about securitisation once it was brought front and centre of the legislative mind for the first time since the aftermath of the financial crisis. As a result, concerns in the Council seemed largely to revolve around the specifics of the STS criteria and how to assign the STS label. In Parliament, by contrast, a wide range of proposals were put forward including rejecting the proposed regulation entirely, quadrupling the risk retention rate to 20% (hardly likely to encourage new entrants to the market), and limiting investment in securitisation to regulated institutional investors (a curious thing to do when you're notionally trying to promote financial stability by using securitisation to spread risk out of the regulated financial sector).

As a result of all of this, a number of significant politically charged issues emerged. We discuss a few of the more important ones below as a guide for what to watch for if, as and when agreement emerges and the Securitisation Regulation comes into being.

Risk retention

This was probably the most high profile of the debates on the Securitisation

Regulation, with the European Parliament's lead MEP (or rapporteur), Dr. Paul Tang, proposing initially that risk retention rates should perhaps rise as high as 20%. By the end of the Parliamentary process, this had moderated to a Parliament position that risk retention rates should vary depending on the method of retention used, but generally within the 5-10% range. Beyond the attention-grabbing headline risk retention numbers, however, were some other equally troubling suggestions for the securitisation markets. Notably, the Parliament also proposed that the European Systemic Risk Board and the European Banking Authority should periodically review the risk retention rate and set it anywhere between 5% and 20%, and that fines should be imposed on originators whose securitised assets performed worse than comparable assets retained on their balance sheets.

Any one of these three proposals would be difficult for the securitisation markets to manage, and the Council and Commission have accordingly been steadfast in resisting them. Moreover, adoption of any of the proposals would make achieving significant risk transfer much more difficult. The increase in risk retention rates would also make securitisation financing far more costly for small originators and others using securitisation-funded origination platforms by dramatically increasing the amount of their own capital required for the transaction.

The other two proposals would each serve to introduce significant potential cost and uncertainty. The proposal for a variable retention rate did not make clear how legacy deals would be treated, raising the spectre of an originator having to somehow acquire up to 15% of the

capital stack in the secondary market in response to a regulatory edict increasing risk retention rates from 5% to 20%. Even assuming the right kinds of positions were available for acquisition in the secondary market, the costs of doing so when the whole market knows you are under an obligation to acquire would likely be substantial.

The adverse selection fines proposed by the Parliament would effectively impose an obligation of result on originators to ensure securitised assets performed as well or better than assets retained. This would be over and above (and far more onerous than) the existing sensible obligation on originators to use the same underwriting standards for assets securitised and assets retained.

Market participants should watch the outcome on all three issues. A manageable compromise that keeps retention at 5% for all methods and avoids frequently revisiting that level appears to be within reach. This would be the best case scenario for industry – maintaining something resembling the *status quo*. However, depending on the result, it is possible that securitisation may become even less useful as a risk transfer tool or become a riskier, more costly proposition for originators.

Eligible parties

One of the other threats to European securitisation comes from the suggestion by the European Parliament to severely restrict who is permitted to participate in the market. The Parliament proposal would restrict the universe of potential investors to European regulated investors or certain regulated entities from third countries whose regulation is deemed equivalent. This provision was introduced in the name of financial stability and ensuring

that only sophisticated investors could access securitisation. It seems more likely, however, that restricting the universe of investors to European (and equivalent) regulated financial institutions would have the effect of concentrating risk in systemically important institutions, thereby decreasing financial stability.

Moreover, the EP would require at least one of the originator, sponsor or original lender to be a regulated entity (often – but not always – the case for public deals, but frequently not for private securitisations) and would severely limit the jurisdictions in which it is permitted to establish securitisation SPVs using vague criteria that would introduce substantial compliance uncertainty.

This is another area where a workable compromise seems possible. Such a compromise would likely involve using existing product governance rules to control access to the market in a more granular, sensible way that strikes an appropriate balance between protecting unsophisticated investors and ensuring that others can access the market and help it revive. Once again, though, the best case scenario for industry is maintaining something close to the *status quo*.

Disclosure, private transactions and data repositories

The issue of public disclosure for securitisation transactions (regardless of whether they are public transactions) has been a concern since the third iteration of the Credit Rating Agencies Regulation (or “**CRA3**”). CRA3 introduced the idea that public disclosure ought to be made for securitisation transactions simply because they were securitisation transactions. This led to a series of

consultations initiated by the European Securities and Markets Authority as it considered how to treat so-called “private and bilateral” transactions. In the end, ESMA deferred the question. The Commission proposal dealt with the issue by proposing disclosure of important but relatively uncontroversial content (loan-by-loan data, transaction documents, etc.) by the sell side and limiting the audience for required disclosures to investors in the transaction and competent authorities. The Council took essentially the same approach, but added in that “potential investors” should also have access to transaction information.

The European Parliament, however, suggested that all investors’ identities (right up to the ultimate beneficial owners) should be disclosed and further suggested the establishment of securitisation data repositories modelled on the trade repositories contemplated in EMIR and the Securities Financing Transactions Regulation. These securitisation data repositories would collect all the required disclosures in relation to securitisations (whether public or private) and make much of the information transmitted to them public (it has never been made clear whether investor identities would be made public). This was notionally to allow prudential supervisors to have an overall view of the securitisation markets so as to better spot emerging risks. This justification, however, completely ignores the fact that securitisation is a relatively small part of the financial markets and that all regulated investors already have to make information available to their supervisors about all of their holdings, including securitisation holdings. Those reporting channels are far better tools for identifying risky behaviour than a tool restricted to securitisation.

While the establishment of securitisation data repositories is not in itself problematic for the securitisations markets, there are issues of scope, cost and compliance to consider carefully. Requiring disclosure of ultimate beneficial owners in all cases is clearly unworkable. An asset manager investing in a securitisation would obviously be in a position to identify its immediate clients (although it would likely be contractually prohibited from disclosing this information), but it would never be able to identify all beneficial owners (e.g. all individual beneficiaries of a pension fund client of the asset manager). Requiring disclosure of immediate investor names would be possible but would act as a serious disincentive to invest in securitisations and is not required for any other asset class. The administration alone would be extremely onerous, and no professional investor wants its rivals knowing the precise nature of its holdings. Investor side disclosure would be a serious problem for the securitisation markets if it makes its way into a final compromise.

Requiring disclosure in a prescribed form for private transactions would also be extremely problematic. These transactions are often private specifically because they involve competitively sensitive arrangements and originators are legitimately concerned to prevent their rivals from even knowing the transaction exists. Even assuming the information disclosed would only be for the consumption of the competent authorities, the very fact of having to disclose the transaction and provide prescribed data in a particular format would add significant costs to private transactions that are clearly disproportionate to the benefits of disclosure. After all, private securitisation transactions often have

more in common with a bilateral bank loan than a public residential mortgage deal, e.g. a corporate receivables financing arrangement between a bank and its corporate customer.

In the context of a disclosure regime that does not require investor-side disclosure or disclosure of private transactions, data repositories could be workable. Even then, it will be important to market participants that such repositories build on exiting initiatives. For example, there is no need to re-invent the wheel on loan-by-loan data templates when perfectly workable ones already exist for use with the European DataWarehouse.

So while securitisation data repositories are not required to help the market function, they seem likely to become a reality. If they do, market participants should be hoping for disclosure obligations limited to information on the transaction itself (and not its investors) where data need only be provided to repositories in respect of public transactions. Furthermore, those data repositories should make use of the work already done in respect of disclosure templates and infrastructure.

ABCP

A number of the concerns that apply to private transactions also apply to asset-backed commercial paper, for the obvious reason that transactions funded by a typical multi-seller ABCP conduit are almost invariably private in nature. It is also important to remember that the proposals initially consulted upon for an STS regime did not contemplate ABCP at all. This is despite the fact that ABCP makes up a very significant proportion of the overall European securitisation markets. Since then, an impressive amount of progress has been made in adapting the proposals to deal with the

concerns of the ABCP market, including emphasising the sponsor and its support for the conduit in due diligence and disclosure obligations.

Nonetheless, important questions remain about the practicality of complying with the full range of disclosure obligations in respect of ABCP and, unfortunately, about market participants' ability to take advantage of the STS regime. Although the Securitisation Regulation contains a tailored set of STS criteria for ABCP transactions and ABCP programmes, the difficulty of ensuring ongoing compliance with all of those criteria, their level of complexity, and the process for obtaining the STS label appears likely to end up presenting sufficient challenges that the label is simply not sought.

In particular, it seems likely that the final text of the legislation will require that all transactions in an STS ABCP programme be STS ABCP transactions, with only a small buffer (e.g. 5%) permitted to be temporarily non-compliant at any given time. If this is the result, sponsors will rightly be concerned that they simply will not be in a position to provide sufficient assurances to investors that their programme will remain STS. If they were to promise that and then fail to deliver, the difficulties for investors and reputational damage for the sponsor would be significant.

Likewise it looks possible that, in order to obtain the STS label, the sponsor and every originator would have to participate in certifying that the programme is STS. Given the number of sellers, the fact that the sellers change frequently and the sellers' desire for confidentiality, this seems like it may be an insurmountable practical difficulty for a number of programmes.

Third country issues

The original Commission proposal was more or less silent on third country issues, meaning relatively few changes would have been necessary to make it practical for third country securitisations (including the UK following Brexit – see “Brexit and Structured Debt” article further on in this publication) to be offered in the EU as STS securitisations. This has subsequently become a point of controversy, with the Council imposing a requirement that the issuer, sponsor and originator of an STS securitisation must be established in the Union and the Parliament keen to build in a third country equivalence regime. Industry had suggested a third option, of allowing individual third country transactions to qualify directly as STS and submit to regulation by an EU competent authority, but that suggestion was not picked up in any of the three texts and seems unlikely to be a late addition in trilogues.

The mood music emanating from the trilogues appears to indicate that third country issues will be parked, with the Council's requirement for parties to be established in the Union remaining and any third country accommodation worked out as a horizontal matter (i.e. a single solution applied across all financial services files) in the context of the Brexit negotiations. This outcome, if it materialises, would be less than ideal from industry's point of view not least because the UK is such an important part of the EU securitisation market today. Moreover, an approach that prevents any third country transaction from taking advantage of the STS regime (and therefore discouraging offering in the EU) seems self-defeating in the context of a regulation the purpose of which is to encourage revival of the markets and the entry of new participants.

Sanctions

One of the more worrying points from the original Commission proposal – largely unmodified by the Council or the Parliament – was the provisions surrounding penalties. The element that received most attention was the possibility that a fine of up to 10% of global turnover could be imposed as a penalty for failure to comply with the regulation. Although this level of penalty is not unprecedented in European financial regulation, industry representatives were concerned about this particularly because of the extremely complex nature of the regulation (and the STS regime especially). This meant that the potential for an honest mistake leading to a breach of the regulation was arguably higher than under normal circumstances.

Compounding the serious potential penalties for failure to comply was the fact that there was no fault requirement – and therefore no due diligence defence. That is, the simple fact of, for example, making an incorrect STS notification was enough to trigger the sanctions provisions and potentially lead to the imposition of these serious penalties, however rigorous the procedures an institution had in place to prevent such mistakes.

The Council in particular made an attempt to soften the language, making reference to the fact that competent authorities should take into account “the extent to which the infringement is intentional or results from a factual error” (an innovation retained by the Parliament), but this only applied at the level of determining the type and level of sanction. It did not provide a defence.

Nonetheless, there are encouraging signs that the parties to the trilogues are

beginning to come round to the virtues of having a standard of negligence or intentional breach of the regulation before sanctions can be imposed. If so, that would be helpful in reducing the chilling effect that might otherwise have been caused by the very serious sanctions regime put in place under the proposed regulation.

Scope, implementation and transitional provisions

The final items to watch in respect of the Securitisation Regulation are its scope, implementation and transitional provisions. While these are certainly technical, they are of crucial importance to the continued smooth functioning of the market.

On scope, the main issue to watch relates to originators. The Securitisation Regulation imposes dozens of obligations on the “originator” of a transaction, but none of the Commission, Council or Parliament texts makes any reference to the fact that a given transaction may have a number of originators, some of whom may have no involvement in the transaction – indeed they may not even know the transaction is happening. A bank that has sold its book of residential mortgages to an asset manager will be an originator of those assets, but will not necessarily be aware if the asset manager subsequently decides to finance the portfolio via a securitisation. Clearly it would be unfair and unproductive to try to impose obligations on the bank in respect of the securitisation, but there is some risk that the Securitisation Regulation might do so – although this would almost certainly be an unintended consequence. The point has been raised with the co-legislators and the Commission, so it is worth watching to see if a clarification is made before the text becomes final.

On transitional provisions, there are a number of issues. Most important among these is undoubtedly the issues around changes to the risk retention, transparency and due diligence rules which apply to all securitisations – not just to STS transactions. Properly drafted transitional provisions would ensure that the new rules applied to new arrangements only (or old arrangements modified after the new rules are introduced). In the context of securitisation, it is particularly important to remember the effect on repeat issuance structures, which are not easily amended to comply with new legislation. It is therefore essential to use the date of establishment of the arrangement (rather than, for example, the date of issuance of any securities) when determining whether a transaction is “new” or “old” for the purposes of the grandfathering provisions. Of course, appropriate provisions should be in place to ensure repeat issuance platforms cannot continue to operate forever according to obsolete rules, so mechanisms can (and should) be put in place to ensure such arrangements are either amended or wound down within a few years of the new rules being introduced. This was the position adopted when the risk retention rules were introduced in Europe in 2011 and a similar approach would be beneficial here.

Further, properly drafted implementation and transitional provisions would ensure that the new rules do not begin to apply until they are fully developed. In the case of the risk retention, transparency and due diligence rules, a number of regulatory technical standards will need to be developed without which the rules in the Securitisation Regulation are not capable of being complied with. For example, the Securitisation Regulation is likely to require periodic disclosure of

loan-level data on the securitised assets, but it is impossible to comply with that obligation until the relevant regulatory technical standards are developed that identify the particular loan level data that must be disclosed, where it must be disclosed and in what format. Accordingly, it is essential that the new regulation does not apply until all of the required level two rules are in place – and ideally an additional period of a few months would be provided once the level two rules are finalised to allow the market to prepare.

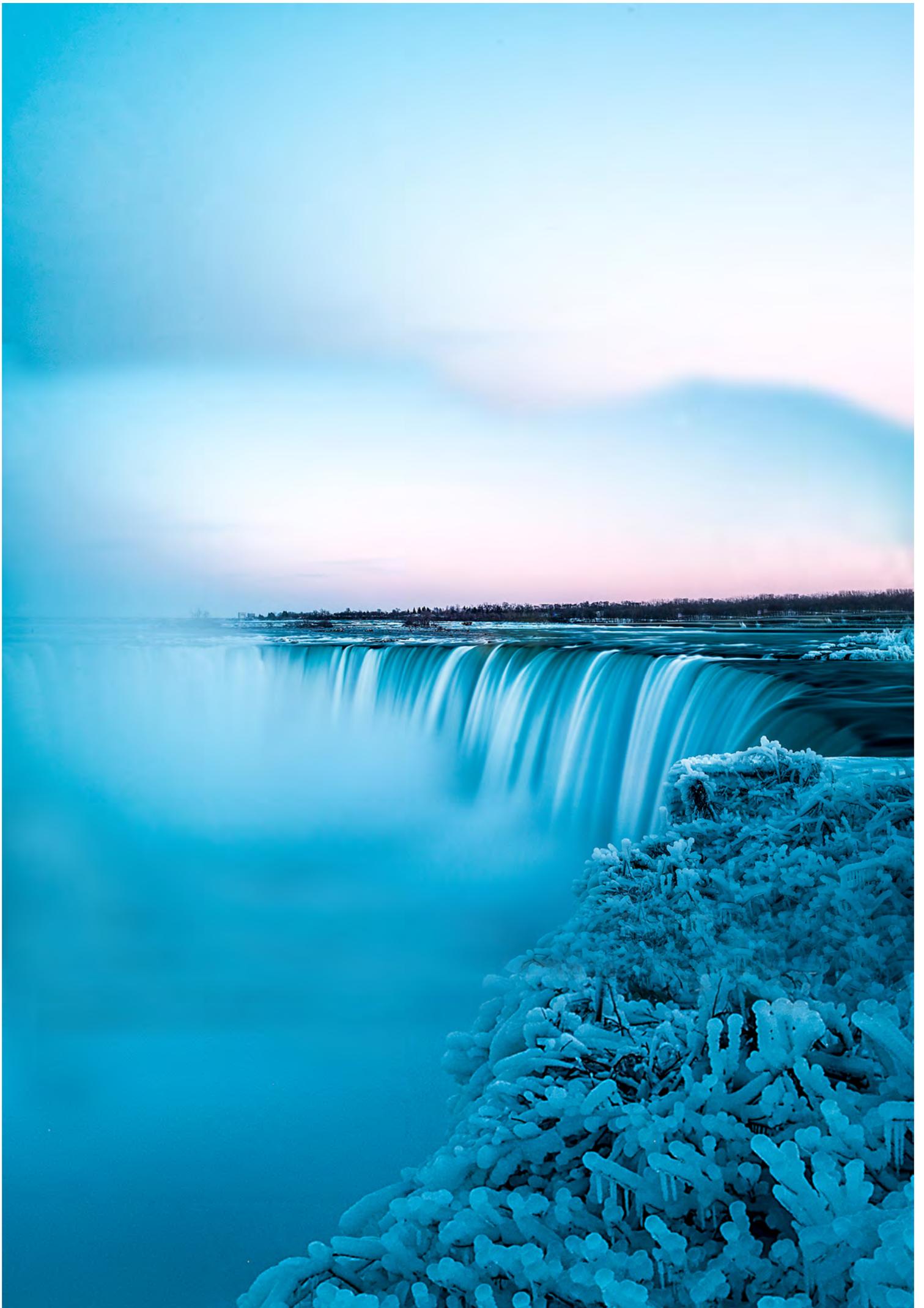
In respect of STS specifically, there is a question of whether any legacy transactions will be in a position to qualify as STS. Certainly, if all STS criteria must be complied with to the letter, then it is unlikely that any legacy transaction could qualify. A number of the criteria are either so specific as to require particular structuring to meet them or require things to have been done prior to issuance which may not have been done. Ideally, policymakers would take a pragmatic view and introduce some flexibility for legacy transactions as they did with the Solvency II “type 1 securitisation” concept. The Parliament showed some

openness to this idea in its compromise text, but it is unclear whether that will make it into the final text.

Each of the Commission, Council and Parliament texts (as well as the three texts for the associated CRR Amending Regulation) has contained problematic provisions in respect of implementation and transitional provisions and the general assumption until recently had been that the Securitisation Regulation would supply starting shortly after its publication in the Official Journal. This has been a source of concern throughout the negotiations, but there have been signs that policymakers are beginning to understand the concerns raised by industry recently. This is therefore an area to watch carefully, as properly drafted transitional provisions and appropriate implementation timelines can make the difference between a helpful, orderly transition to a new legislative framework and a chaotic, disruptive one.

Conclusion

The European securitisation industry planted the seed for this new regulation over half a decade ago with the idea for the Prime Collateralised Securities label. We have – to mix metaphors – come a great distance but it is still possible that the regulation will stumble before it crosses the finish line. Even assuming, as seems likely, that it does cross the finish line, the Securitisation Regulation will be a piece of legislation like any other – the imperfect product of endless compromise with a wide range of stakeholders. Given the importance of some of the issues outstanding, it is still far too early to make predictions about whether the Securitisation Regulation will achieve its goal of helping revive the securitisation markets in Europe. Time to achieve this is, however, not infinite and the industry needs matters with the Securitisation Regulation to be resolved to allow securitisation in Europe to move forward.



US REGULATORY REFORM: BACK TO THE DRAWING BOARD?

Transaction structure and disclosure for offerings of asset-backed securities to US investors are heavily influenced by US laws and regulations that apply to the financial services sector. This piece discusses potential directions for US legislative and administrative reform efforts that could impact asset-backed securities offerings.

How might reform happen?

Broadly, regulatory reform can be made by executive order, by legislation, or by administrative action. We look at the early indications of possible reforms and the procedures in each of these areas before turning to particular areas of relevant regulation and how they are developing.

Potential reforms indicated by presidential executive orders

An executive order signed by the president on 3 February 2017 (the “**Core Principles EO**”) articulated certain “Core Principles” including preventing taxpayer-funded bailouts, enabling American companies to be competitive with foreign firms in domestic and foreign markets, advancing American interests in international financial regulatory negotiations and meetings, and making regulation efficient, effective and appropriately tailored for regulating the US financial system. The Core Principles EO directed the Secretary of the Treasury to report by 3 June 2017 on “the extent to which existing [laws and regulations] promote the Core Principles and what actions have been taken, and are currently being taken, to promote and support the Core Principles”.

On 24 February 2017, another presidential executive order directed federal agencies to evaluate their regulations to identify regulations that, *inter alia*, eliminate jobs or inhibit job creation, impose costs that exceed benefits, or are outdated, unnecessary or ineffective.

These orders coupled with statements made during the 2016 presidential campaign generally indicate that the new administration could pursue a reform agenda with respect to regulation of the US financial system, including a reversal of at least some elements of the regulatory architecture put in place following the 2008 financial crisis. That said, there are limits to what the executive branch can accomplish on its own, and it faces significant challenges to getting its agenda through Congress, despite Republican majorities in both the House of Representatives (the “**House**”) and the Senate.

Legislative reform by Congress

To enact new legislation or to repeal all or portions of existing legislation, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”), a bill would need to be passed by both houses of Congress and then signed by the President. Since January 2017, the Republican Party has had majorities in both the House and the Senate. It is worth noting, however, that recent disagreements in the House between the Republican leadership and members on the Party’s extreme right wing raise doubts as to whether financial services regulatory reform legislation could pass the House. In the Senate, the Republicans have a majority, with 52 of the 100 seats, but 60 votes are needed to overcome a “filibuster” by the Senate’s Democratic minority and bring any regulatory reform bill to a vote. The filibuster threat is

certain to complicate Republican efforts to deregulate the financial services sector by means of legislation, at least absent elimination of the Senate’s legislative filibuster rule (which is considered to be highly unlikely at this time).

One possible model for legislative reform is the Financial CHOICE Act which, if enacted, would make sweeping changes to the Dodd-Frank Act. Some of the proposals (discussed further below) include reducing the scope of risk retention, repealing the Volcker Rule and lightening the burden of prudential regulation on banks. Representative Jeb Hensarling, the Chairman of the House Committee on Financial Services, had proposed this legislation in the 2015-2016 Congress and is sponsoring a successor bill with similar provisions in the current Congress. This bill has not received Democratic support and is considered unlikely to be passed in its current form by the Senate. Another possible legislative reform that might be expected to attract bipartisan support (if not majority) in Congress would re-impose the former Glass-Steagall Act’s requirement of separation between commercial banking and investment banking.

Administrative reform

Legislative reform often requires agency action to implement. These implementing measures can be made subject to administrative reform without Congressional action. Relevant prudential regulators and federal agencies are,

however, limited by the scope of authority granted to them by their respective governing statutes. A federal agency, such as the Securities and Exchange Commission (“**SEC**”) or the Commodities Futures Trade Commission (“**CFTC**”), may take action to adopt amendments to implementing regulations that it adopted under a particular statute – which may also give the agency general or limited authority to grant exemptive relief. In doing so, agencies must comply with applicable federal law, such as the Administrative Procedures Act, which calls for a public notice and comment process. Other relevant acts specify topics an agency must analyse during the rulemaking process. Additional procedural requirements vary by agency. For example, the SEC is specifically required by the Securities Exchange Act of 1934, as amended, to consider whether a proposed rule would promote efficiency, competition and capital formation and the impact that it would have on competition.

The Dodd-Frank Act includes provisions that require several federal agencies to jointly adopt implementing regulations. For example, the implementing regulations for Section 619 of the Dodd-Frank Act (commonly referred to as the “**Volcker Rule**”) were jointly adopted by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (“**FDIC**”) and the SEC. Similarly, six federal agencies jointly developed and adopted the risk retention rules mandated by Section 941 of the Dodd-Frank Act. Amending such jointly adopted regulations would require complex inter-agency coordination and take substantially more time than amending regulations adopted by just one agency.

It is important to note that administrative reform by federal agencies of existing regulations may be challenged in federal court and would then be subject to judicial review, which applies to agency action that amends or rescinds existing regulations as well as to the adoption of new regulations.¹ In a key 1984 decision, the US Supreme Court established principles of judicial deference to administrative action,² ruling that where Congress has not directly spoken to the precise question at issue, courts are to uphold an administrative agency’s reasonable or permissible interpretation of a statute. The extent of judicial deference to administrative interpretation has, however, been limited by subsequent decisions, and the federal courts on the whole have more latitude to rule that an agency action is inconsistent with the underlying statutory mandate. If administrative reform of the existing financial regulatory scheme is challenged in court, the relevant agencies would likely be expected to show that the changes were reasonable in light of the relevant policies, alternatives and facts.

What might reform look like?

Risk retention requirements

The Financial CHOICE Act proposed legislative reform that would significantly reduce the scope of the Dodd-Frank Act’s credit risk retention requirements to eliminate retention for all asset-backed securities that are not backed by residential mortgages. Administrative reform options could include allowing additional forms of risk retention and simplifying how value determinations are made. Such reforms could allow for increased flexibility in structuring transactions and lead to a decrease in related compliance costs. In addition, reforms may lessen potential

conflicts with the risk retention requirements of other jurisdictions for cross-border transactions. To the extent risk retention requirements were designed to encourage responsible underwriting practices, a roll-back of these requirements could enable less conservative underwriting practices (which may result in increased default risks).

The Volcker Rule

The Volcker Rule generally prohibits banks from engaging in proprietary trading and holding ownership interests in private equity and hedge funds. The Financial CHOICE Act contemplates legislative reform that would repeal of the Volcker Rule. During his campaign, however, the president suggested that he might support keeping the Volcker Rule. On 4 April 2017, a now-retired member of the Board of Governors of the Federal Reserve System, Daniel Tarullo, in his “Departing Thoughts” remarks indicated support for legislative reform of the Volcker Rule and proposed an approach that would not apply it to banks with less than \$10 billion in assets and other banks that report less than a nominal amount of trading assets. If the Volcker Rule is not repealed by legislative reform, administrative reform options could include issuing new guidance to clarify the scope of existing rules, adopting broader exemptive relief for securitisation transactions, expanding the CLO exception to permit these vehicles to hold bonds, and amending the definition of “ownership interest” to exclude investment grade securities. These reforms could permit increased flexibility in structuring asset-backed finance transactions and decrease related compliance costs.

¹ Merrick B. Garland, *Deregulation and Judicial Review*, 98 Harv. L. Rev. 505 (1985).

² *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984).

Securitisation disclosure requirements

Legislative reform options regarding disclosure requirements applicable to issuers of asset-backed securities include repealing or amending Section 7(c) of the Securities Act of 1933, as amended, which requires the SEC to adopt specified regulations regarding asset-level disclosures. SEC rulemaking would likely be required to implement any such legislative reform and clarify disclosure obligations. Absent legislative reform, administrative reform options could include SEC rulemaking actions to reduce the information required to be disclosed in connection with asset-level disclosures. The SEC could also amend its rules to eliminate or scale back the disclosures required in connection with risk retention.

Bank capital requirements

Many securitisation sponsors and investors are financial institutions subject to bank capital requirements. Since its enactment, the Dodd-Frank Act and related implementing regulations have prompted substantial changes in the structure and management of the US banking sector. The Financial CHOICE Act would provide a regulatory “off-ramp” for banks that elect to be strongly capitalised under traditional measures of soundness (i.e., without reference to risk-based measures). Such banks would be eligible for relief from the Dodd-Frank Act’s “enhanced prudential standards” and the capital and liquidity standards imposed under Basel III, including total loss absorbing capacity (TLAC), liquidity coverage ratio and net stable funding ratio requirements. This type of reform would likely be designed to primarily benefit smaller banks.

On 13 March 2017, the FDIC’s Vice Chairman, Thomas Hoenig, proposed an alternate version of reform in a speech at

an annual conference of the Institute of International Bankers. He proposed structural separation of traditional banking activities and non-traditional activities within banking organisations. As proposed, this reform contemplates splitting traditional and non-traditional banking activities into separately capitalised and managed intermediate holding companies under a single, top-tier financial holding company. After such restructuring, banks would be granted relief from many of the regulatory burdens imposed by the Dodd-Frank Act.

Shortly before his retirement, then-Governor Tarullo, in a letter dated 21 March 2017 to the Chairman of the Senate Committee on Banking, Housing and Urban Affairs endorsed developing a tiered regulatory regime for banks based on their size and activities. Such regulatory reform would aim to lessen regulatory burdens on smaller regional banks and community banks. Tarullo indicated support for maintaining strong leverage ratio requirements, detailed risk-based capital requirements, and a robust supervisory stress testing system for the largest banks in the United States. Tarullo ended his 4 April 2017 “Departing Thoughts” remarks with the following: “[a]s proposals for regulatory change swirl about, it is crucial that the strong capital regime be maintained, especially as it applies to the most systemically important banks.”

Swap regulation

To the extent an ABS offering involves a swap regulated by the CFTC, that agency’s regulatory priorities could impact the transaction. The Financial CHOICE Act would require the CFTC and the SEC to harmonise all regulations and interpretive guidance

they have issued (dealing with “swaps” and “security-based swaps,” respectively) pursuant to Title VII of the Dodd-Frank Act.

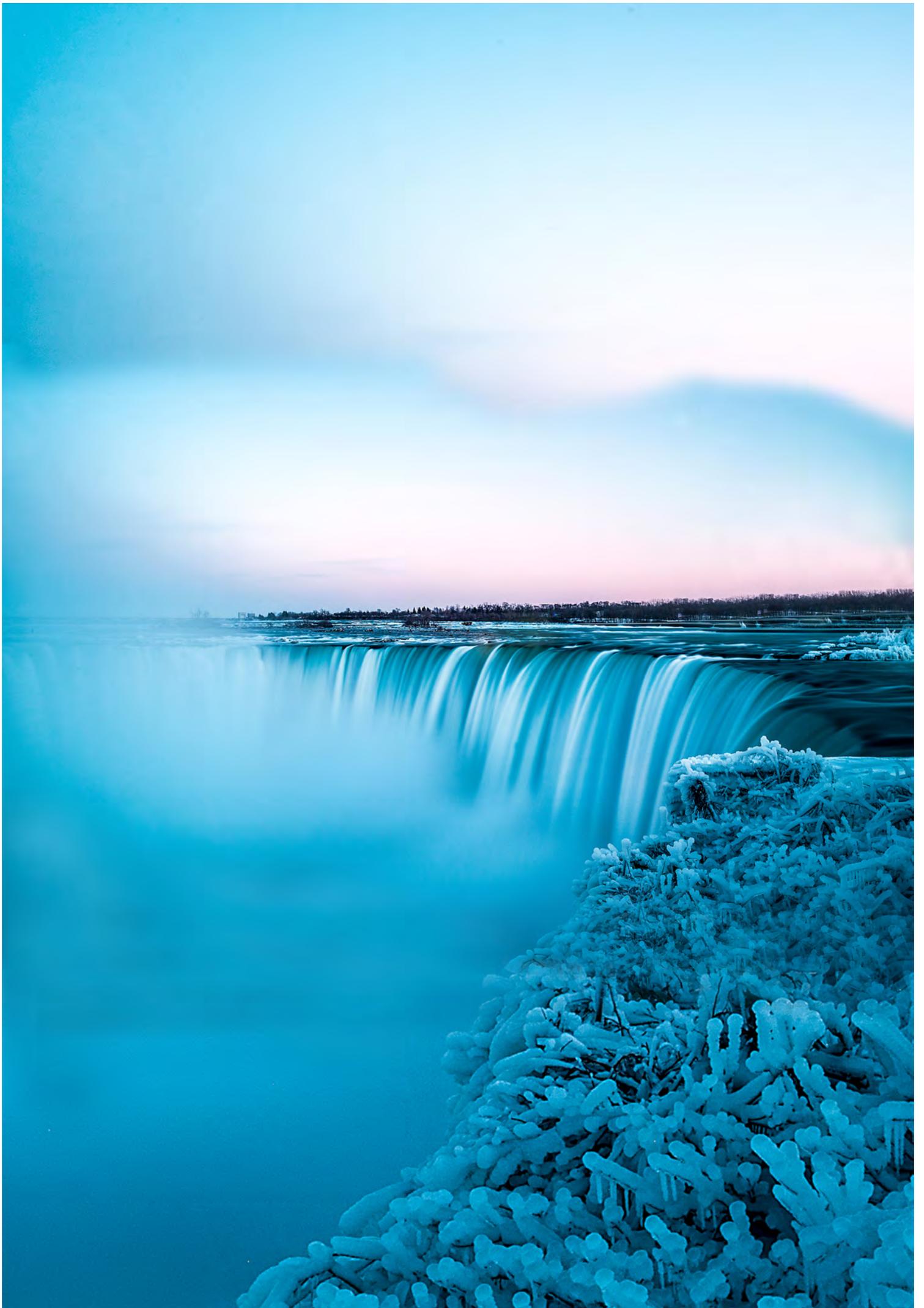
On 15 March 2017, the Acting Chairman of the CFTC, J. Christopher Giancarlo, speaking at the annual conference of the Futures Industry Association, discussed reinterpreting the CFTC’s mission. Pursuant to an executive order relating to regulatory reform issued by President Trump on 24 February 2017, the CFTC is undertaking an agency-wide review of its rules, regulations and practices to make them simpler, less burdensome and less costly. In connection with this review, the CFTC voted on 3 May 2017 to seek public input on simplifying and modernising its rules.

The CFTC expects to continue to lead US implementation of swap market reforms set forth in Title VII of the Dodd-Frank Act (which is not currently the subject of any repeal proposals). The CFTC intends to ensure that US swap regulations do not conflict with those of other countries or fragment the global marketplace. The Acting Chairman would like to see the CFTC adopt a flexible, outcomes-based approach for cross-border equivalence and substituted compliance. In the international arena, the CFTC intends to continue to work constructively with its counterparts. It also intends to continue participating in international standard setting bodies, while embracing the administration’s policy in favour of advancing American interests in international financial regulatory negotiations and meetings. As a voting member of Financial Stability Oversight Council created by the Dodd-Frank Act,

the CFTC will seek to address the question of “whether the amount of capital that bank regulators have caused financial institutions to *take out* of trading markets is at all calibrated to the amount of capital needed to be *kept in* global markets to support increased commercial lending and the overall health and durability of US financial markets.”

Conclusion

As set out above, a wide range of possibilities is on the table for reforms to US financial regulation. Due to the political challenges of making legislative change, it currently appears that federal agencies carrying out administrative reform is the most likely candidate for changes to ABS regulation. While it is too early to know what the detail of any changes might be, the potential for challenges to rule-making in federal court means such reform is unlikely to involve a full repeal of any set of implementing regulations under the Dodd-Frank Act. It could, however, provide expanded exceptions and fewer disclosure requirements. This would allow for more flexibility in structuring asset-backed financings and reduce compliance costs.



REGULATORY ROUNDUP

Changes to regulation remain central features of day-to-day life in the structured debt markets. In addition to regulation aimed directly at our markets and products, securitisation and structured debt products are often affected in an incidental way by a variety of other rules. Because of the complexity of securitisation transactions, prospectus rules, derivatives rules, financial product marketing rules and a host of others are relevant to most transactions done in the structured space. In this article, we look briefly – and with a securitisation lens – at each of a series of more general regulatory developments that are important for our markets.

I. PRIIPs AND SECURITISATION

The last year has seen an increasing level of focus on the Packaged Retail and Insurance-Based Investment Products (PRIIPs) Regulation in the securitisation space and also for a number of other products. Although the regulation has been on the books for a number of years already, a looming implementation date (at first it was 31 December 2016, but that has since been delayed to 1 January 2018) has brought increased focus.

The regulation is a key pillar of the EU investor protection agenda and its fundamental purpose is to impose additional rules around the marketing of PRIIPs to retail investors in the European Economic Area (“EEA”) through the introduction of a mandatory short form disclosure regime. The scope of the Regulation is broad and is expressed to apply to PRIIPs “made available” to retail investors (rather than “sold” to retail investors). The issuers, originators and – to a lesser extent – managers will therefore need to carefully consider whether their products are “made available” to retail investors in the EEA.

In order to help market participants prepare for the application for the PRIIPs Regulation, we have provided answers to some common questions below, but it is important to remember that a significant degree of uncertainty still surrounds fundamental elements of the legislation,

such as the products that are in scope and the actions that will trigger its application. A number of national regulators have issued statements in an attempt to help clarify but ultimately further clarification will be necessary from the European authorities in order to allow markets to comply efficiently. In this respect, the Joint Committee of the European Supervisory Authorities has announced its intention to publish a questions and answers document to provide further guidance to the markets. Publication of that document was expected imminently at the time this publication went to print in late May 2017.

What is a PRIIP?

The definition of a PRIIP is quite broad, and a number of public statements have been made by regulators and policymakers indicating that they may consider it to be even broader than the market had expected. This has been the source of consternation for other markets trying to determine whether their products are caught – and continues to cause some uncertainty around whether covered bonds are PRIIPs.

For purposes of the securitisation markets, however, it is mainly relevant to note that the definition of a PRIIP includes “instruments issued by special purpose vehicles...or securitisation special purpose

entities...where...the amount repayable to the retail investor is subject to fluctuations because of exposure to...the performance of one or more assets which are not directly purchased by the retail investor”. There is broad agreement in the market that this definition will capture most securitisation transactions.

What obligations does the PRIIPs Regulation impose?

The regulation requires a PRIIP manufacturer to produce and publish a key information document (or “KID”) prior to making the PRIIP available to retail investors in the EEA. The KID must be short (it is limited to 3 sides of A4 paper), clear, easy to read and provide the key information required for the investor. Distributors (being persons advising on or selling PRIIPs) must provide the KID to the retail investor to enable them to make an informed investment decision.

Despite public securitisations generally being PRIIPs, the initial reaction of most securitisation professionals was to expect that the PRIIPs Regulation would be largely irrelevant to securitisation markets because the deals are not offered to retail investors. That isn’t quite right, and care must be exercised both around the definition of “retail investor” and around what it means to “make available” a PRIIP to retail investors.

The definition of “retail investor” in the regulation refers to the definition of “retail client” in MiFID2 (being broadly any client that has not been classified as a professional client). The definition is sufficiently broad and flexible that it is hard to exclude the possibility that a retail investor might inadvertently be allowed to find its way into the book on a securitisation transaction. For example, the definition of a MiFID2 “retail client” includes entities entitled to be treated as professional clients but who “opt down” and choose to be treated as retail clients. Municipalities or local public authorities are a good example of investors who may need to be treated as “retail investors” but would not look out of place in a securitisation order book. This is because municipalities and local public authorities (excluding those that manage public debt at the national level) must be treated as retail clients unless they have opted to be treated otherwise and meet specified criteria. Moreover, practical issues clearly arise as to how to distinguish between regional governments (which can be treated automatically as professional clients) and public sector bodies, local public authorities and municipalities (which must be opted up).

Care must also be exercised around what it means to make a product available to retail investors. Although securitisation products are not *offered* to such investors, the concept of “making available” is surely broader than that, even if its precise limits remain uncertain. One national competent authority has even suggested that the mere fact of admitting notes to trading on a regulated market could be sufficient to “make available” those notes to retail

investors. While we – and the market generally – think that interpretation is overbroad, it throws into sharp relief the differences of opinion and the associated challenges of managing compliance.

Difficult as the concept is, it is essential that securitisations are not “made available” to retail investors, given that the alternative is trying to fit all the key information relating to the transaction into a KID limited to three sides of A4 – surely an impossible task even in respect of a simple securitisation.

What is the market approach to compliance?

The market approach to compliance is still developing, but the general approach is to take reasonable measures to ensure that PRIIPs (and therefore most securitisations) are not made available to retail investors within the meaning of the PRIIPs Regulation. Practically speaking, those measures include a selling restriction in the prospectus (and relevant subscription agreement) prohibiting sales to retail investors. That selling restriction is paired with a prominent legend in the prospectus indicating that the products are not intended for retail investors and stating that consequently no KID will be prepared. Forms of selling restriction and legend intended for this purpose have been developed and published by the International Capital Market Association. There are a number of variations on this language to deal with different situations, including standalone offerings, programmes with a retail element to them and programmes where only professional investors are ever intended to be targeted.

When should compliance measures be rolled out?

As mentioned above, the PRIIPs Regulation begins to apply from 1 January 2018 and both the selling restriction and the legend should be deployed for transactions where any part of the offering period is in 2018 or later. That said, there are no grandfathering provisions, so some market participants are choosing to include at least the legend immediately for offerings of instruments that will still be outstanding on 1 January 2018. This is driven by a concern that failure to flag the product as inappropriate for retail investors in the offer documentation might lead to suggestions it was “made available” to such investors even where no subsequent offer is made. A countervailing concern is that the PRIIPs Regulation uses the MiFID2 definition of “retail client” which does not apply until 1 January 2018. Consequently, managers may not yet have completed their preparatory work and in such cases would not necessarily be in a position to identify MiFID2 retail clients and avoid selling to them.

Ultimately, the precise approach is a matter for discussion between issuers, originators and their counsel on the one hand and managers and their counsel on the other. In any case, issuers, originators and managers should be thinking about their approach to compliance well in advance of the application date and should consider whether and what compliance steps they wish to take at this stage.

II. THE NEW PROSPECTUS REGULATION (PD3)

The words “brainstorm” and “regulation” rarely appear in the same sentence. Yet, on 29 March 2017, issuers, investors, lawyers, accountants, stock exchanges and regulators from across Europe gathered at the offices of the European Commission for an interactive workshop to “brainstorm” key items to be addressed in the proposed pan-European “Level 2” Prospectus Regulation. This was, apparently, something of an experiment and the first time that the European Commission has adopted such an informal approach to legislation.

PD3: Status

It is notable that the more detailed “Level 2” measures¹ (relating to the regime governing prospectus content, offers to the public and admission to trading on EEA regulated markets) started to be discussed in some detail well before the Level 1 measures were officially finalised. Current status (as at late May 2017) is as follows:

Level 1

In November 2015, the European Commission put forward its proposal for a new Prospectus Regulation (which is nonetheless somewhat counterintuitively referred to as “PD3” because it follows two iterations of the Prospectus Directive) to replace the existing Prospectus Directive regime². The process to agree a “compromise text” for the new Regulation, involving the European Commission, the Council and the European Parliament, came to a close towards the end of last year and “final” text was adopted by the European Parliament and Council in April and May 2017. The new Prospectus Regulation is therefore expected to be published in the Official Journal of the

European Union soon. Pending that publication, the latest version of the new Prospectus Regulation which is publicly available is the 26 April 2017 version adopted by Council on 16 May 2017.

Level 2

Notwithstanding the fact that there were still some final legislative hoops to jump through on the Level 1 Regulation, the European Commission mandated ESMA in February 2017 to start work on drafting the corresponding Level 2 measures – hence the workshop in Brussels on 29 March. The reason for such haste is that the European Commission has indicated that it is intending that the final measures under the Level 2 Prospectus Regulation will be published at least 6 months ahead of the implementation date for the PD3 regime. This is to allow adequate time for practitioners to digest the new requirements – a luxury practitioners more concerned with the Securitisation Regulation seem likely to be denied (see our article earlier in the publication entitled “The EU Securitisation Regulation”).

Wholesale debt provisions preserved

For those working in the field of structured debt, one of the key provisions in the PD3 text will be in relation to denominations and wholesale debt. One of the most contentious points in the November 2015 Commission draft was the removal of the lighter disclosure regime for wholesale debt (as compared to retail debt) and the removal of the EUR 100,000 denomination exemption from the public offer rules. In the 26 April 2017 text, the concept of a wholesale “public offer” exemption with a threshold of EUR 100,000, has been

preserved. The same threshold also allows for the use of a lighter disclosure regime – including exemption from the requirement to produce a summary.

PD3 introduces a further concept, applicable from 2019. There is, in addition to the wholesale provisions mentioned above, an exemption for securities only sold to “professional” investors and admitted to trading on a “professionals only” market. As yet, few markets would fit this description. Some may, however, develop over the next two years before this provision begins to apply.

PD3: Timing – When will measures take effect?

The European Commission has indicated that its aim is to publish the new regulation in the Official Journal this summer (possibly in July 2017). It will be in force 20 days after that.

As mentioned in relation to the professional markets provisions, the bulk of the provisions will not take effect for a further 24 months – that is, some time in 2019. A few, however, are due to become effective somewhat earlier. These are generally most relevant to markets other than structured debt, but we describe them briefly below.

Which provisions are due to take effect immediately?

One such provision is where an issuer already has securities admitted to trading. Additional fungible securities may be admitted to trading on the same regulated market without having to produce a prospectus, however, an upper limit of 20% per annum of the amount of existing securities will apply. There is

¹ Under the four stage Lamfalussy legislative process.

² Further background on the PD3 aims and its role in the overall Capital Markets Union (CMU) project context are contained in our article “PD3: A brief history of the Prospectus Directive in the context of CMU” in last year’s June 2016 publication “Navigating the Tangled Forest”.

already a similar provision under the existing regime, but the current limit is only 10%. Additionally, the new exemption will be available to all “securities”, rather than just for shares, as is currently the case. It is important to note that this is only an exemption from the requirement to produce a prospectus for admission to trading. Any “offer to the public” would still trigger a prospectus requirement. However, because securitisations and covered bonds are typically only offered in denominations of EUR 100,000 or more anyway, a

separate public offer exemption would normally apply as well.

Another key provision coming into effect immediately relates to convertible and exchangeable bonds. No prospectus will be needed for the admission to trading of shares resulting from the conversion or exchange of other securities or resulting from the exercise of rights conferred by other securities. There is, though, a similar 20% per annum cap. This limit is new; currently no limit is imposed. The European Commission argued that this new 20% cap on resulting shares is to

ensure that issuers do not issue convertible bonds as a route to avoid preparing fuller share prospectuses. However, as a result of lobbying, carve-outs from the 20% limit were drafted into the final Compromise text, such as for contingent convertible (or “CoCo”) bonds and for certain other regulatory capital instruments.

In the UK, the Financial Services Authority has already issued a consultation on changes to its Handbook to give effect to these provisions from Summer 2017.

PD3 – Key Features (Compared With PD)

Wholesale	<p>A “wholesale” distinction remains.</p> <p>A minimum denomination of Euro 100,000 (or equivalent) is a trigger for:</p> <ul style="list-style-type: none"> – an exemption from the need for a prospectus for an offer to the public; and – a different prospectus disclosure standard – plus an exemption from a prospectus summary – when admitting to trading. <p>The “wholesale” disclosure will also be available for bonds admitted to trading on a restricted “professionals only” market or segment and no resale to non-qualified investors.</p>
“Basics”	<ul style="list-style-type: none"> • “Approved prospectus” for public offer or admission to trading on EU regulated market. • Definition of “offer to the public” unchanged; “advertisement” now a “communication”. • Home Member State concept/criteria for selection stay same as in PD. • Passporting concept remains (as does the translation of summary requirement). • 12 month life span; Prospectus supplements and investor withdrawal rights remain. • Tri-partite prospectuses and base prospectuses are still available. • No additional prospectus required for resale if written consent to use.
Content	
Summary	<ul style="list-style-type: none"> • 7 pages, maximum (extra pages where range of securities or guarantors); • “<i>accurate, fair, clear and not misleading</i>”; “<i>read as an introduction to the prospectus</i>”; • Prescribed format in four sections; maximum of 15 risk factors; • Base Prospectuses only require issue-specific summaries (not a general one for Base); • “PRIIPs” (Reg (EU)1286/2014) “key information document “ (KID) can be used instead; • Host Member State can require translation.
Risk factors	<ul style="list-style-type: none"> • Presented in limited number of categories. • In each category, the most material risk factors shall be mentioned first.

Incorp. by ref.	<ul style="list-style-type: none"> • Broader categories will be permitted.
General disclosure	<ul style="list-style-type: none"> • <i>“necessary information which is material for ... making an informed assessment...”</i> • <i>“Easily analysable, concise and comprehensible”</i>. • Unclear, as yet, what Level 2 prospectus disclosure and content requirements will be. • Recital 43 suggests no specific tax disclosure required, just a general warning.
Exemptions from prospectus: Public offer	<p>As well as the Euro 100,000 denomination, some exemptions in Article 1(4) include (among others):</p> <ul style="list-style-type: none"> • Addressed to investors who acquire for a total consideration of Euro 100,000; • “Qualified investors”; • Fewer than 150 persons per EEA state; • Employee share schemes (with proviso); • Securities offered in connection with a takeover by means of an exchange offer or allotted in connection with a merger or division (with proviso).
Exemptions from prospectus: Admission to trading	<p>Exemptions in Article 1(5) include (among others):</p> <ul style="list-style-type: none"> • Securities fungible with securities already admitted to trading on same regulated market, provided represent, over a period of 12 months, less than 20% of securities already admitted; • Shares resulting from conversion or exchange – subject to similar 20% cap, but with exceptions for some scenarios (e.g. grandfathering; certain 2014/59/EU (BRRD) resolution steps); • Employee share schemes; • Securities offered in connection with a takeover by means of an exchange offer or allotted in connection with a merger or division (with proviso); • Shares offered or allotted free of charge to existing shareholders.
New concepts	<ul style="list-style-type: none"> • Simplified (reduced) disclosure for SMEs and an “EU Growth” prospectus. • Simplified (reduced) disclosure for certain secondary issuance after 18 months’ admission. • “Universal registration document” with shorter approval times for frequent issuers and approval waiver available after filing for 2 consecutive years.

III. EU SWAP MARGINING REQUIREMENTS

The European Market Infrastructure Regulation (Regulation (EU) 648/2012) (“**EMIR**”) was introduced in the wake of the global financial crisis in 2008, with the intention of reducing the systemic risk posed to financial markets by over-the-counter derivatives. To that end, EMIR imposes various obligations on parties entering into OTC derivatives, including a number of “risk mitigation techniques” such as transaction reporting and portfolio reconciliation requirements. These risk mitigation techniques also include a requirement for certain parties to uncleared OTC derivatives to post variation margin (“**VM**”) and initial margin (“**IM**”) in respect of their obligations under those OTC derivatives. The content of these margining obligations is set out in Regulatory Technical Standards made by the European Commission in late 2016 (Regulation (EU) 2016/2251), which entered into force on 4 January 2017 (the “**Margin RTS**”).

The Margin RTS apply to all uncleared OTC derivatives entered into between financial counterparties (which, in broad terms, includes banks, investment firms, insurance companies and certain types of investment funds) and what are commonly referred to as “NFC+” entities, that is, entities that are not financial counterparties but which have entered into uncleared OTC derivatives having an aggregate notional amount which exceeds a particular threshold, being EUR 1 billion for credit and equity derivatives, and EUR 3 billion for other types of derivatives, including interest rate and currency swaps, but excluding, for this purpose, the notional amount of any OTC derivatives entered into for hedging purposes. Non-financial counterparties for

which this is not the case are commonly referred to as “NFC-” entities. Importantly, when determining whether a non-financial counterparty (“**NFC**”) is a NFC+ or NFC-, it is necessary to look at the aggregate notional amount of all non-hedging OTC derivatives which have been entered into by NFCs which are in the same accounting group as the relevant entity.

Thus, the mandatory margining rules will apply to a securitisation issuer which is a NFC+, but will not apply to a securitisation issuer which is a NFC-.

It will generally be the case that OTC derivatives entered into by a securitisation issuer will be for hedging purposes. In the case of true sale securitisations, the swaps will generally be interest rate and/or currency swaps to hedge the cashflows on the underlying asset pool so as to enable the issuer to meet its obligations under the notes. In the case of a synthetic securitisation, where the issuer may enter into a credit default swap, while that CDS does not hedge the issuer’s own exposures, if the issuer is consolidated into the same accounting group as the bank, it will be hedging the bank’s exposure to the credit risk on the underlying loan exposures, which means that the CDS will still constitute a hedging transaction for the purpose of determining whether the issuer is a NFC+ or NFC-. In contrast, if the issuer in a synthetic securitisation is not included in the bank’s consolidated accounting group, then it will only constitute a NFC+ if it has itself entered into credit default swaps having an aggregate notional in excess of EUR 1 billion, which is significantly higher than the notional amount of the individual CDS

transactions currently seen in synthetic securitisations in the market.

Although many securitisation SPVs are consolidated into the same accounting group as the originator bank, most banks have, since the introduction of EMIR, taken steps to consolidate their non-hedging derivatives activities into financial counterparties within the group, such that the aggregate notional amount of non-hedging OTC derivatives entered into by NFCs within the bank’s consolidated accounting group is below the relevant thresholds. Accordingly, any securitisation issuers forming part of that accounting group will be NFC- entities, and therefore not be required to comply with the Margin RTS requirements.

However, where the securitisation issuer does form part of a NFC+ group, it will be required to comply with the Margin RTS. The Margin RTS provide for the posting of both VM and IM. However, the IM requirements are being phased in, and initially will only apply to transactions where both parties belong to groups which have an aggregate notional amount of OTC derivatives that is above the EUR 3 trillion threshold. This threshold will reduce over time until 1 September 2020, from which point the IM requirement will apply where both parties belong to groups having an aggregate notional amount that is above EUR 8 billion.

In contrast, the VM requirements apply to all OTC derivatives between financial counterparties or NFC+ entities which are entered into from 1 March 2017. They will also apply to transactions which are amended or restructured on or following that date where those

amendments affect the economic substance of the transaction.

Where the Margin RTS apply, they prescribe rules regarding matters such as what constitutes eligible collateral and the frequency of margin posting. In the case of IM, additional requirements are imposed in relation matters such as concentration limits and the segregation of posted collateral. However, the key challenge for a securitisation issuer which is subject to the Margin RTS is that it will not generally have access to high quality liquid collateral to post as margin. Given

that these margining requirements only took effect from 1 March 2017, and that they do not apply where the securitisation issuer is a NFC-, as is the generally the case, the market has not yet developed techniques to enable a NFC+ securitisation issuer to comply with the Margin RTS. It is likely that this would require some form of liquidity facility, probably provided by the hedge counterparty itself, in order to provide the issuer with the necessary collateral to post as margin. As this would merely involve the issuer's swap obligations being transformed into a loan obligation,

it should not change the fundamental economics of the transaction, but it would add complexity, and would need to be analysed by the rating agencies and incorporated into their criteria for securitisation swaps.

Finally, by way of contrast, although the Margin RTS will apply to a hedge counterparty entering into swaps in connection with a covered bond transaction, they will not apply to the covered bond entity.

Pending Developments

On 4 May 2017, the European Commission published its proposals for certain amendments to be made to EMIR as a result of the three-year review of the regulation undertaken pursuant to Article 85 of EMIR. These proposals included expanding the scope of entities which are classified as financial counterparties for the purposes of EMIR to include alternative investment funds ("**AIFs**") (as defined in Directive 2011/61/EU (the Alternative Investment Fund Managers Directive), securitisation special purpose entities ("**SSPEs**") as defined in

Regulation (EU) No 575/2013 (the Capital Requirements Regulation) and central securities depositories authorised in accordance with Regulation (EU) No 909/2014 (the Central Securities Depositories Regulation). The effect of this expanded scope would be that any of these entities which enter into OTC derivatives would be subject to the mandatory margining and clearing obligations (unless they are able to avail themselves of certain limited exemptions), and it would no longer be possible for such entities to rely on being NFC-entities to avoid those requirements.

This presents a particular issue for some AIFs, and for most SSPEs, which are set up as special purpose vehicles and do not have ready access to liquid collateral for the purposes of posting collateral as required by the Margin RTS.

As these changes are to a level 1 regulation, they will need to go through the EU legislative process. Accordingly, at this time it is not possible to say whether these proposals will be implemented in their present form or, if they are, when such changes would take effect.

IV. US SWAP MARGINING REQUIREMENTS

Since 1 September 2016, variation margin (“**VM**”) and initial margin (“**IM**”) requirements for non-centrally cleared swaps (“**Uncleared Swaps**”) have been introduced in various jurisdictions around the world (see previous section of this Regulatory Roundup on EU swap margining requirements, for example). VM reflects the daily change in market value of the Uncleared Swap and IM reflects an estimate of the risk (over a certain period) of trading in the Uncleared Swap.

In the United States, compliance with the final margin rules (the “**US Margin Rules**”) issued by the United States prudential regulators (the “**PRs**”) and the Commodity Futures Trading Commission (the “**CFTC**”) is the direct obligation of banks, dealers and other regulated financial entities registered as swap dealers with the CFTC (each such swap dealer, a covered swap entity or “**CSE**”). The US Margin Rules apply to any Uncleared Swap that a CSE enters into with another swap dealer or entity defined as a financial end user, unless an exemption applies. Under the US Margin Rules, most special purpose vehicles (“**SPVs**”) such as securitisation issuers or asset companies are considered to be financial end users and therefore will be subject to the US Margin Rules in its Uncleared Swaps with CSEs.

What do the US Margin Rules require?

Variation margin. VM is required to be exchanged by counterparties on Uncleared Swaps entered into on or after 1 March 2017. While counterparties were previously able to apply a *de minimis* threshold in exchanging margin, this practice is no longer permitted with respect to VM. As in several other

jurisdictions, the United States regulators, in separate letters issued by the prudential regulators and by CFTC staff, have provided CSEs limited relief until 1 September 2017. This relief is subject to certain conditions and is available only if the parties are unable to document or operationally implement margin requirements until then.

Initial margin. Requirements for counterparties to exchange IM are phased in through 2020 based on each party’s aggregated outstanding average notional values of Uncleared Swaps. This threshold, calculated using the months of March, April and May of the relevant year, are calculated on a group-wide basis (transactions with affiliates are counted only once), and the threshold drops from USD 3 trillion for a September 2016 start date gradually down to USD 0.75 trillion for a September 2019 start date, with all relationships subject to IM requirements starting in September 2020 (subject to a USD 8 billion threshold for financial end users; calculated using the months of June, July and August of the previous year).

Application to legacy swaps. The US Margin Rules apply only to Uncleared Swaps to the extent they are entered into, or materially amended or modified, on or after the applicable implementation date. Accordingly, these requirements would not apply to an Uncleared Swap entered into by an SPV and a CSE before the applicable implementation date which is not amended or modified in any material respect after such date.

What exemptions may be available to SPVs?

Regulatory relief for Uncleared Swaps with non-US counterparties.

The US Margin Rules would generally not apply if there were no nexus to the United States for an Uncleared Swap. In cases where an Uncleared Swap transaction among non-US counterparties involves only a limited connection to the United States, the US margin rules may not apply or substituted compliance may be available. The conditions for relief for foreign transactions in the PR rules are different from conditions in the CFTC’s rules.

For example, the PR rules do not apply if an Uncleared Swap is entered into by a foreign CSE (a CSE that is not a US entity, a branch of a US entity, a US branch of a foreign entity, or a subsidiary of a US entity) and the counterparty is not a US entity (including a branch of a US entity, a US branch of a foreign entity, or a US-regulated swap dealer that is a subsidiary of a US entity). If guarantors are involved, the same restrictions apply to the guarantor.

The CFTC rules provide that Uncleared Swaps of a foreign CSE will be exempt from CFTC margin requirements where the foreign CSE’s obligations (and the obligations of the counterparty) are not guaranteed by a US person, where the foreign CSE is not a US branch of a foreign CSE, and the foreign CSE is not a foreign consolidated subsidiary. A foreign consolidated subsidiary is a foreign CSE in which an ultimate parent entity is a US person and has a controlling financial interest in accordance with US GAAP (accounting principles). However, the Uncleared Swap will be subject to CFTC margin requirements if it is not covered by a comparability determination made by the CFTC with respect to the IM collection requirements in the relevant foreign jurisdiction and if the foreign CSE

enters into any inter-affiliate swaps that transfer the risk from the Uncleared Swap in question directly or indirectly to an affiliate (defined using accounting principles) that is a US CSE or a CSE guaranteed by a US person.

In order to determine which margin rules (PR or CFTC) apply to a CSE, the sponsor of an SPV will need to check directly with its CSE counterparty, as this information is not publicly available.

Captive finance companies are not classified as financial end users.

Captive finance companies are not considered to be financial end users and are therefore not subject to the US Margin

Rules. Under Section 2(h)(7)(C)(iii) of the Commodity Exchange Act, a captive finance company (“**CFC**”) is an entity:

- whose primary business is providing financing;
- which uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures;
- 90% or more of which arise from financing that facilitates the purchase or lease of products; and
- 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.

The staff of CFTC’s Division of Clearing and Risk clarified in its Letter No. 15-27 that the first prong of the CFC test is satisfied by an SPV only if it is:

- wholly owned by a CFC;
- consolidated with a CFC; and
- the SPV’s sole activity is facilitating financing undertaken by the CFC.

Most securitisation SPVs would not qualify as CFCs. SPVs that enter into Uncleared Swaps with CSEs and do not qualify for the CFC exemption would be subject to the US Margin Rules as financial end users.

V. MIFID2 AND SECURITISATION

MiFID2 comes into force on 3 January 2018. As the deadline looms, the financial services industry in the EU is gearing-up for implementation, including in respect of potential impacts on capital markets activity.

There are a number of key issues under MiFID2 for securitisation market participants, including new requirements around product governance, allocation processes and policies, conduct of business and increased disclosure in respect of inducements and management of conflicts of interest.

Product governance

Product governance is one of the MiFID2 topics attracting much attention at the moment. In particular, there is a focus on the concept of a “target market” and how MiFID2 will impact the distribution of products and financial services in the EU. These requirements apply to the distribution in the EU of investment services and products, including the marketing of financial instruments (such as securities), even where – as in the securitisation markets – marketing is to professional investors only.

The product governance requirements include determining the “target market” for the financial instruments. Proposed guidance requires target market analysis to take into account a minimum of six factors, including the client’s objectives and experience. MiFID2 also requires that a “negative” target market be identified, meaning a group of investors that the product is not appropriate for. This also needs to take into account the relevant factors, so it will not be sufficient to apply a blanket “not for retail” legend. An interesting example being debated in the asset manager space at the moment

concerns the scenario where a fund is designed for capital-generation, whereas the investor is seeking income-generation; under the new rules the investor (despite being appropriately experienced in the investment) may still fall into the “negative” target market for that particular fund. It’s easy enough to imagine similar issues arising on securitisation transactions with contrasts between stated investment strategy and, say, the level of the capital stack at which an investor wishes to invest or the type of deal they buy (e.g. an investor who normally invests in managed CLOs decides to invest in a credit card securitisation). In any case, this brings into sharp focus the degree of analysis that is required on investor intentions when marketing an investment.

Not only will an issuance require the prior identification of a target market, but the distribution and sale will need to be reviewed to assess the actual end investors against the target market. Other parties involved in the distribution (such as those providing placing services, if any) are likely also to need information on the target market to inform their activities, as well as needing under MiFID2 to confirm before providing the services that they understand and agree with the target market.

Allocation processes

A similar focus on “granularity” in the distribution and placing process comes through in the MiFID2 provisions around allocation policies. MiFID2 will require allocation policies and approaches to be discussed with the issuer, specific issuer considerations to be taken into account in the placing, and that issuer sign-off is obtained on the proposed approach. Additionally, MiFID2 sets out that allocations should not be inappropriately

influenced by existing or future relationships with investors. Some of the examples given of such inappropriate influence are fairly obvious – such as making an allocation to an investor to incentivise fees for unrelated services. But guidance goes on to refer to allocation not being expressly or implicitly conditional on receipt of future orders, with the UK Financial Conduct Authority also having recently made statements around allocations being skewed towards asset managers due to the greater revenues they provide elsewhere (such as trading commissions). All of this will mean looking at allocation policies to see if quantitative factors (such as amount of previous business with an investor) on an allocation are still permissible, or whether policies need to be reduced to qualitative factors (such as experience of the investor) only.

Inducements and conflicts of interest

What we see in both the product governance and allocation policy provisions is effectively “expectation setting” by the EU regulators as to practice in the capital markets space, and this theme is continued in the increased guidance under MiFID2 on inducements and conflicts of interest.

MiFID2 makes clear that it is not acceptable to manage possible conflicts of interest just through disclosure (such as a generic disclosure in an engagement agreement or terms of business). Moreover, MiFID2 goes on to highlight particular situations where it might not be possible to manage a conflict. The consequence is that there could be instances where a mandate should be turned down (such as where an underwriter is also a lender to the issuer, and issuance proceeds will be

used to repay the loan). This could raise practical issues on regular issuance programmes where there might be extensive relationships with an issuer group.

Interestingly, MiFID2 also requires that where an entity is an adviser to the issuer (advising on possible alternative routes for financing or structuring the issuance) and will be providing underwriting/placing, then prior to the mandate it will need to set out the different alternatives to the issuer and how it has tailored its final recommendation to the issuer client – again, looking for a level of granularity specific to the issuer client.

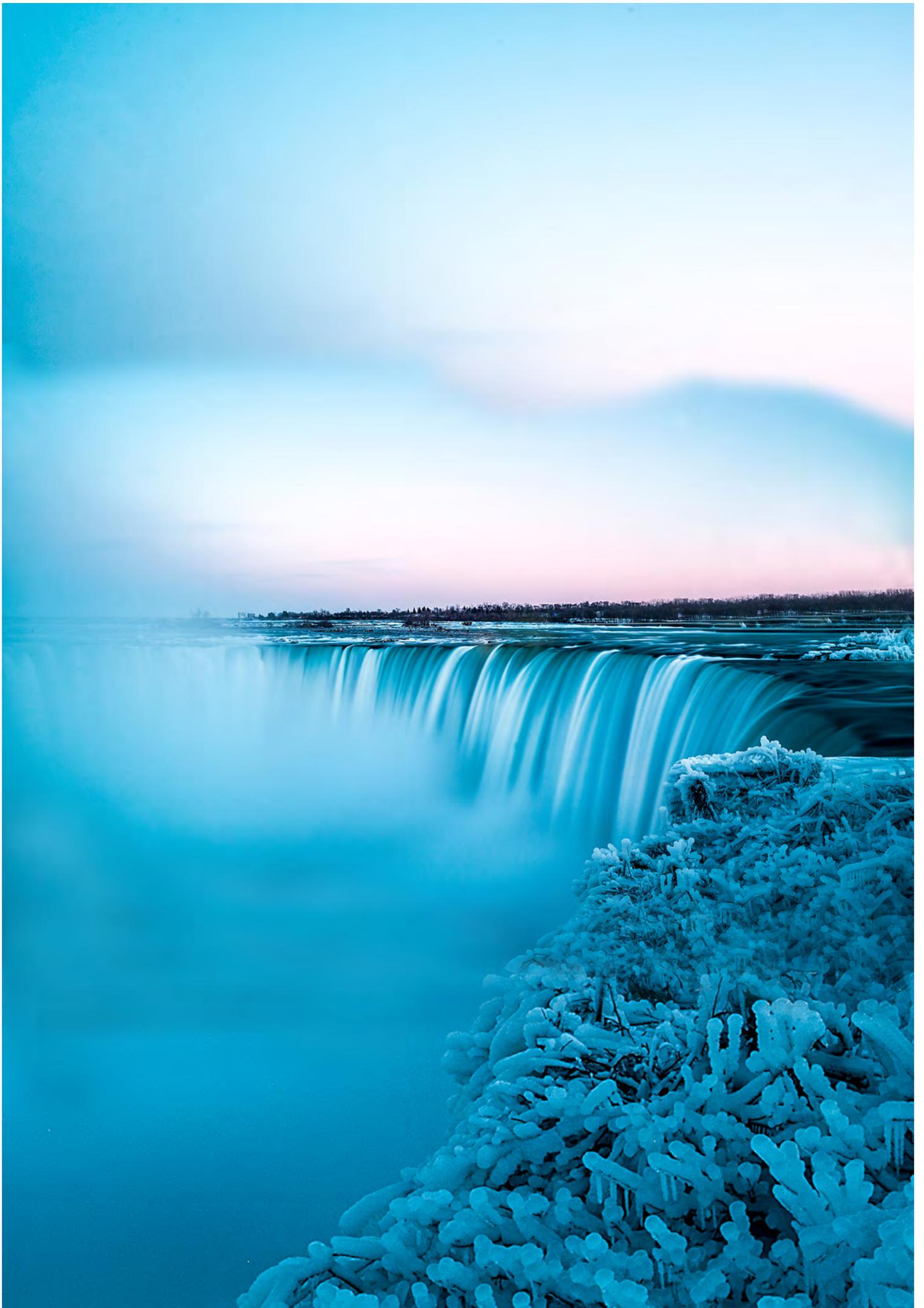
Finally, MiFID2 also enhances the rules around inducements and the need to disclose all fees and commissions in

relation to a service which is not received from the client. This has revived a long-standing debate around whether, when acting as underwriter, both the issuer and end-investors are clients for regulatory purposes. The current state of debate is leaning towards a conclusion that they are, and that will mean disclosure to investors of all fees received from the issuer. What this means in practice, and the extent of disclosure to meet the obligation, is still being debated.

Conclusion

MiFID2 raises a number of practical challenges for market participants, and it is clear that securitisation's status as a "wholesale" market will not be sufficient to completely insulate it from these new rules. What on a first read can feel like a documentation task, manageable

through updates to documents and repapering of clients, on closer inspection raises a number of questions around current market practice. In particular, the required level of granularity and tailoring to different clients which will need to be introduced into processes will need changes in practice and increases the amount of work to be done for implementation.



BREXIT AND STRUCTURED DEBT: CAREFUL WHAT YOU WISH FOR

The impact of the United Kingdom leaving the European Union following the referendum on 23 June 2016 will be felt far and wide. Virtually every aspect of the economy, business and trade – as well as many aspects of day-to-day life – will be affected. Indeed, even though the UK has not yet left the EU, the consequences are already being felt. Sterling has fallen significantly in value since the referendum result, there are reports of EU public procurement processes requiring bidders to be based in the EU throughout the life of the contract (effectively excluding many UK bidders) and supply chains being reorganised to reduce or eliminate the need for intermediate products to cross the English Channel.

It should be no surprise, then, that Brexit will have a significant impact on the structured debt markets as well. The issue of EU financial services “passporting” has been much discussed in this respect, but more fundamental issues need to be considered as well, including issues surrounding choice of law, recognition of judgments and the effect on insolvency analysis. Although the legal changes will formally take effect only after the UK formally ceases to be a member of the EU (which is unlikely to happen before 29 March 2019), businesses will need to make arrangements to prepare well in advance of that date.

One key piece of information businesses need so they can prepare is the nature of the post-Brexit arrangements between the UK and the remaining 27 EU Member States (the “EU27”). The nature of these arrangements will determine, in large part, what preparations businesses need to make – and the process of negotiating them has barely begun. There remains, therefore, significant scope for businesses to analyse their key priorities and communicate these to key actors on both sides of the negotiations to try to achieve as many of them as possible.

In order to assist with the process of formulating those priorities, this article will

look at a number of the legal issues Brexit raises for structured debt markets, review the UK Government’s proposed approach to Brexit and try to suggest a “wish list” of items industry might lobby for in order to minimise the market disruption Brexit will inevitably cause.

The legal issues raised by Brexit

Passporting

While the UK is a member of the European Union, UK-regulated firms are able to carry on licensable activities in other EU jurisdictions without needing an additional local licence and *vice versa*. Absent an agreement to the contrary, which seems unlikely, passporting rights will be lost when the UK ceases to be a member of the EU. This will have a number of consequences on securitisation deals.

Risk retention

The most obvious of these consequences is to do with risk retention. While a majority of securitisation transactions marketed in the EU rely on an originator or original lender (neither of which requires any special regulatory status) as the risk retainer, a significant minority rely on the sponsor retaining. Being a “sponsor” within the current meaning of the EU risk retention rules requires that the relevant

entity fall within certain categories of regulated institution defined under the Capital Requirements Regulation. That status is likely to be lost once the UK ceases to be a member of the EU, meaning UK-regulated entities are unlikely to be able to continue as “sponsors” of securitisation transactions with EU investors after Brexit.

This raises substantially different concerns for new and existing transactions. New transactions will simply need to be structured around this obstacle from the outset. This might involve finding an EU-regulated entity to sponsor the relevant transaction or using an originator or original lender to do the retention rather than a sponsor. The use of the originator route would certainly be a feasible method of future-proofing, though it does not come without its own challenges. The experience of the CLO market shows that 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 more complex because the deal structure will already be in place and will become non-compliant as a result of a

change in circumstances, rather than the act or omission of any transaction party. In addition to the usual difficulty of amending transaction documents for a live deal, the EU risk retention rules explicitly prohibit changes to the risk retention structure in almost all circumstances. An exception to this prohibition does exist in “exceptional circumstances” – and Brexit certainly qualifies as exceptional. That said, the exemption only explicitly contemplates changes to the retention option and methodology – so it remains possible that absent clarification changes to the identity or type of retainer would be prohibited even in such exceptional circumstances.

As a result, for existing transactions it is possible that some comfort will need to be obtained from the provisions regarding the application of sanctions. At the moment, the EU risk retention rules are articulated as obligations on the investors, rather than any sell-side entities. Accordingly, breaches of the rules can result in sanctions on investors, but sanctions may only be imposed on those who become exposed to a non-compliant securitisation by their “negligence or omission”. Although it seems highly unlikely that existing investors would be sanctioned for having previously invested in a securitisation that later became non-compliant as a direct result of Brexit (it’s hardly the result of their own “negligence or omission”), EU-regulated investors would be unlikely to buy the bonds on the secondary market after they became non-compliant. That, in turn, would reduce demand and liquidity, and increase volatility.

Transaction counterparties

Securitisations are complex transactions with a large number of parties, and regulation plays a key role. Many counterparties require regulatory approvals in order to carry out their roles (e.g. CLO managers may require MiFID approvals to manage certain assets for the issuer).

Others are chosen because their regulatory status makes them better equipped to play their role (e.g. a liquidity facility provider is typically a regulated bank to avoid concerns that the issuer drawing down the loan is taking deposits). In yet other cases, an entity’s regulatory status determines aspects of the transaction structure (e.g. different structures will need to be put in place depending on the EMIR classification of the issuer).

Of course, where transactions are UK-only or have no UK nexus, no problem will arise. A UK-authorized asset manager will remain UK-authorized after Brexit, so a UK issuer will have no problem. Likewise, an Italian issuer can continue to rely on a French asset manager, as both will be in the EU27. The problem arises where there is a cross-border element involving the UK and the EU27, e.g. a UK-authorized asset manager wishes to continue managing the assets of a Dutch issuer after Brexit without the benefit of EU passporting rights.

These types of regulatory issues can be relevant for a wide variety of transaction counterparties across a number of transaction types. Under EMIR, a UK firm party to an in-scope derivative will go from being e.g. an NFC- to being a third country entity as a result of Brexit, with associated changes in EMIR obligations. Securitisation counterparties such as account banks, cash managers, servicers, trustees, and paying agents can also all be relying on passporting rights depending on where they provide their services (whether that is from the UK into the EU27, or from the EU27 into the UK).

Needless to say, investment banks marketing transactions also generally rely on passporting rights to do so across the EU at the moment, but these functions are normally performed at a

particular point in time for each issuance (meaning issues for existing deals will not arise) and the functions are more easily moved to an entity with the relevant authorisation in an appropriate jurisdiction. Assuming the relevant lead managers have authorised entities in both the UK and the EU27 then this should not present as big a challenge.

There are also some potential mitigants. Equivalence has been repeatedly proposed as an alternative to passporting. Equivalence can indeed help to solve some issues, but it is unstable (generally revocable by the EU Commission on 30 days’ notice) and narrow (equivalence is granted on a sector-by-sector basis, rather than being universal like passporting). There are also likely to be delays in formally establishing equivalence, as different processes exist in each area for assessing equivalence of third country regimes and granting recognition. This is despite the fact that the UK will, on the day of Brexit, aim as far as possible to retain the law in precisely the same form as before Brexit (see discussion of the Great Repeal Bill below). As a result, together with existing UK “gold-plating” of many EU financial regulatory rules, the UK Government sees the UK as “equivalent plus” to the EU.

One example where equivalence might be helpful is the EU’s MiFID2 (in force from January 2018). MiFID2 will introduce a “third country regime” for providing services into the EU. Under this regime, non-EU firms from “equivalent” non-EU countries will be able to register to provide services across the EU (similar to the passport the UK firms currently have). This will be helpful for some UK transaction participants (such as UK CLO managers), assuming the EU determines the UK to be an equivalent jurisdiction (which, along with the timing of such a determination, will be an

important focus for the financial services part of the Brexit discussions).

Transitional periods, or “phased implementation” of Brexit, following the end of the two year Article 50 period – so allowing existing EU access rights for firms to continue for a period of time, to avoid a regulatory “cliff edge” – would also be of significant assistance. The UK Government may also seek a bespoke deal for the UK (on the basis, as set out above, that the UK Government sees the UK as “equivalent plus” to the EU) which allows UK financial services firms to continue to have the same rights of access to EU markets.

Credit Rating Agencies

While not technically “passporting” in the same way, credit rating agencies (“**CRAs**”) are regulated at an EU level, and permit CRAs to operate throughout the Union. EU rules prohibit undertaking credit rating activities within the Union unless the agency is registered and also prohibit the use of credit ratings for a variety of regulatory purposes (such as calculating capital under external rating based approaches) unless that rating has been issued or endorsed by an appropriately authorised credit rating agency. As UK CRAs are currently registered with – and directly supervised by – European authorities, the UK will need to establish its own CRA regulatory framework and implementing structure. Moreover, UK CRAs will either need to ensure they have a registered CRA entity within the EU27 or become a certified third country CRA in order to allow their ratings to continue to be used by EU-established regulated investors.

The Securitisation Regulation and the STS regime

This is an area of EU law that has not yet taken effect but where Brexit is nonetheless expected to have a serious impact when it does. As described

above in our article on the EU Securitisation Regulation, that legislation is due to introduce a new category of securitisations referred to as “simple, transparent and standardised” or “STS”. According to EU Commission plans and the associated CRR Amending Regulation, STS securitisations would get a number of regulatory benefits as compared to non-STS securitisations. Notably, investments in STS securitisations would be eligible for lower capital charges in the hands of banks and insurers and would also be eligible for inclusion as “high quality liquid assets” for the purposes of banks’ liquidity coverage ratio. All of this is of course a powerful incentive for EU regulated investors to invest in STS securitisations over non-STS securitisations.

Although the Securitisation Regulation is (at the time of going to print in late May 2017) still in the process of being finalised, it seems likely it will provide that transactions cannot be considered STS unless the originator, sponsor and issuer are all established in the EU. Because the UK is seen as the only (soon to be) third country that would be able to take advantage of an equivalence regime in the short- to medium-term, a great deal of political resistance has materialised to the idea of introducing any kind of third country equivalence regime for STS (or otherwise facilitating third country access). Instead, a number of EU27 Member States are taking the position that such provisions should be contemplated only as part of a “horizontal solution” (that is, a solution applicable across financial services files) in the context of a broader Brexit deal.

While it might be possible in some cases to securitise UK assets in a structure designed with all EU parties, this would not be straightforward. Thus, in order to

preserve EU investor demand for UK securitisations, it would be desirable for the UK to make arrangements with the EU27 to permit UK securitisations to more sensibly qualify as STS as part of the Brexit negotiations.

Choice of law

Some market participants have been wondering since the Brexit referendum whether any provisions need to change in their English law securitisation documentation. While the asset purchase and servicing documentation will generally be governed by the law of the jurisdiction where the assets are located, English law has, historically, been a popular choice for the governing law of other transaction documents used in asset-backed financing (such as the cash management, financing or bond documentation). The reasons for this popularity, such as freedom of contract and emphasising the importance of parties’ commercial bargains, do not derive from EU law and will therefore be unaffected by Brexit. The continuing benefits of English substantive law are an important reason parties seem to be concluding in general that Brexit is not in itself a reason to stop choosing English law to govern transaction documents.

Moreover, as a result of the EU’s Rome I Regulation, courts in EU member states will continue to be obliged to give effect to the parties’ choice of law, whether the law chosen is that of an EU Member State or not. On the UK side, it is very likely that the UK will continue after Brexit to apply the terms of the Rome I Regulation, though as a UK law rather than as EU law (see the discussion of the Great Repeal Bill below). In any event, English courts upheld the parties’ express choice of governing law before Rome I’s predecessor, the Rome Convention, came into force and there is no reason to doubt that they will continue

to do so after Brexit, whether English law or some other law is chosen.

Notwithstanding the above, there are certain elements of EU law that provide helpful clarity in determining conflicts of laws issues surrounding cross-border securitisations. The special rules in the Rome I Regulation in relation to assignment and contractual subrogation support the financial markets, and in particular the securitisation industry. These special rules help parties determine the legal comfort they need in order to ensure the effectiveness of the “true sale” of the assets from the relevant seller to the special purpose vehicle where multiple jurisdictions are involved. Without it, true sale would still be possible but doubt around applicable law might lead to duplication of efforts among lawyers from the various jurisdictions.

Under Rome I, the law governing the assigned or subrogated claim determines its assignability, the relationship between the assignee and the debtor, the conditions under which the assignment or subrogation can be invoked against the debtor and whether the debtor’s obligations have been discharged. This aspect of Rome I has, despite certain imperfections, provided a key building block when structuring cross-border transactions. In particular, where assets are being transferred from an originator in one jurisdiction to an SPV located in another jurisdiction, Rome I is very helpful in allowing the parties to have certainty concerning the legal effectiveness of the relevant assignment. Once Rome I ceases to apply in the UK, it would clearly be helpful to cross-border securitisations, therefore, for its effects in respect of the law on assignment and contractual subrogation to be maintained.

Choice of jurisdiction and enforceability of judgements

As well as choice of law considerations, jurisdiction and enforcement matters are receiving increased focus following the Brexit referendum. English courts have long been a popular forum due to their expertise, commerciality and relative speed in resolving financial disputes. There is no reason to think any of this will change following Brexit. However, depending on arrangements between the UK and the EU following Brexit, consideration may need to be given to the enforceability of a judgment from an English court in EU member states (and *vice versa*). At present, English judgments are enforceable in EU member states under the EU Brussels I Regulation and exclusive jurisdiction clauses in favour of English courts mean other EU courts must generally defer to the English courts if seized of a relevant dispute.

Because the Brussels I Regulation applies only to benefit EU court judgments, it will cease to apply to English judgments following Brexit. That said, it is entirely possible that arrangements for automatic recognition of English judgments in the EU may be achieved. For example, the UK could accede to the Hague Convention on Choice of Court Agreements, which obliges courts in participating states to recognise exclusive jurisdiction clauses and to enforce judgments given by the chosen courts. Since the EU is already a party to the Hague Convention, separate ratification by the UK following its departure from the EU would significantly resolve the uncertainties relating to choice of courts and enforceability of judgments as between the UK and the EU27, at least for transactions entered into after the UK accedes to the Hague Convention.

Failing such arrangements, English judgments would be in a similar a

position to that of, say, the judgments of New York courts, whose enforceability in EU member states depends on the local law in each of those states.

Insolvency

Another area where EU law is crucial to cross-border securitisations is insolvency law. Typically, the parties will be concerned to understand the consequences of the insolvency of each of the originator and the issuer. EU rules, such as the EU Insolvency Regulation (and, in the case of a credit institution originator, the Credit Institutions Winding Up Directive and the Bank Recovery and Resolution Directive (BRRD)) help achieve certainty in the insolvency analysis relevant to transactions. Similar to the considerations around choice of law, most of the important EU insolvency rules are procedural in that they set out a framework for cooperation and recognition for cross-border insolvency cases. That is, EU insolvency rules largely serve to determine which national legal system will take the lead on an insolvency process where assets are distributed over a number of EU jurisdictions rather than setting out substantive law rules around the conduct of the insolvency and the distribution of assets to creditors. Substantive law of this type is left to the law of individual Member States where the insolvency proceedings are taking place.

Once the UK is no longer an EU Member State, the EU Insolvency Regulation will no longer function in such a way as to allow insolvency proceedings taking place in the UK to be automatically recognised throughout the EU27. Even though the UK is expected to continue to apply existing EU legislation as part of its domestic regime (see discussion of the Great Repeal Bill below) that will only allow English courts and insolvency officials to take jurisdiction. UK legislation

cannot of course have the effect of obliging EU27 countries to automatically recognise these proceedings or defer to the UK's insolvency process. Similar considerations apply in the context of the Credit Institutions Winding Up Directive or the BRRD, although those pieces of legislation contain some limited third country provisions which may assist in the recognition of any UK proceedings even after Brexit.

The result of this is that, absent arrangements with the EU27 designed to promote certainty in cross-border insolvency matters, transaction parties may be incentivised to seek additional certainty by ensuring to the extent possible that securitisation SPVs are strictly connected either to the UK or to the EU27, but not both. By way of example, such connections would likely include asset ownership, incorporation or exercising management functions, among others.

In the event that there is no agreement between the UK and the EU27 (either as a bloc or a series of bilateral agreements between the UK and individual Member States) before Brexit, the UK will lose the benefit of the rules on jurisdiction, cross-border cooperation and recognition. One possible solution is for the UK to promote the adoption of the UNCITRAL Model Law on Cross-Border Insolvency by EU27 Member States (the UK has already adopted it in the form of the Cross Border Insolvency Regulations 2006), but despite having been published in 1997, the only EU Members to have adopted it so far (other than the UK) are Greece, Poland, Romania and Slovenia. Within Europe, given the existing EU framework, it is unlikely that there will be much incentive for Member States to adopt it. In addition, the Model Law is not as comprehensive as existing EU insolvency rules, although UNCITRAL is currently seeking to enhance the Model Law so it may become more

attractive to Member States in the future. Even if more Member States do decide to adopt it, one of the key practical difficulties is that the Model Law does not preclude other jurisdictions from commencing competing insolvency proceedings. Further, in terms of recognition and cooperation, it is dependent upon a formal application being made to the local court where the insolvency proceedings are sought to be recognised. This is by contrast to recognition and cooperation under the EU Insolvency Regulation which is automatic and therefore more time- and cost-effective.

The “Great Repeal Bill” and the domestication of EU law

The vote to leave the EU happened almost a year ago, on 23 June 2016. On 29 March 2017, the UK formally triggered the process of leaving the EU by giving the so-called “Article 50 notice”. While broad plans have been discussed and preliminary negotiating objectives have been published, not a great deal of overt progress has been made. Indeed, as of late May 2017, formal negotiations had not yet begun.

What we do know is that the UK Government plans to reduce disruption by preserving, to the extent practical, all EU rules on the day Brexit takes effect. These include key European rules relevant for securitisations such as prudential rules for banks, insurers and funds, and the Credit Rating Agencies Regulation. This is to be accomplished by the so-called “Great Repeal Bill” described by the UK Government in a White Paper entitled “The United Kingdom's exit from and partnership with the European Union” published in February 2017. As described in the White Paper, the Great Repeal Bill would:

- Repeal the European Communities Act 1972 (the “ECA”), which is the key

piece of domestic legislation which gives effect to EU law in the UK.

- Preserve all EU and EU-derived law as it stands immediately before the UK's exit from the EU, allowing Parliament or, as appropriate, the UK's devolved legislatures to decide later what to keep, amend or repeal.
- Enable changes to be made to existing EU and EU-derived law by secondary legislation (that is, Government orders that are not subject to the same Parliamentary approval process as normal acts of Parliament) where such EU or EU-derived law would otherwise “not function sensibly” after the UK's withdrawal from the EU. This is to ensure that the UK's legal system “continues to function correctly”.

Absent the preserving provisions, of course, the repeal of the ECA would automatically cause all directly-applicable EU law (including all EU regulations) to cease to have effect in the UK. Importantly, it would also cause hundreds or thousands of existing pieces of secondary legislation that implement EU law to fall away. There is some industry support for the Government's proposed approach. For example, the Association of British Insurers has called for Solvency II to be directly implemented into UK law following Brexit and expressed support for the Government's proposal for a Great Repeal Bill.

Conclusion – the wish list

The Great Repeal Bill provides a route by which immediate disruption may be reduced. The rules may have a different source of legal authority on the day before and the day after Brexit, but their substance should largely remain the same – albeit the onshoring of regulation will inevitably cause differences in approach between the UK and the EU27 sooner or later, even if the wording of the legislation were to remain identical.

Furthermore, there are a number of problems (many of which are identified above) that are simply not within the gift of the UK Government or Parliament to solve on its own, but which are nonetheless central to the continued ability of structured debt markets to carry on functioning in a sensible way. These areas will need to be the subject of negotiations between the UK and the EU27, and it is to be hoped that the resulting arrangements reached will promote continued stability and legal certainty. A few items that industry might want to include in its wish list for the arrangements between the UK and the EU27 are as follows:

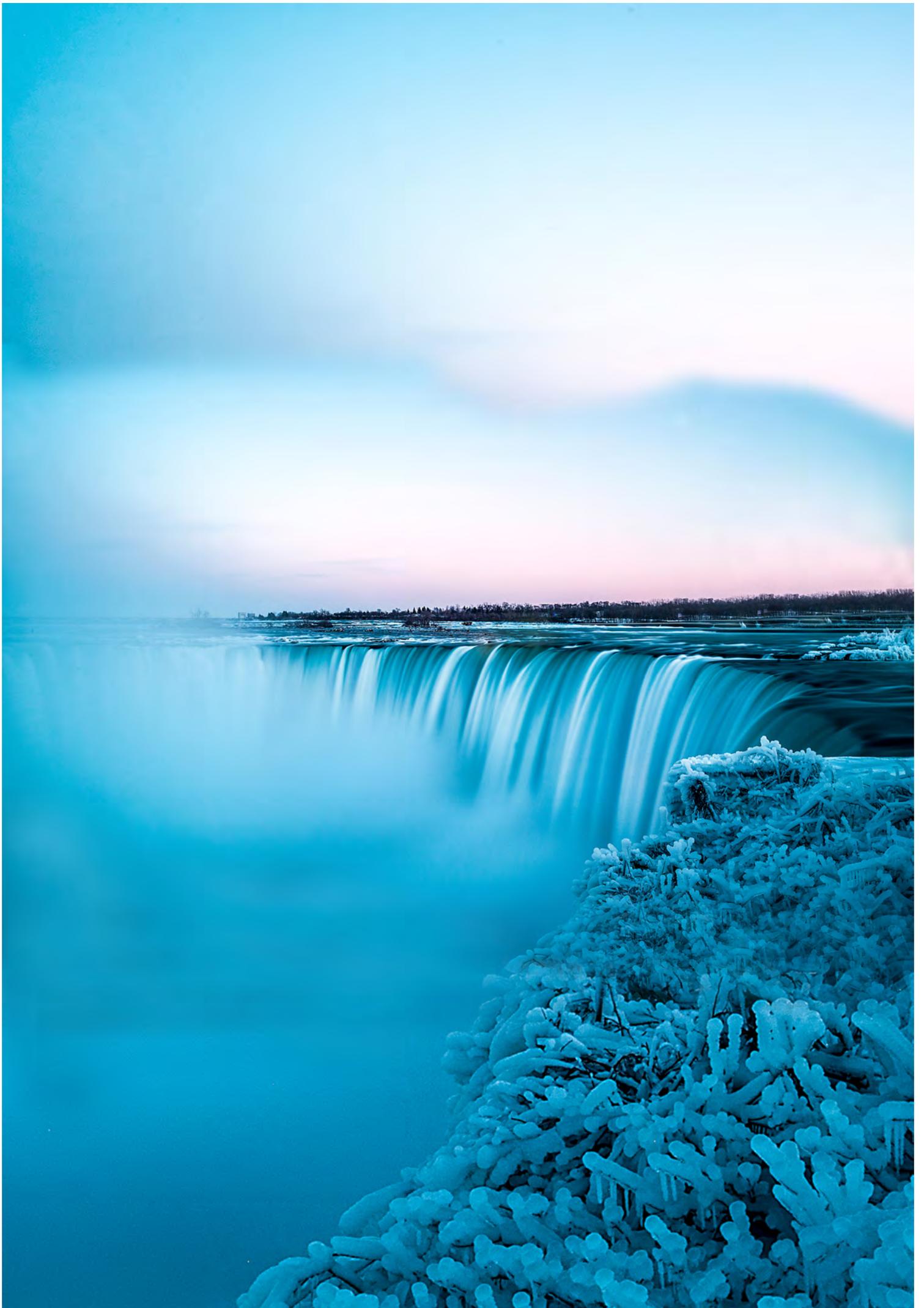
- **Equivalence/passporting:** While it seems highly unlikely that passporting in its current form will continue to be available between the UK and the EU27 after Brexit, it is in everyone's interest that cross-border business should continue to be facilitated so far as possible. Therefore, it would be desirable for arrangements to be put in place to grant mutual regulatory equivalence on as broad a basis as possible and with a higher degree of stability than exists for current equivalence arrangements. Equivalence arrangements should be put in place that cover, at a minimum, the provision of banking and asset management

services and the associated permissions (that would allow e.g. sponsors and CLO managers to continue to perform risk retention duties on a cross-border basis), OTC derivatives rules, credit rating agencies and securitisation specific rules (including STS qualification). We would suggest a substantial lead time (i.e. measured in years) for withdrawal of equivalent status in order to provide the necessary stability to promote use of the ability to do cross-border business on this basis. Even more helpful, but also more difficult to negotiate, would be an appropriate dispute resolution mechanism to resolve issues of non-equivalence and thereby prevent withdrawal of mutual recognition. Finally, there would need to be appropriate transitional rules so that arrangements entered into in reliance on the equivalence status would remain compliant during their lives even if the equivalence arrangement was terminated before the transaction's maturity.

- **Jurisdiction and enforceability of judgments:** The UK Government should make arrangements for the UK to accede separately as a party to the Hague Convention immediately upon exiting the EU so that there is continuity in the effectiveness of exclusive jurisdiction clauses and the enforceability of judgments as between the UK and the EU27. In addition, grandfathering arrangements should be sought between the UK and the EU27 so that agreements entered into in reliance on the provisions of the Brussels I should continue to be able to rely on its provisions.
- **Choice of law:** It is extremely helpful that Rome I applies universally – that is, it does not discriminate on the basis of whether the relevant conflicts of

laws rules are being applied to an EU Member State's laws or a third country's laws. In this sense, rules determining the law governing assignments and contractual subrogation need only be maintained on the EU side. Similarly on the UK side, the Great Repeal Bill should *prima facie* maintain these rules as well. Therefore the EU27 and the UK Government should have little to do in order to maintain the favourable status quo, but they should nonetheless have their attention drawn to the importance of maintaining these provisions.

- **Insolvency:** In many ways, this is the most difficult of the legal issues presented above to solve. It is no accident that limited progress has been made by the EU on converging insolvency law within the Union. Nonetheless, the UK Government and EU27 should seek so far as possible to take a coordinated approach on cross-border insolvencies so as to minimise uncertainty and avoid discouraging cross-border securitisations.
- **Phased implementation:** One of the key threats to an orderly exit is the fact that any Brexit deal between the UK and the EU27 is likely to be produced at best a few months prior to the expected date of Brexit, and would only be approved (if at all) much closer to that date. It is critical, therefore, that any Brexit deal should provide sufficient time for markets and market participants on both sides of the English Channel to adapt before changes take effect. To achieve this, we would suggest phased implementation of all rule changes over several years, paired with transitional provisions that would grandfather existing arrangements wherever possible.



SYNTHETIC SECURITISATION: A NEW DAWN

A growing market

One of the growth stories in securitisation markets over the last few years has been the re-emergence of synthetic securitisation. Synthetic securitisation had been very popular in the years leading up to the global financial crisis in 2008, but in the aftermath of the crisis, activity levels dropped off dramatically. However, beginning around 2012 the industry began to rediscover synthetic securitisation and, particularly since 2014, it has become one of the key portfolio management techniques being used by banks to manage their credit exposures and the capital requirements of their lending activities.

This growth is evident in various ways. First, there has been expansion in the types of portfolios being securitised through synthetic securitisation. Synthetic securitisation was once largely confined to assets which were not well-suited to traditional securitisation, such as large revolving corporate loan facilities, trade finance obligations and some types of SME loans. However, given lower levels of activity in the traditional securitisation market in recent years, and as banks have had less need for funding and liquidity, they have begun to look at synthetic securitisation of loan portfolios such as residential mortgages, small-scale commercial real estate loans and consumer loans.

Secondly, there has been a broadening of the jurisdictions in which synthetic securitisation is being used. Traditionally, synthetic securitisation was predominantly used by banks in Germany, the UK, the Netherlands and Switzerland, with much less activity in other countries. However, in recent years, there have been transactions right across

Europe, including in Italy, Spain, France, Ireland, Portugal, Sweden and the Czech Republic. Further, there are increased levels of interest evident in countries such as Poland, Hungary and Slovakia. Outside the EU, the last 12 months have also seen transactions being executed by banks in North America and Japan, and this trend also appears set to continue, reflecting the general focus on bank capital in financial markets the world over.

Thirdly, just as banks in more jurisdictions have begun to use synthetic securitisation as a portfolio and capital management tool, the technique is being used by a broader range of banks within each country. Where once synthetic securitisation was largely confined to the larger banks, smaller banks are increasingly looking to tap these markets. While synthetic securitisation has historically been most attractive for banks operating on the Advanced IRB approach under the Basel capital accord, in the last couple of years banks operating under the standardised approach have also begun exploring these opportunities.

Finally, there has been significant growth in the investor base for synthetic securitisation, with a number of specialised investment funds having been formed (in many cases specifically) to invest in these transactions, alongside a small number of very significant longstanding investors. While the market does remain dominated by those larger investors, the attractive investor returns provided by synthetic securitisation have led to many more investors entering the field. In addition to the traditional pension and hedge fund investors, two additional categories of investor have emerged. One is supranational entities such as the

European Investment Fund and the International Finance Corporation. The EIF in particular has become a very large investor in SME synthetic securitisations across Europe, often partnering with smaller banks. The IFC has also been active, seeing synthetic securitisation as way of leveraging their support for lending activity which is in line with their development objectives. The other category of investors now entering the market is insurance companies, which see synthetic securitisation as an adjunct to their traditional credit insurance business. Synthetic securitisations take advantage of insurance companies' comparatively high credit ratings to provide protection on an uncollateralised basis in a way which most of the traditional fund investors are unable to do. While few transactions have been executed with insurers to date, this does appear to be a market segment that is set to grow.

The regulatory environment

The attractiveness of synthetic securitisation to banks is closely tied to the impact of such transactions on the bank's risk-weighted assets. A classic synthetic securitisation involves the originator bank purchasing credit protection on the junior and/or mezzanine tranches of a portfolio of exposures, while retaining the senior tranche itself. Where the transaction is structured in such a way as to satisfy the requirements for significant risk transfer under the Basel securitisation framework (in the EU, as implemented through the Capital Requirements Regulation), the result is that the originator bank is able to substitute its exposure to each individual securitised exposure with its exposure to that retained senior tranche. Further, as a

result of the securitisation, the risk weight associated with that retained senior tranche is significantly reduced to, in a best-case scenario, 7% of the nominal value of that senior tranche.

Regulators have a margin of discretion when it comes to determining whether a bank has satisfied the requirements for significant risk transfer, and for a number of years regulatory reluctance to recognise such transactions acted as a limit on the number of transactions in the market. This is major reason no transactions were seen in some jurisdictions such as France and Spain for a number of years. However, in the last few years, regulators have become more receptive to recognising significant risk transfer, leading to the growth in synthetic securitisation outlined above.

Whether this trend continues will, to a certain extent, depend on the continuing evolution of the regulatory landscape in the coming years. The proposals for Simple, Transparent and Standardised (“**STS**”) securitisation currently going through the EU legislative process (discussed in our article on the EU Securitisation Regulation earlier in this publication) largely exclude synthetic securitisation. The result of this is that most synthetic securitisations will not be able to take advantage of the reduced risk weights that will apply to STS securitisation positions. This will, in turn, result in significant increased risk weights that will apply to the senior tranches, and thus a lower reduction in the bank’s risk-weighted assets in respect of the securitised portfolio.

The main exception to this is in the context of synthetic securitisations where the protection seller is a government or supranational entity which attracts a zero per cent risk weight under the CRR. The proposed Article 270 of the CRR

provides that where such a synthetic securitisation relates primarily to SME exposures and otherwise complies with the criteria for STS securitisation (other than the requirement for there to be a true sale of the securitised exposures), the originator bank will be able to apply the STS risk weight to the retained senior tranche of that synthetic securitisation, leading to a 50% reduction in its risk-weighted assets in respect of that senior tranche.

It has been reported that as part of the trilogue discussions to finalise the Article 270 of the CRR, the ability to apply the STS risk weights to the retained senior tranche of a synthetic securitisation will be extended to include synthetic securitisations involving private sector institutional investors (such as pension funds and hedge funds) where the investor provides cash collateral for its obligations under the securitisation. If, as appears likely, this extension remains in the final version of the amendments to the CRR, this will significantly reduce the impact of the increased risk weights in the context of synthetic securitisations of SME exposures. At the same time, however, the capital weights of certain underlying asset types are themselves increasing, which will at least partially offset the effect of the increasing risk weights on the retained senior tranche. That is to say, a synthetic securitisation may well produce a similar nominal reduction in the bank’s risk-weighted assets (in terms of the number of euros), even though the capital benefit will be a smaller percentage of the capital charge associated with those assets prior to the synthetic securitisation.

The current reform proposals also require the EBA to undertake further analysis on proposals to extend the application of the STS framework to synthetic securitisation at some point in the future. To a certain

extent this builds upon work undertaken by the EBA over the course of 2015, in which it conducted extensive consultations on whether there should be a STS regime for synthetic securitisation. The product of that work was a report it published in December 2015 in which it recommended allowing originator banks to benefit from STS-level risk weights for synthetic securitisations of SME exposures that complied with certain requirements. In some ways this conclusion overlaps with proposals to extend STS treatment to SME synthetic securitisations under Article 270, although the EBA report also considered additional requirements that are more specifically tailored to the common features of synthetic securitisations.

Another aspect of the current proposed reforms which will have a significant impact on the synthetic securitisation market over the next few years is the final outcome on grandfathering. The current proposal is for banks to be able to elect to continue to apply the existing risk weights to their outstanding securitisation positions at the time the amendments come into effect for a period up to 31 December 2019. This grandfathering is expected to lead to significant activity in synthetic securitisation markets over the course of 2017 as banks prepare – among other things – for the much higher securitisation risk weightings that will be introduced by the currently pending amendments to the CRR.

In many ways, the regulation of synthetic securitisation is in the position which true sale securitisation was in a few years ago. The regulatory attitude appears to be thawing, as regulators have begun to appreciate that, appropriately structured, synthetic securitisations can provide real benefits to the banking system and support lending to the real economy, particularly in crucial sectors such as

SME lending, without reintroducing the kind of systemic risks caused by some of the various arbitrage synthetic securitisations that were prevalent prior to the financial crisis and illustrated in films such as *The Big Short*.

The PCS Risk Transfer Label

Another recent development in the synthetic securitisation market is the introduction of the Risk Transfer Label by Prime Collateralised Securities. Launched in March 2017, the Risk Transfer Label is intended as an analogue of the PCS Label for true sale securitisation, but adapted to reflect features specific to synthetic securitisation. The label may be awarded to synthetic securitisations that meet criteria which are, broadly, based on the criteria for the PCS True Sale Label, as

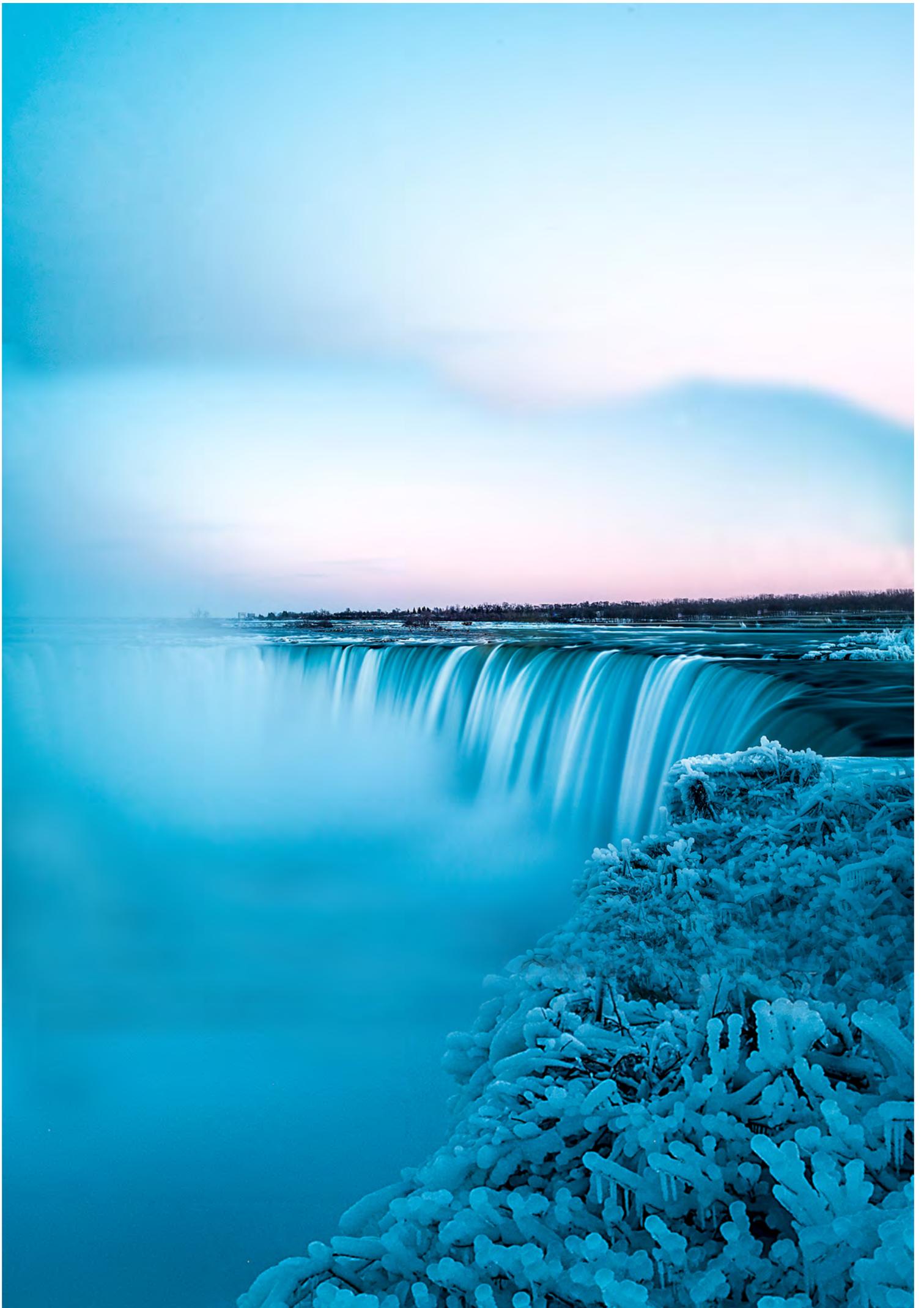
well as some additional features derived from the proposed requirements for STS securitisation and the EBA report on synthetic securitisation published in December 2015 referred to above.

The PCS True Sale Label is widely considered to have been instrumental in the rehabilitation of true sale securitisation following the global financial crisis, and the Risk Transfer Label is intended to serve a similar purpose, to provide a mechanism by which the industry can demonstrate to regulators that certain types of synthetic securitisation have a part to play in financial markets.

The first transaction to be awarded the PCS Risk Transfer Label was the ARTS MidCap 2016-2 transaction originated by UniCredit.

Conclusion

Synthetic securitisation has, over the last four or five years, re-established itself as an important part of the securitisation landscape. As banks have come under increasing capital pressure, synthetic securitisation has emerged as one of the portfolio and capital management tools banks can use to manage their capital requirements while also creating attractive opportunities for investors. At the same time, regulators across the EU have become more receptive to such transactions. Together, these factors have combined to drive a growth in synthetic securitisation. It will be interesting to see how this product continues to evolve in the coming years.



SECURITISED ORIENTATION WAREHOUSE FINANCING: A FLEXIBLE FUNDING TOOL

A notable recent theme in the European securitisation market has been the move towards securitised warehouse financing facilities as a means of providing funding for originators of mortgage loans, auto leases and other consumer assets. While the use of warehouse financing is not of itself a new phenomenon and has been an important funding source for a variety of originators for many years, the current changeable nature of the public markets, combined with lenders willing to lend on an asset-backed basis has made warehouse financing an increasingly attractive option.

Securitised warehouse financing can be broken down into three broad categories. First, warehousing transactions where a lender provides asset-backed loan or note facilities to a borrower to acquire a portfolio of assets in the market. The increasing number of non-bank lenders over recent times, particularly in the UK, is partly the result of non-traditional lenders acquiring seasoned portfolios of assets (often consumer-related) from banks looking to de-leverage. In addition, investors such as asset managers and insurers on the lookout for higher-yielding opportunities have increasingly sought to acquire such portfolios. Such “portfolio acquisition” warehousing is usually seen as an interim step, where a public market refinancing is being readied and will be executed once market conditions permit. There are a number of ways these transactions can be structured and documented, though they will typically be carefully designed around the particular requirements of the borrower and lenders. They will therefore look quite different to the structure for a public asset-backed deal.

The second broad category of warehousing transaction can be termed “public transaction” warehousing. This comprises those transactions that have the broad features of a public

transaction (the notes may be listed and cleared, for example) but the notes are preplaced on closing with a small number of key relationship lenders. Again, the intention may be to support the financing of a portfolio acquisition by the borrower or alternatively own originations of the borrower, though this second category has the advantage that such financing can be more quickly refinanced in the public market, as the transaction is already in a form that can be more widely marketed to other investors.

The third broad category of warehouse financing, which can be termed “origination warehouse financing,” is asset-backed financing that may be an attractive long-term option to smaller or start-up originators who are looking for a flexible funding solution in order to grow their business and may have no immediate desire to approach the public markets, though this may be the ultimate goal. In such circumstances, obtaining funding on a relationship basis with a small number of key funders may better equip such originators to meet their strategic objectives. It is this third type of warehouse financing that is the main focus of this article.

As we discuss below, this particular sub-set of warehousing allows scope for the use of innovative, bespoke

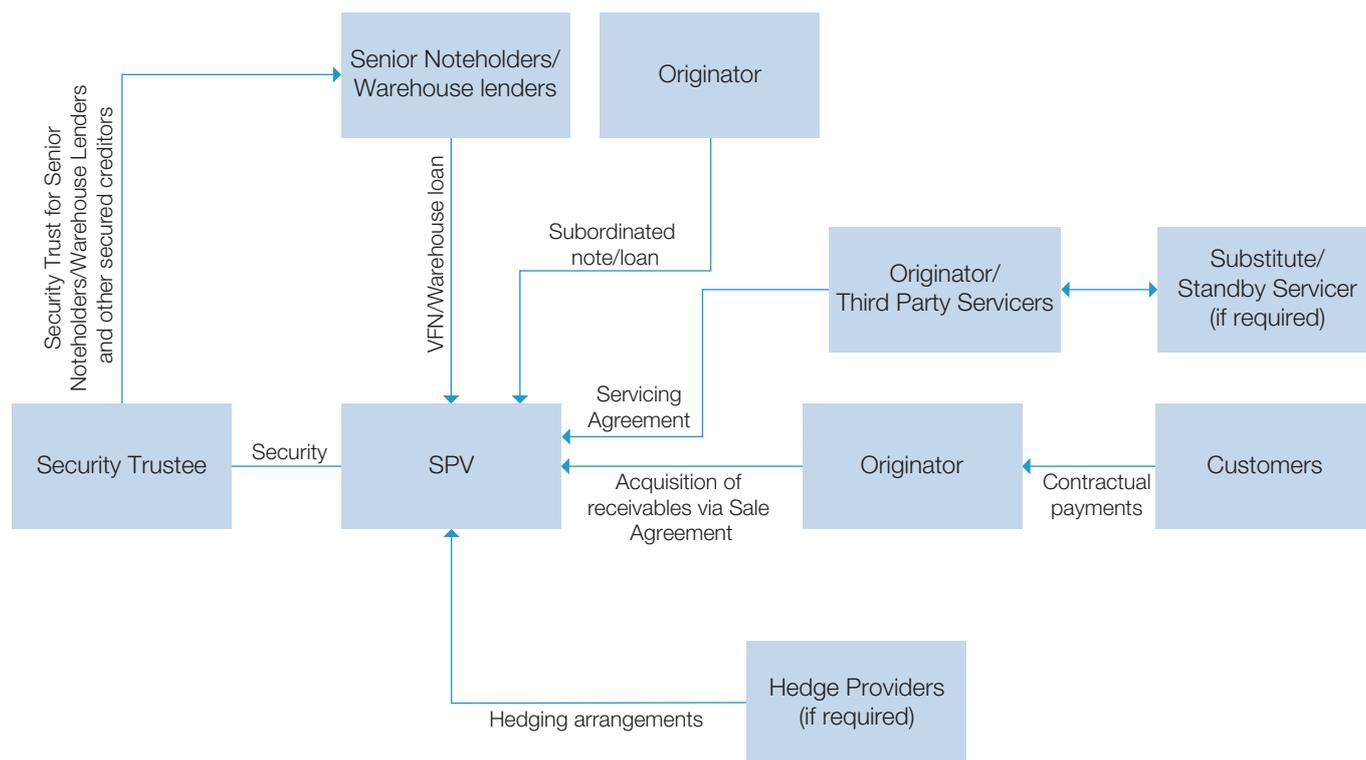
structures and lends itself particularly well to situations where the underlying assets in question represent new asset classes or products which have not yet been “publicly” securitised.

We also discuss a number of key considerations that arise where a rating is sought for any type of warehousing. In these cases, additional creativity may be needed to preserve the flexibility of such warehouse transactions in light of rating agency requirements.

Warehouse funding – typical structure

Securitised warehouse funding is traditionally structured as funding provided by a small number of lenders (sometimes even just one) on a limited recourse basis to a special purpose vehicle (“SPV”). That funding is secured on a portfolio of assets acquired by the SPV from the originator. The funding may take the form of a loan or, more commonly in newer structures, a variable funding note (“VFN”). Moreover, the lenders will typically fund only a proportion of the assets in the portfolio, with the originator itself funding the remainder via a subordinated loan or note.

Simplified warehouse structure



Key points in warehouse structures

Flexible funding for originations

For a first time originator accessing the public market, the transaction will often be structured as a “stand-alone”, as opposed to something more complex such as a multiple-issuance platform or a master trust. This is particularly likely where regular issuances of securities on the public markets are not contemplated. In the case of stand-alone public RMBS transactions, the portfolio of assets acquired by the issuing SPV on closing of the transaction is typically static.

By comparison, where origination warehouse financing is used, more flexibility is often built in by permitting the SPV borrower to use cash received upon repayment of the portfolio assets to purchase new assets (as opposed to

repaying the senior lenders) during a designated “revolving period”. Structures where the lenders fund the SPV borrower via a VFN mechanic may also permit the SPV borrower to increase the portfolio size by issuing new notes or increasing the note principal amount in order to purchase new assets from the originator, up to an agreed facility limit. Likewise, the VFN mechanic typically permits the SPV borrower flexibility to repay notes and reduce the size of the portfolio at any time in order to better fit the changing funding requirements of the originator.

Warehousing transactions also commonly include a simple mechanic for the lenders, the SPV and the originator to increase the facility limit. Origination warehousing transactions may often start with a relatively low lender commitment that can be increased over time as the originator becomes more experienced in running the

transaction, lender risk appetites change and the structure of the transaction evolves. A key point for lenders therefore, is the extent to which they are exposed to the quality of the portfolio which, as noted above, may change over time. Eligibility criteria for new assets to be sold by the originator into the portfolio will need to be discussed and agreed, as will the representations and warranties to be given by the originator in respect of the assets. These are frequently more bespoke and less standardised than the asset warranty package included in public transactions. Trigger events signalling the end of the revolving period (and following which the transaction must commence amortisation and the repayment of the senior lenders) will also be an important negotiation point given the potential impact of any termination of the revolving period on an originator’s ability to fund the origination of new assets.

For originators, the price for such flexible funding from lenders may be a requirement to comply with specifically negotiated reporting requirements in respect of the asset portfolio, which may differ from that which is generally required to be provided to the wider investor base in public transactions. Lenders are often permitted to conduct audit checks at the relevant originator's premises and to undertake checks on compliance with asset warranties.

Lenders may also seek to embed within the transaction further controls over the relevant originator's origination, credit and collection policies to prevent any potential drift toward riskier lending practices. This may be particularly relevant where the originator is a start-up or has a limited trading history in the relevant asset class.

Rated warehouse structures

Increasingly, both lenders and originators are looking to obtain credit ratings for warehouse transactions. This brings its own challenges, as the flexibility of warehouse structures must then be balanced with the requirements of the rating agencies. On the other hand, the better regulatory capital treatment certain European lenders will receive in respect of a rated loan or note is an important consideration, not least because it can then translate into lower borrowing costs for the relevant originator. Helpfully, there is a wider range of rating agencies involved in private ratings for rated warehouse structures as compared with typical public transactions.

Important considerations relevant to the ratings process include:

- Issuer corporate structure

Whereas the majority of public transactions use an orphan SPV issuer, which is not part of the originator's corporate group, there is more variation

in warehousing transactions, particularly in the case of new start-ups or where start-up capital has been provided by means of private equity funding.

In such cases, it may be preferable from a corporate perspective to establish the borrowing SPV as a group company and on the balance sheet of the originator group (depending on tax and other drivers this may be in a different jurisdiction to the originator group). Where the intention is for the warehouse facility to be rated, a key point of analysis for a non-orphan SPV will be the extent to which the vehicle will be immune from any insolvency of the corporate group as well as the extent to which secondary liabilities (e.g. tax) of the corporate group, may become liabilities of the borrowing SPV with a corresponding impact on any repayment to the warehouse lenders. The answer to this question will depend very much on the legal analysis in the jurisdictions where the borrowing SPV and originator are based.

In the UK, structural mitigants will typically be needed to ensure an adequate level of comfort is provided to the rating agencies that the borrowing SPV will not be liable for any secondary tax (including VAT) liabilities that might arise where the SPV is part of the originator group. Likewise, pensions liabilities of the originator (if applicable) will need to be analysed and (where appropriate) addressed in each transaction.

- Recourse to the originator

Due to the bespoke nature of warehouse arrangements, certain events of default or termination rights may be included in the financing documentation that relate to the performance of the originator or servicing entity (e.g. an event of default may be included in respect of the insolvency of the originator or the default by the originator in any of its material

obligations). These would be unusual in a public transaction, where there would typically be a strong focus on disentangling the credit of the SPV from that of the originator. For the same reason, these types of provision may need to be considered carefully in rated deals in order to allay any concerns of the rating agencies.

- Repayment date mismatch

Where the rating obtained is based on the ultimate payment of principal, the rating agencies will expect the final repayment date to be a short period after the last maturity date of the assets in the portfolio. However, many warehouse transactions are structured with 2-3 year maturities on the basis that the lenders will exit the transaction after that time with the assets refinanced in a public term deal or otherwise.

Where the expected repayment date of a warehouse facility is before the final maturity date of the assets, as may be the case for long-dated assets such as mortgage loans, the borrower SPV's repayment obligation will need to be carefully formulated in order to mitigate any rating agency concerns that it could trigger a fire sale of the assets. One way of addressing this issue is to permit the lenders (or require the originator) to conduct an orderly disposal of the portfolio if repayment has not occurred by the expected repayment date (as opposed to articulating the repayment obligation as a "hard" repayment date).

- Funding mechanics

As noted above, senior lenders will only fund a portion of the assets acquired by the SPV borrower from the originator, with the remainder financed by subordinated lending from the originator or, in some cases, mezzanine lending from another lender group.

The calculations that determine the proportion of the SPV's total assets funded by the senior lenders at any time may therefore be complex. In a rated transaction, such calculations may need to accord with the relevant rating agency's models to ensure the senior funding can achieve the required rating. A feature of private origination warehousing is that a number of different asset classes may be funded within the same warehouse facility (e.g. auto receivables, mortgage loans and unsecured consumer loans may all be funded through the same facility) and this can make such funding calculations even more complex.

- Operational Risk

Notwithstanding the extra control that lenders often have in warehouse transactions (as compared with public deals), the rating agencies will need comfort that the transaction (and, in particular, the servicing and cash management function) can continue and that scheduled interest and principal can be paid by the borrower despite any originator, servicer or cash manager default or insolvency. As such, the back-up servicing and cash management mechanics familiar to investors from public transactions will often be replicated in some form in rated warehouse transactions, including the use of "warm" back-up counterparties ready to take over running of servicing or cash management functions at short notice should this be necessary. It should also be noted that private origination warehousing can generally be structured to work with the IT and cash management systems of the originator and such deals (whether rated or not) make use of single or dual (interest and principal) payment waterfalls. Third party cash managers may also be used in some cases.

- Other considerations

Besides legal structure, other considerations may affect the ability to obtain a rating for a warehouse facility, including the availability of historic performance information for the assets in the portfolio. The requirement that at least some information on the transaction and originator is made publicly available as a result of the rating process may also dissuade certain originators.

Regulatory and tax considerations

As noted above, warehouse arrangements normally constitute "securitisations" for EU regulatory purposes. Indeed, as mentioned above, in some cases the transactions are deliberately structured to be rated securitisations for regulatory purposes. This means lenders and originators alike will need to be mindful of their retention obligations under the relevant EU regulations, including the Capital Requirements Regulation (for banks) or, depending on the nature of the lender, the AIFM Regulation (for funds) or Solvency II (for insurers). In particular, originators should be aware that the 5 per cent. risk retention obligation will apply to any warehousing structured as a securitisation, just as it would in respect of a public securitisation.

In addition, the Credit Rating Agencies Regulation may also apply, though the specific obligations imposed under the Credit Rating Agencies Regulation will differ depending on whether a full public rating or alternatively, a private rating is sought. Where a public rating is sought in respect of the transaction, the CRA Regulation will require that a second rating be sought in many cases. The disclosure obligations under the Credit Rating Agencies Regulation are unlikely to ever apply, but depending on timing of the transaction and the outcome of the legislative negotiations,

it may be wise to consider the transparency requirements of the proposed Securitisation Regulation that is likely to become law in the near- to medium-term (see our article on the EU Securitisation Regulation earlier in this publication).

To properly structure the transaction from a tax perspective, a number of factors will need to be examined, including the location and status of the lenders and of the SPV borrower as well as the location of assets. This will determine which tax risks arise. The tax analysis will focus on whether any stamp or transfer taxes arise, the VAT treatment of any services provided, whether withholding tax arises on any deal cash flows, secondary tax liabilities (as to which, see above discussion relating to issuer corporate structure) and the corporation tax treatment of the SPV (including, if the borrower SPV is an originator group company, transfer pricing).

In relation to the latter, it is possible to structure a UK warehousing SPV as a "securitisation company" as defined in the Taxation of Securitisation Companies Regulations 2006 (SI 2006/3296) meaning that it will be subject to corporation tax solely on its retained profit amount stipulated in the payments waterfall in the transaction documents. In transactions involving such an SPV, withholding tax risk can be mitigated if the warehouse lenders are, for example, based in the UK (or act through a UK branch), are treaty passport holders or, where the deal timeline permits, by applying for treaty clearance. Alternatively, the listing of notes (most commonly on an exchange other than an EU regulated market, such as the International Stock Exchange in the Channel Islands) may address withholding risk in certain scenarios. Adjustments may need to be made to the finance documentation to ensure a smooth listing process.

Conclusion

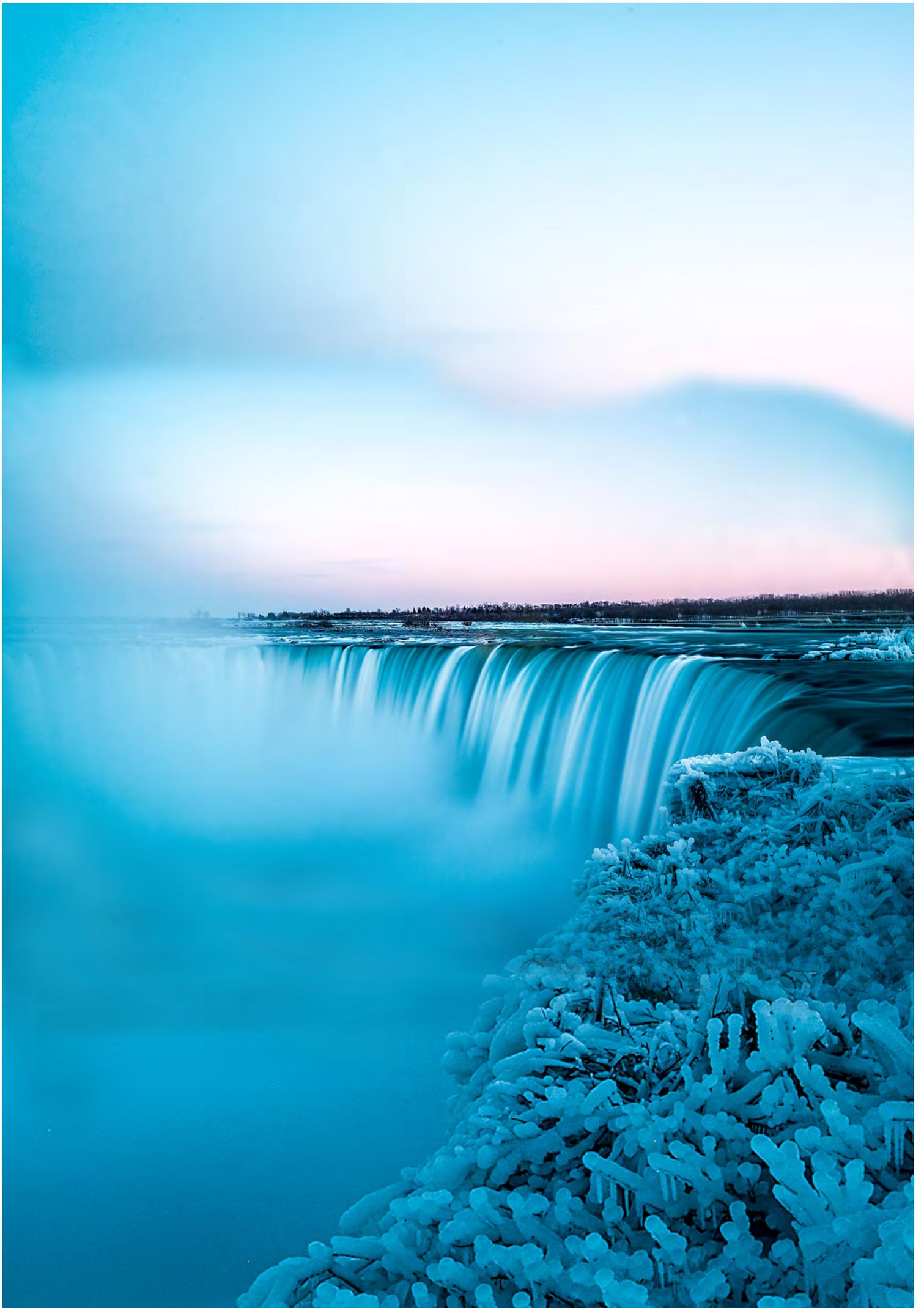
For so long as public transactions carry significant execution risk, lenders and originators (non-bank originators in particular) alike are likely to continue to look to securitised warehousing as an important financing channel. Some originators may view warehousing structures as temporary, with a view to eventual refinancing through the public markets. Increasingly, for other originators who have no need or desire to refinance such warehouse funding through the public markets, the private and flexible nature of warehouse funding may be a better fit with their corporate strategy over the long term. The development of this market is largely driven by a combination of lender appetite, the term of financing required and liquidity needs all of which will factor into lenders' decisions as to what type of

warehousing they are willing to put in place. A noticeable trend in recent transactions has been the increase in non-bank lenders (such as funds) who, more typically seen as investors in the public term securitisation market, are willing to provide funding for private origination warehousing in the right circumstances. As discussed above, private warehousing allows for bespoke structures with funding mechanics structured to meet the particular needs of fund investors (to have the funding instrument cleared and listed, for example).

For longer term origination warehouse structures, the ability to obtain a rating is clearly beneficial to lenders because it allows them to reduce regulatory capital costs. We therefore expect more warehouses to be rated going forward, meaning the warehousing

structures used will continue to adapt and adjust in order to address the points discussed above.

The great virtue of securitised origination warehousing is its flexibility. It can be long-term where required by the originator and lenders are happy with this, but lenders may also see warehouse financing as more short-term in some circumstances, and the flexibility of the structure allows adjustment with time to meet the evolving needs of the parties. In some cases, a more liquid funding instrument may be preferable and there is even a developing trend towards transactions conceived of as warehousing being structured as pre-placed transactions using a public ABS structure. The result is an increasingly blurred line between "private" warehousing transactions and "public" securitisation transactions.



RULE 144A VS REGULATION S DUE DILIGENCE: MIND THE GAP

As the European primary market for ABS issuance has remained erratic, issuers are again looking to the US capital markets for improved pricing, liquidity and a deeper investor pool. However, with the significant benefits of accessing the US capital markets come increased regulatory compliance requirements and exposure to additional liability. Over the years, while the gulf in market practices has narrowed between Rule 144A and Regulation S-only offerings, one key area where the approach continues to differ is in respect of due diligence.

Introduction

The offer and sale of securities is regulated in the US by the Securities Act of 1933, as amended (the “**Securities Act**”) which requires the registration of all offers and sales of securities with the Securities and Exchange Commission (the “**SEC**”) unless there is an available exemption. Rule 144A under the Securities Act provides a safe harbour for the resales of securities by initial purchasers to “qualified institutional buyers” (as defined in Rule 144A). Rule 144A is generally considered the most efficient and effective method to offer European ABS to US investors.

By contrast, Regulation S provides that offers and sales in offshore transactions outside of the US with no directed selling efforts in the US are not subject to Securities Act registration requirements. Regulation S-only offerings will, of course, still be subject to local regulation in the jurisdiction where the offering takes place. For the purposes of this article, we will contrast the rules for UK offerings (regulated by a mix of European and UK legislation) with those applicable to Rule 144A offerings.

Liability for disclosure under Rule 144A offerings, the ‘due diligence defence’ and the 10b-5 letter

Although securities offered and sold in the US in reliance on Rule 144A are not required to be registered under the

Securities Act, such sales remain subject to the anti-fraud liability provisions of the US Securities Exchange Act of 1934, as amended (the “**Exchange Act**”) and, in particular, the broad provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Rule 10b-5 provides that it is unlawful for any person in connection with the sale of a security “to make any untrue statement of material fact or to omit to state a material fact necessary in order to make statements made, in light of the circumstances under which they are made, not misleading”. Rule 10b-5 imposes potential civil liability on the managers as well as the issuer for incorrect or incomplete disclosure in connection with a sale of securities. As a result of the breadth of Rule 10b-5 liability, market practice has developed to insist on enhanced due diligence in the context of Rule 144A offerings when compared to the level of diligence typically undertaken in Regulation S-only offerings, where the standard will be aligned to local requirements.

The practice of establishing a “due diligence defence” originates from the statutory framework created by the liability provisions of the Securities Act applicable to registered securities offerings. Under this framework, a “due diligence defence” is a statutory defence against disclosure liability available to the managers and other third parties (but importantly not to issuers

or originators) participating in a registered offering where it can be established that they have acted with the standard of reasonableness that is required of a prudent person in the management of their own property, and on this basis formed no knowledge of, or reasonable ground to believe in, the existence of material omissions or material facts that required disclosure. Although, as discussed above, Rule 144A securities offerings are not subject to the liability provisions of the Securities Act, the due diligence practice that has developed in response to the Securities Act liability framework in the context of registered offerings informs the due diligence procedures applied by managers in the unregistered Rule 144A context.

The hallmark of the due diligence defence in a US offering is the delivery of a “negative assurance” letter or “10b-5 letter” issued by counsels to both the issuer and managers and addressed to the managers confirming that, in the course of conducting customary due diligence procedures, nothing has come to counsels’ attention that would cause them to believe that the offering materials contain misstatements of material facts or omissions of such facts that would cause the offering materials to be misleading. While the 10b-5 letter provides essential support for managers in managing risk related to underwriting a Rule 144A transaction, the 10b-5 letter

alone is not sufficient to support the 'due diligence defence' and does not replace other facets of the due diligence exercise, as explored in more detail below.

Liability for disclosure in Regulation S-only offerings – the position under English law

In the context of UK Regulation S-only offerings, liability for errors in the prospectus could give rise to both civil and criminal liability. Most notably, section 90 of the Financial Services and Markets Act 2000 ("**FSMA**") provides that persons responsible for the prospectus are liable to pay compensation to a person who acquires securities and suffers a loss as a result of an untrue or misleading statement in, or omission of a matter to be included from, the prospectus. The persons responsible for the contents of the prospectus are set out in paragraph 5.5.4 of the UK Prospectus Rules and include the issuer, each person who is stated as accepting responsibility for the prospectus and each person who has authorised the contents of the prospectus. It is probable that underwriters of the issue and arrangers may be caught by section 90 of FSMA, even though they would typically disclaim responsibility for the prospectus. There is however a statutory defence available from section 90 FSMA liability where, having made reasonable enquiries, such person reasonably believes the information to be true and not misleading or the matter whose omission caused the loss to be properly omitted. The reasonableness test is an objective test but is applied separately to each person and the way in which a person discharges his or her obligations may differ depending on the circumstances involved.

Additionally, criminal liability for the contents of the prospectus may arise under sections 89(1) and (2) of the Financial Services Act 2012 (the "**Financial Services Act**") and attaches to a person who deliberately or recklessly makes a false or misleading statement or dishonestly conceals material facts in connection with a statement for the purpose of inducing another to acquire or dispose of securities. Further, section 90 of the Financial Services Act makes it an offence for a person to do something which deliberately or recklessly creates a false or misleading impression as to the market or price or value of investments. Both sections 89 and 90 of the Financial Services Act may apply to misstatements in, or omissions from, the prospectus.

As with the position for a Rule 144A offering, a thorough due diligence process may therefore assist in providing a potential defence to liability for defective disclosure in the prospectus in the context of a Regulation S-only offering. That said, the market has not generally developed in the same way to require independent, third-party comfort akin to the 10b-5 letter for the managers in UK Regulation S-only offerings.

Documentary and legal due diligence

One of the primary differences between a Rule 144A and Regulation S-only offering is the documentary due diligence exercise undertaken in most Rule 144A offerings. In the US, documentary and legal diligence procedures have developed over time through case law and SEC guidance to involve the collection and review of information relating to the securitised assets, the originator and its underwriting or sourcing processes, the servicer and the issuer. This exercise is particularly important because US case law cautions against

taking management's representations and statements at face value.

The process generally begins with legal counsel to the managers preparing a document request list, which is sent to the originator, servicer and their legal counsel. Once the scope of the review is agreed, documents are compiled and are reviewed by both legal counsels. The purpose of the review is to verify that there are no material structural or legal impediments to the proposed transaction, confirm the accuracy of the offering documents and minimise the reputational risk of the managers. The documents provided in response to the diligence request list are reviewed, missing documentation and information is identified and requested and any issues which may impact on the offering disclosure are discussed and addressed.

Both Regulation S-only and Rule 144A offerings typically include diligence of the underlying assets, which is conducted in accordance with market standards relating to the applicable asset class. Such review may, for example, include a thorough review of commercial mortgage loans or reliance on third party reports for pools of residential mortgages. While there is not generally a notable divergence between the approach to the standard of the asset-level diligence exercise when comparing a Rule 144A and Regulation S-only transaction, from a Rule 10b-5 perspective such exercise will have pronounced importance in supporting the disclosure materials relating to the assets and providing comfort on the accuracy and strength of the representation and warranty package delivered by the seller of the assets.

Additionally, diligence sessions between senior management of the relevant originator and servicer and the managers

are generally undertaken for both Rule 144A and Regulation S-only offerings. The purpose of these sessions is to ascertain in detail the scope of the business of the originator and the servicer, the markets in which they operate, relevant strategy, risks and other material information relating to the offering. Historically the intensity of management diligence in a Rule 144A context was seen to be higher than for a Regulation S-only offering. However, over time the trend has been to move towards the Rule 144A approach for Regulation S-only offerings also.

Lastly, auditors are generally required to provide comfort assurance to the managers and originators on both Regulation S-only and Rule 144A offerings. This comfort typically takes the form of a pool audit letter reflecting the results of sample testing the actual assets in the pool against the data tape and an “agreed upon procedures letter” providing comfort to the managers on the statistical information contained in the prospectus. There may however be certain nuanced differences in the form or substance of the comfort given by the auditor depending on whether the offering is made in reliance on Regulation S or Rule 144A. These differences will derive largely from the internal procedures of the auditor (that themselves normally take account of national professional practice guidelines) and the level of comfort that is required by the managers for that transaction given their enhanced liability under Rule 10b-5.

Rule 15Ga-2

Rule 15Ga-2 became effective in June 2015 and requires the issuer or underwriter of rated Rule 144A ABS to make public the findings and conclusions of any third-party due diligence report they obtain. They must do this by furnishing a Form ABS-15G on the SEC’s

public EDGAR database. The disclosure must contain the actual findings and conclusions expressed in the report (though there is no requirement to file the entire report) and must be filed on EDGAR at least five days prior to the first sale in the offering. It has become market practice for issuers to bear the responsibility for filing this form.

The introduction of the requirement to publicly disclose third-party due diligence conclusions has raised questions with respect to identifying which reports are third party due diligence reports as defined by the rule, the format reporting should take, and the extent to which offering participants assume any liability with respect to compulsory EDGAR filings. Notwithstanding the introduction of Rule 15Ga-2, written legal due diligence reports prepared by counsel are generally not delivered to managers on Rule 144A offerings; the findings of the legal due diligence are generally discussed and they instead rely in part on the 10b-5 letters (which are, after all, issued on the basis of an evaluation of the diligence undertaken).

Timing of liability

Rule 10b-5 liability for material misstatements or omissions attaches at the point of sale with respect to the offering materials delivered to investors as of that time, including the preliminary or “red” prospectus and any supplements. By contrast, liability under English law attaches at the point of publishing the final or “black” prospectus. It is therefore important in the context of a Rule 144A offering that all diligence is completed prior to launch of the transaction and that any changes made to the red prospectus are notified to investors prior to the pricing of the transaction. For both Regulation S and Rule 144A offerings, diligence will typically be updated or

“brought down” on pricing and closing the transaction. Such bring-downs are generally conducted by way of a call or email confirming that there have been no material changes to responses previously given as at the relevant bring-down date.

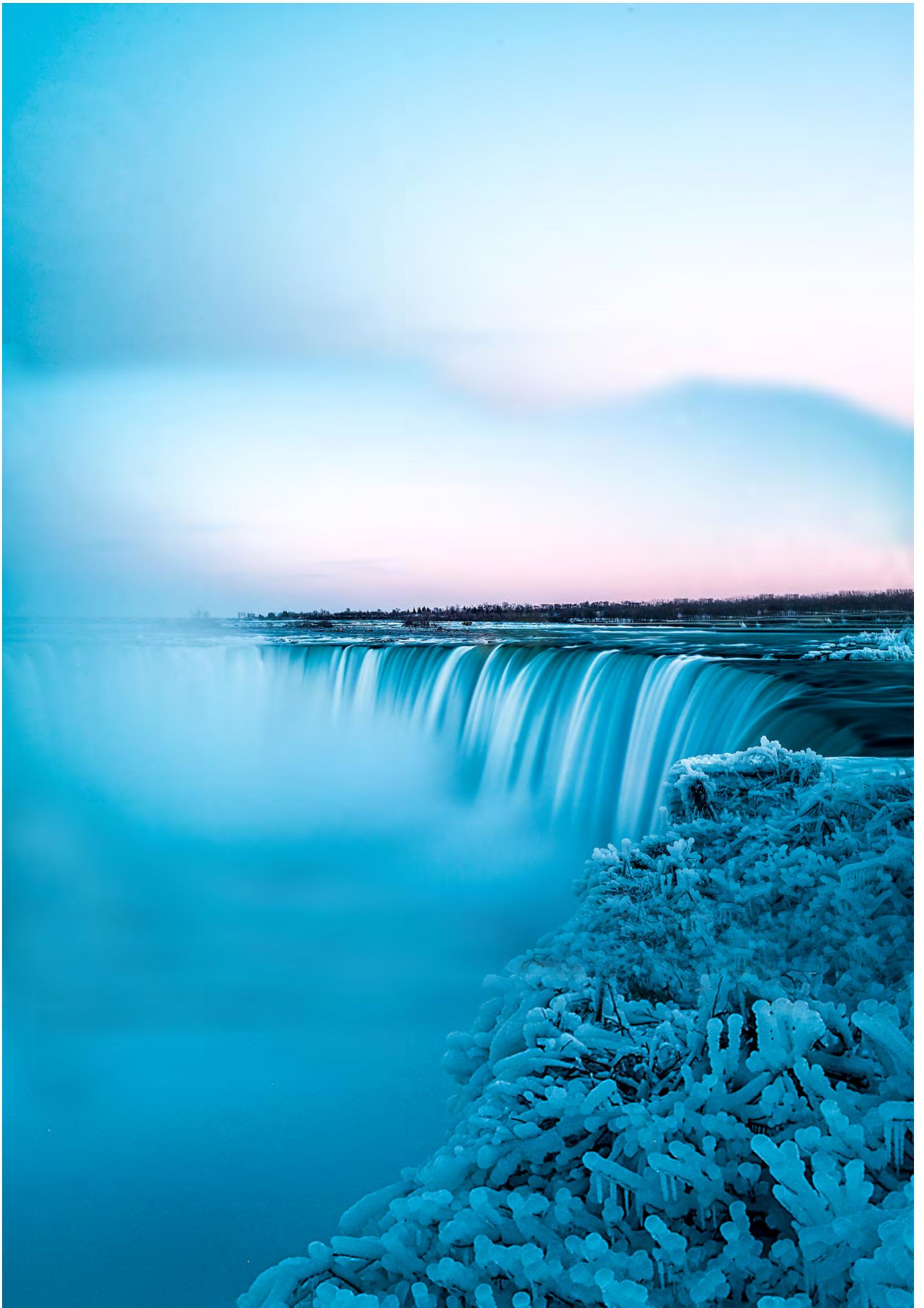
This is, however, another area where Regulation S practice is moving toward Rule 144A offerings notwithstanding the actual legal position. Consequently, most managers and issuers will wish diligence to be completed and accurately reflected in the prospectus prior to the launch of a Regulation S transaction. Liability for the red prospectus will be established as between the issuer and the manager through representations and indemnities in favour of the managers in the relevant subscription agreement.

Conclusion

Regulation S-only and Rule 144A offerings have in common the use of due diligence to protect against legal liability and reputational risk and to stress test the viability of a transaction. While in many respects the lines drawn between the standards of a Regulation S and Rule 144A offering have become blurred over time, there remain some differences in the approach to due diligence. Issuers will need to balance the significant benefits of accessing the US capital markets against the additional costs and time requirements associated with the enhanced diligence effort. Whether an offering is made in reliance on Regulation S or Rule 144A, it is clear that the appropriate level of diligence required to claim the status of “duly diligent” and to open the door to establishing a defence will depend on an analysis of the particular offering and the challenges that it presents.

Comparison table

	Rule 144A standards and practices	UK Regulation S-only standards and practices
Timing of liability for prospectus disclosure	Attaches at the “time of sale” to all disclosure materials (i.e., the red prospectus and any pre-pricing supplements thereto) delivered to investors as of such time.	Attaches at the point of publishing the black prospectus.
Negative assurance/ 10b-5 letter	Delivered by both counsels to issuers/originators and managers.	Not required.
Documentary diligence	Conducted by counsel in support of the negative assurance letter.	Not required.
Diligence of underlying assets	Conducted by counsel in accordance with market standards relating to the applicable asset class. Written reports are not generally prepared.	Conducted by counsel in accordance with market standards relating to the applicable asset class. Written reports are generally delivered.
Management due diligence	Conducted by counsel and managers.	Conducted by counsel and managers.



TRUSTEES AND MODIFICATIONS: IS IT TIME TO AMEND THE PROCESS?

Introduction

Market participants frequently need to adjust and adapt their structured debt transactions during their life, a process normally initiated by the originator or issuer. Such amendments are typically borne out of a desire to adapt to changes in circumstances, for example rating criteria that change after the transaction has closed. Issuers sometimes perceive the noteholder meeting process to be a lengthy and expensive mechanic that, in certain cases (and despite best intentions), may not be available as a practical matter because of noteholder apathy and the intricacies of a somewhat archaic solicitation method. In an effort to simplify the process, issuers often call on the trustee as the noteholders' representative to exercise its discretion to consent to a proposed modification. This standard feature of structured debt transactions is a useful resource for market participants as it can afford the issuer a quicker, cheaper and more streamlined method of seeking to amend documents.

However, while the exercise of trustee discretion is widely recognised as being of value as a tool that offers flexibility where otherwise noteholders would need to be involved, the interpretation of the scope of trustee discretion is perceived by some as being too narrowly drawn. A trustee typically has the ability to agree to modifications that fall into three predefined categories, but care should be exercised to avoid mistaking that for a licence to make commercial decisions requiring a finely balanced value judgment about the impact of a particular modification on the interests of individual investors.

Once asked to exercise its discretion, a trustee must consider whether such exercise would fall within its powers and, if it does, whether it would be reasonable to exercise its discretion. Trustees often ask to be provided with sufficient information to make an informed decision, and without such information are unlikely to feel empowered to exercise discretion. Trustees have been criticised for the arbitrary nature of their decisions in this regard, particularly where the amendments may appear straightforward and immaterial from the point of view of other market participants. As we discuss below, choosing between a noteholder or trustee-led consent request will often be carefully considered by market participants keen to balance cost and practical considerations.

In this article we consider the current appetite, and the means employed, for the exercise of trustee discretion in respect of amendments. We also consider recent developments in this area, how the current process might be improved, and what role the trustee might continue to play in the amendment process for structured debt transactions. Finally we consider whether additional and/or alternative amendment mechanisms may be better to facilitate commercial parties' requirements.

The role of the trustee

Before we consider the role played by trustees in the amendment process, it is important to reflect upon the general nature of a trustee. Trustees are selected, paid, and indemnified by the issuer. Acting as a conduit between the issuer and the noteholders, the ability of a trustee to exercise its discretion on behalf of the noteholders can ensure that a

transaction continues to be "fit for purpose" over its life without having to engage directly with a large number of disparate investors who may not agree with one another and who, absent the discretions afforded to the trustee, may limit the ability of an issuer to take a particular action. However, while trustees are appointed by the issuer, their role is as the representative, and as a vanguard against any action that may adversely impact the interests, of the noteholders. This dichotomy is not without issue. Transaction parties need to recognise that a trustee is first and foremost a fiduciary for the noteholders, and while trustees are increasing being asked to act "commercially" within the bounds of their duties, they cannot let business pressures impact their primary duty to noteholders.

Of course, this also means that trustees have a much freer hand when being directed by noteholders, as is often the case on retained deals. In such cases, the trustee need not consider the effect of the amendments on noteholders – from a strict legal perspective, it should only need to check that the noteholder resolution is valid as to form. That said, commercially you would also expect it to ensure that its own position is not adversely affected. The perception of originators, however, is increasingly that trustees are insisting on unnecessarily cumbersome processes delving into the substance of amendments, which are inappropriate when directed by noteholders. A more pragmatic approach by trustees in such cases might help build goodwill from originators, making trustees' concerns more likely to be addressed quickly and seriously when real difficulties arise.

Trustee discretion: permitted categories of amendment

Trustees are empowered to consent to transaction amendments which typically fall within the following categories. Amendments which, in the opinion of the trustee, are (i) of a minor, formal or technical nature, (ii) to correct a manifest error, or (iii) not materially prejudicial to the interests of the noteholders.

Amendments which are of a minor, formal or technical nature

It is not necessary to establish that the transaction documents contain an error or a mistake to make use of this first head. Rather, the trustee need only be satisfied that the relevant transaction documentation will be “improved” as a consequence of the proposed amendment. An amendment could be agreed to be (i) of a formal nature where it does not alter the substantive legal effect of a document, (ii) of a minor nature where it may affect the substantive legal effect of a document, albeit in such a manner that the impact of the amendment on the rights of the other parties would be unimportant, and (iii) of a technical nature typically where it updates technical information included in a transaction document, for example the correction of a legislative provision.

Amendments which are to correct a manifest error

Satisfying the trustee that it may consent to an amendment on the basis of manifest error requires the requesting party to meet the standard of establishing to the satisfaction of the trustee that (i) the error is “plain and obvious”, (ii) the relevant transaction document did not reflect the common intention of the parties as at the date such document was finalised, and (iii) the solution, as well as the error, is manifest.

Amendments which are not materially prejudicial to the interests of the noteholders

This third head of trustee discretion permits the trustee to consent to amendments which are not materially prejudicial to the interests of the noteholders. Because of the breadth of amendments possible under this head (especially as compared to the other two heads of trustee discretion above), it is the one most frequently relied on by parties requesting amendments to transaction documentation. The trustee is required to consider the potential negative impact of the amendment on the interests of noteholders and make a determination as to whether the noteholders would, or could, potentially be left in a materially more disadvantageous position if the proposed amendments were made.

Facilitating the exercise of trustee discretion: trustee consent letters

Trustees have the right to agree to certain changes to transaction documentation, but no obligation to do so within a particular timeframe or at all. However, as a fiduciary, they must consider whether they ought to exercise their discretion in the circumstances, even if on balance they feel unable to do so. A trustee must, typically with the assistance of counsel, make its own determination as to whether to exercise its discretion in the manner requested. Various processes have developed and resources are ordinarily made available to a trustee as it determines whether it is empowered and willing to exercise its discretion. A trustee is not required to monitor whether particular events occur, or certain circumstances exist during the life of a transaction, and accordingly in the exercise of its duties may rely

on professional advice and on certifications as to fact furnished by the transaction parties.

Trustee consent letters, around which an industry has developed, fall within this latter category. While a trustee consent letter does not offer a conclusion that a trustee can unquestioningly follow, it is a practical tool that endeavours to provide the trustee with a comprehensive and compelling map of relevant considerations. Trustee consent letters are persuasive and act (i) as a means for the party requesting the amendment (typically the issuer) to demonstrate how it has reached its conclusion that the trustee may (and should) exercise its discretion, and (ii) as a certificate that the trustee may rely on if, on completion of its own analysis, it forms the same opinion as the requesting party and exercises its discretion as requested. Trustee consent letters are routinely expected, if not required, as part of the trustee’s reliance regime, even when amendments may be considered to be minor.

While the provision of trustee consent letters may have previously been considered an obstacle or an unnecessary additional cost, the process of preparing, and the exercise of trustee discretion based on, trustee consent letters has been significantly improved over recent years, with market practice largely having reached consensus as to the expected form and content of a trustee consent letter. Although the documentation rarely (if ever) explicitly contemplates the preparation of a trustee consent letter, let alone prescribes a particular form, a trustee would normally expect it to include:

- a clear request, providing detailed background as to what the amendment is and why it is required;

- a detailed description of the powers that the requesting party would like the trustee to exercise and an analysis as to why the conditions to the grant of the trustee's consent are satisfied, in particular commentary on the absence of material prejudice to noteholders (assuming the request is made on the basis of "no material prejudice");
- a certification that the request does not relate to any subject matter where decisions are reserved to some other party or parties and that the request would not trigger a default; and
- other additional protections for the trustee on a case-by-case basis.

In order to agree to a modification, the trustee must be sure it is acting within its powers. If the trustee cannot satisfy itself that the proposed modification sits squarely within the scope of its discretionary powers, it will not be in a position to exercise its discretion. Doing so would expose the trustee to challenges from noteholders and other transaction parties, potential liability and negative reputational consequences.

While the exercise of trustee discretion can to many on the sponsor side seem an unnecessarily onerous path to navigate, the ability of a trustee to agree to modifications ensures the involvement of an experienced participant and conduit to agree changes on behalf of investors. The challenge for the capital markets community is to find an appropriate balance between (i) the legitimate concerns of a trustee to avoid incurring liability, (ii) tackling investor apathy and solicitation complexities, (iii) investors' need to be involved in significant changes to the terms on which they invested, and (iv) the increasingly complex needs of typical capital markets transactions which often require rapid responses to technical and bespoke demands.

A look back and current developments: AFME language

In November 2009 in our "*New Beginnings*" publication, we identified two key issues with the trustee consent process in the aftermath of the credit crunch. One was the need for better communication with noteholders in order to permit them to take effective action and the second was the need to manage commercial parties' expectations at the outset about the scope of the trustee's ability to act on the noteholders' behalf. The first concern has begun to be addressed more effectively, with terms and conditions now typically providing that notices can be delivered to investors through standard industry products such as Bloomberg (and thus a more direct information channel to noteholders has been created). The second concern, however, has presented more challenges, and market participants are still looking to adjust the amendment process and the involvement of the trustee in structured debt transactions to make the process more universally workable.

In addition to limitations on the use of the trustee's traditional discretionary powers as discussed above, issuers and sponsors have historically found it challenging to generate sufficient investor engagement to permit success via a noteholder meeting. This is most problematic where amendments are required simply to maintain the *status quo* and ensure smooth running of a transaction in the light of external changes in circumstance. Such amendments (due to their nature) may not elicit sufficient investor interest or participation. These twin challenges have, over recent years, given rise to a trend for "hardwiring" into the transaction documents consent to

certain types of modifications provided relevant conditions are met (e.g. changes to maintain the rating of the notes where rating criteria change). Such "hardwired" modification provisions serve to compel the trustee to consent to changes under certain circumstances but typically only where the proposed amendments relate to specified subject matters.

This effort to ensure transactions are capable of adapting with market developments and to combat perceived investor apathy initially manifested itself as an increased use of negative consent. Where negative consent provisions are included in a transaction, noteholders are deemed to consent to, and direct the trustee to consent to, particular amendments unless a defined proportion of investors register their objection to the proposed amendment within a specified period of time. These "snooze, you lose" mechanics, once a measure of last resort, have been increasingly viewed as a practical solution permitting the transaction sponsor to deal with technical or administrative matters that do not fit neatly within the range of amendments that can be made under the trustee's traditional heads of discretion and/or where rapid response is required. While the attempt to make certain heads of consent mandatory at the turn of the decade has largely been abandoned by market participants, the Association for Financial Markets in Europe ("**AFME**") published a template modification clause in 2014 which incorporates a model form of negative consent wording and is intended for use alongside (and in addition to) existing modification provisions. The AFME approach has gained widespread market acceptance since its publication.

The AFME wording allows the use of negative consent to facilitate certain modifications to transaction documents (for example amendments required to reflect changes in rating agency criteria, to enable securities to remain listed on a stock exchange and to comply with regulatory changes such as those driven by FATCA and EMIR) without noteholder consent and without having to take into account all the considerations normally required in a traditional exercise of trustee discretion. The use of negative consent in AFME's model is contingent upon, among other things, (i) receipt by the trustee of certain evidence establishing the factual basis for the request, including a certification that the proposed modifications are necessary in view of the facts described and that the amendments proposed achieve only the specified effect, (ii) the issuer having given 30 days prior notice of the proposed amendments without at least 10 per cent. of noteholders (by principal amount outstanding) having registered their objection, and (iii) the trustee being satisfied that its own position is not prejudiced.

When it was published, the appetite for inclusion of such modification language was significant and it became routine for it to be included, especially in new transactions. It was even adopted for a number of large programmes when they were amended. While initially there was some debate as to what modifications would be requested in practice under some categories (such as those driven by EMIR and FATCA), the passage of time and the benefit of experience has gone some way to resolving that uncertainty. Importantly, where once trustees may have objected to the inclusion of certain elements of the negative consent language, they are now increasingly relaxed about it. However, while such negative consent language seemed to

gain wide acceptance for a time, investors have recently been raising concerns about it. These concerns mainly stem from the fact that the low objection thresholds of negative consent procedures allow a very small number of investors to block a change that may well have been agreed by the trustee on the basis of "no material prejudice". In light of these investor concerns, a number of recent deals have included only the three traditional heads of trustee discretion to amend deals, with no such modification language or a more limited form of negative consent language adopted. Market participants are currently watching the direction of travel in this respect.

Streamlining the amendment process: prevention rather than cure

As market participants look back on nearly a decade of activity since the onset of the financial crisis, a lot has been learned but little has changed. Many transactions, whether master trust, standalones or programmes, have had to develop and adapt for the latest rating criteria, changes in deal features or react to the increased burden of regulation and investor demands. As this pace of change shows no signs of abating, the time is right to again consider how to respond to these factors to ensure that structured finance transactions can be effectively managed and stand the test of time. This is especially so for on-balance sheet treasury funding transactions.

If the move away from so-called hardwired modification language back to the traditional heads of trustee discretion continues to progress perhaps a new regime of prevention, rather than cure, is a potential way of avoiding any impasse. It has become clear that there is a relatively short list of reasons transactions typically need to be amended. Dealing

with changes in regulation, the desire to make transactions as efficient as possible (e.g. in order to release trapped cash which may incur unnecessary transaction costs) and reflecting changes in rating criteria are often at the top of that list.

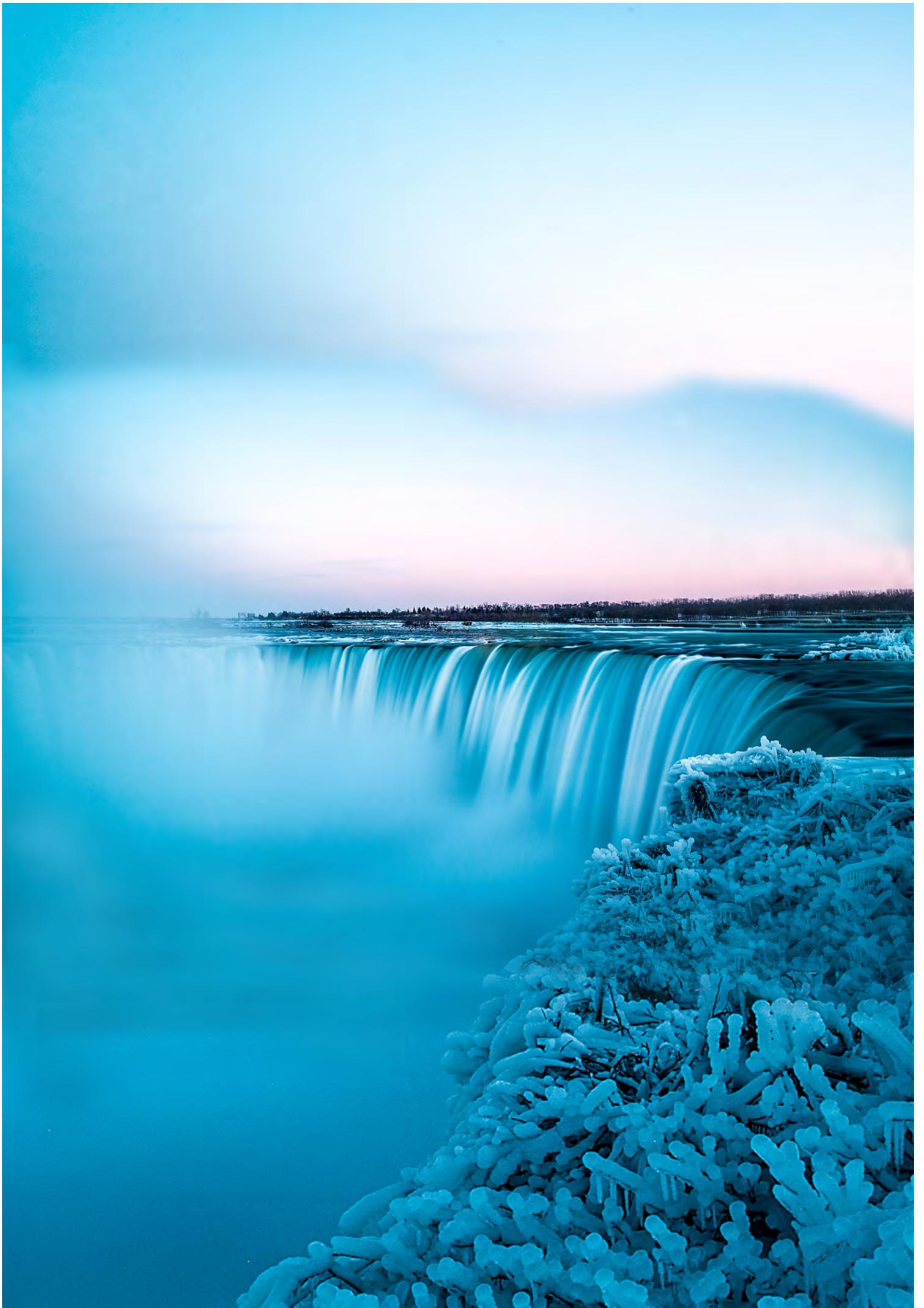
To minimise the need to make changes during the life of the transaction, sponsors could seek, where possible, for triggers or financial covenants to be defined by reference to standards set by a third party, such as a rating agency, to avoid the need to amend the relevant covenant or trigger in the transaction documents when the relevant rating agency does so in its criteria. For other issues, such as changes to reflect regulation, or operational changes for efficiency, sponsors could discuss key concerns with investors up front and design a bespoke amendment process whereby the sponsor has to demonstrate or certify that no adverse effect would result from the amendments by reference to an external standard that tracks investors' named concerns (e.g. no adverse effect on ratings). This may be a more efficient way to deal with such amendments rather than relying on exercises of trustee discretion under the traditional heads. Although these ideas are not new, a careful consideration of the reasons a transaction might be amended and how best to deal with that at the outset of transactions would undoubtedly be helpful. While it may be possible to divorce the trustee from certain aspects of the amendment process this will not operate to alleviate all concerns. Indeed, investors may not wish to relinquish the safeguards offered by trustee involvement. Therefore, while these ideas provide food for thought, it is important that such drives for efficiency should not lead to a disenfranchisement of noteholders. Not least, modification of the basic terms of a transaction should always require noteholder consent.

Conclusion

As described above, the post crisis years have involved a lot of learning, but relatively little change. It is not in the interests of sponsors, investors, or trustees for the amendment process to be impractical, time consuming or costly. The flexibility offered by trustees agreeing to amendments falling within the three traditional heads of trustee discretion has proved valuable and ultimately investors' concerns should rightly remain sacrosanct. However, in light of the ever changing context of, and challenges faced by, structured debt transactions it should be possible to continue to design efficient amendment processes around changes in circumstance that are

foreseeable at the time a deal is being structured. Such foreseeable changes should, wherever possible, be contemplated and hardwired into transaction documentation upfront. These might include more mechanical amendments to directly import changes via references to external standards (such as financial ratios in rating criteria) or areas where more judgment is required, such as adapting to known changes in the law. There might even be some limited areas where noteholders are happy to accept that defined amendments can be made by an issuer on the basis of a certification from a sponsor that a change is not materially prejudicial to noteholders or has no rating effect,

rather than insisting that such a determination be made via the exercise of trustee discretion. In this way, it may be possible to pare back the requirement to call on trustees to exercise their discretion to areas where their input or that of another independent noteholder representative to review proposed changes would truly add value. This would have the added benefit of reducing the scope of trustee involvement to unforeseen requests. It may also have the benefit of improving communication between buy side and sell side so as to better balance investors' concerns and needs with originators' requirements around operability of their funding platforms.



ASIA-PACIFIC STRUCTURED DEBT: TRADE, DELEVERAGING AND FUNDING

The structured debt and securitisation markets in Asia-Pacific remain lively, fuelled by continuing economic growth, trade and, in some cases, a wish to de-lever the banking sector. With the notable and significant exception of the finance of trade, the structured debt and securitisation markets in the region also remain very largely domestic, rather than regional or global.

Given the strong national differences, it makes sense to highlight the widely varying levels of activity across the region. Some countries are seeing significantly more activity than others – for instance, Singaporean covered bonds, credit cards in Australia and the domestic Chinese ABS market have all been strong performers recently.

The reasons behind markets in some jurisdictions seeing more activity than others might be said to be driven by the different speeds with which the economies and the banking systems in those jurisdictions have developed over time. It is also driven in large part by the differing speeds at which markets in the underlying assets are developing in the different regions – it's hard to do a credit card securitisation in a market where the average consumer doesn't have a credit card.

Australia

The relatively mature economy in Australia is no stranger to securitisation with RMBS issuances frequenting the capital markets for a number of years. In the context of those strong capital markets and the growth in consumer credit in Australia, which has steadily continued over the last decade, it was only a matter of time before the securitisation markets were tapped to provide funding to a credit card business. The recent Latitude securitisation issuance is an example of this, where

a credit card master trust structure was optimised for the Australian credit card product. The heavily oversubscribed issuance, at 3.2 times across the capital structure, shows there is significant investor appetite for consumer credit risk in Australia.

Singapore

Since DBS issued its inaugural covered bond in 2015 other Singaporean banks, such as UOB and OCBC, have followed suit establishing programmes and issuing covered bonds. This has helped them raise significant funds backed by their Singaporean mortgage portfolios. Take up has been so significant that the Monetary Authority of Singapore reported in 2017 that DBS and UOB were already around halfway towards the Singaporean encumbrance limit of 4%. At the Asian Covered Bonds Forum in March it was also suggested that covered bonds may be made eligible for repo transactions with the Singaporean central bank – though it is expected that only SGD denominated bonds would qualify. This may provide an incentive for the first issuance of an SGD denominated covered bond, which local banks have, to date, shied away from issuing given the already low onshore issuance costs of unsecured senior bonds. Additionally, if a market for SGD denominated covered bonds grows, it would provide foreign banks, such as Standard Chartered and Maybank, with an option to match-fund their SGD

mortgage lending businesses with SGD funding.

Chinese ABS

Significant efforts have been made in China to develop deeper and broader capital markets and the establishment of a legal framework for securitisation issuance has helped make progress towards this goal. In the first nine months of 2016 there were more than RMB 584 billion of domestic issuances under the two approved securitisation programmes – the Asset Backed Specific Plan (ABSP – available for Chinese corporates) and the China Credit Asset Securitisation programme (CAS – available for Chinese banks). However, the domestic Chinese commercial banks continued to be the largest single class of investors in Chinese securitisations, which only goes to highlight the deep reliance on bank funding in the Chinese economy and the role of domestic banks, which are heavily leveraged, in credit intermediation.

One regulatory initiative, designed to assist domestic Chinese banks with deleveraging, was re-introduced in May 2016 – a pilot programme under which non-performing loans can be packaged up and securitised. Early uptake saw both the Bank of China and China Merchants Bank utilise the scheme with aggregate initial issuances of RMB 283 million. However, since the purpose of the scheme is to de-lever the banks, its success will be judged not only by the

volume of issuances but by whether or not there is significant participation by investors outside the banking sector.

The foreign auto-sector is also becoming more involved with the Chinese securitisation markets, with each of General Motors, Mercedes-Benz, Ford and Volkswagen issuing asset-backed notes in China in 2016. This is also reflective of the slowly growing foreign investor participation in Chinese ABS generally – May 2016 also saw the People’s Bank of China open the interbank bond market to a much wider pool of investors, whereas it had previously been limited to banks providing RMB clearing and certain securities firms and asset managers participating in the qualified foreign investor schemes.

Financing trade

The finance of trade-related receivables has continued apace throughout the region with three particular areas of note:

- the growing use of supply chain finance and reverse factoring to allow suppliers to large corporates to access hard-to-find credit, with an element of fintech being employed in some instances, seeking to make exposure to trade receivables more accessible to a wider pool of investors;
- more transactions involving a Chinese aspect to them – whether financing a Chinese supplier to offshore debtors, or onshore debtors of a foreign supplier – the latter being indicative of the broader switch in the Chinese economy to domestic consumption; and
- off-balance sheet treatment for corporates, with a heavy emphasis on the use of insurance products to achieve this, again often coupled with an element of fintech to either allow the risk in the receivable to be distributed

more easily or to quickly check the eligibility of the receivables which are proposed to be added to the financing.

The historically strong trading links between the major cities in Asia-Pacific naturally make any financing of that trade cross-border and multi-jurisdictional in nature. The key points a financier of trade receivables must consider are three-fold:

- Do they really have risk to the debtor of the receivable, or pool of debtors, with no element of supplier-risk in play?
- In the event the supplier becomes financially distressed does the financier have, or can it quickly obtain, sufficient control over the cash flow from the debtor(s)? Exchange controls in some jurisdictions are one thing to consider which can make this difficult.
- Is there a sufficiently frequent and detailed flow of information to properly understand the nature and quantum of the receivables being financed and the way they are being originated and serviced?

These risks are drawn into particular focus where a supplier wishes to raise working capital finance against its debtor book – it is not simply selling the receivables outright, but rather wishing to use them as quasi-collateral for the financing. Structured debt techniques can be used to provide protection for a financier against each of these risks, giving those financiers a strong and robust controlling position, in each relevant jurisdiction, should the supplier get into difficulty.

Securitisation regulations – risk retention

Risk retention rules are a good example of how care needs to be taken in structured debt transactions in Asia-Pacific. This involves ensuring that, to the extent the

transaction structure (including investors or even potential future investors) creates a territorial nexus with a jurisdiction, that nexus is identified and the relevant securitisation regulatory regime is adequately addressed. The EU and the US are especially important regimes to address in this respect. For instance:

- EU rules – where an EU credit institution, insurer or alternative investment fund is or may become exposed to a securitisation transaction, an appropriate person (in the EU, an “original lender”, an “originator” or a “sponsor”) must retain a 5% material net economic interest in the transaction in an appropriate manner. Where a transaction is undertaken and funded entirely within Asia-Pacific, it is unlikely that the EU rules will be immediately relevant, however, if these rules are not complied with few if any EU-regulated institutional investors will ever be in a position to invest in that particular transaction at any point the future. Deciding not to meet those requirements therefore limits syndication and distribution opportunities for a transaction; and
- US rules – where 10% or more of the initial investors in a securitisation transaction are “US persons” as defined in the US risk retention rules, the foreign transaction safe harbour exemption to the US risk retention rules will not be available. Where the originator in the transaction does not intend to comply with the rules, steps therefore need to be taken to exclude, or limit, the participation of US investors in that transaction. In contrast, however, to the EU rules, the US rules only apply at the point of issuance so a US investor who takes exposure to the transaction in the secondary market would not normally, of itself, trigger a requirement to comply with the rules.

Asia-Pacific regulators take differing approaches to risk retention:

- China – under CAS rules, which apply to domestic banks, the originating bank must retain a 5% vertical or junior horizontal interest. There is no risk retention requirement on Chinese corporates undertaking a securitisation under the ABSP;
- Australia – the Australian Prudential Regulation Authority announced in November 2015 that it would not be adopting a risk retention requirement and the new prudential securitisation requirements it has now released, which come into force in January 2018, reflect that position;
- Hong Kong – paragraph 4.2 of CR-G-12 in the HK Monetary Authority's Supervisory Policy Manual, which was released in June 2016, prohibits Hong Kong authorised institutions from investing in securitisation transactions to which foreign risk retention rules are

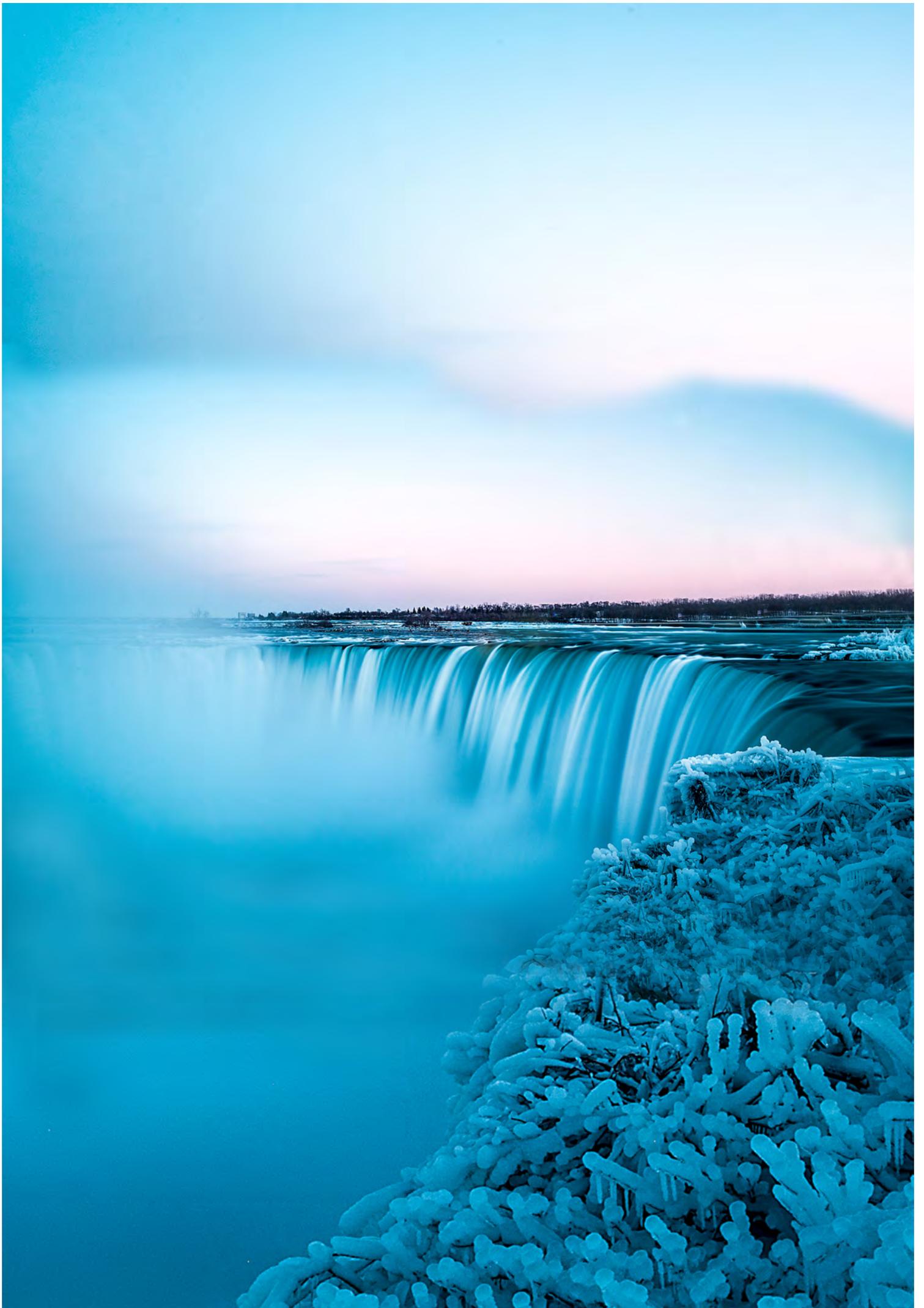
applicable unless the originator of the transaction complies with those rules. No domestic risk retention rules have been introduced; and

- Singapore – the Monetary Authority of Singapore's consultation paper P001-2017 outlined MAS's intention to introduce a risk retention rule requiring the originator of credit claims or receivables to retain a material net economic interest in a securitisation and demonstrate a financial incentive in the performance of the assets in the securitisation.

The future of the structured debt and securitisation markets in Asia-Pacific

Market participants and regulators in Asia-Pacific are becoming more familiar with securitisation and structured debt transactions and the way they can be and are being used to benefit the region and the banks and corporates doing business there. As the market continues

to develop, transparency will be important and regulators will be keeping a close eye on how transactions are being structured and the risks to which they may be exposing their participants and the broader economies. And there will be growing activity in the years to come. Persistently growing trade, bank deleveraging, increasing domestic consumption and demand for consumer credit, investor diversification, a desire to deepen to the capital markets and the emergence of non-bank providers of credit – these are only some of the factors which will have an impact, in one form or another, on the dynamic mix of economies in Asia-Pacific and all of which can and do take advantage of securitisation and structured debt transactions to help finance business, provide credit to consumers, diversify risk, create investment opportunities and open markets. As flexible and functional transactions, structured debt and securitisation techniques are well suited to the Asia-Pacific region.



CONTACTS

London



Stephen Curtis
Partner

T: +44 20 7006 2281
M: +44 77 1754 2517
E: steve.curtis@cliffordchance.com



Andrew Forryan
Partner

T: +44 20 7006 1419
M: +44 77 8570 0124
E: andrew.forryan@cliffordchance.com



Kevin Ingram
Partner

T: +44 20 7006 2416
M: +44 77 8529 6111
E: kevin.ingram@cliffordchance.com



Simeon Radcliff
Partner

T: +44 20 7006 2786
M: +44 77 9850 3537
E: simeon.radcliff@cliffordchance.com



Christopher Walsh
Partner

T: +44 20 7006 2811
M: +44 77 7591 1240
E: christopher.walsh@cliffordchance.com



Maggie Zhao
Partner

T: +44 20 7006 2939
M: +44 79 3122 9292
E: maggie.zhao@cliffordchance.com

London



David Bickerton
Regional Managing Partner
T: +44 20 7006 2317
M: +44 79 1726 5755
E: david.bickerton@cliffordchance.com



Clare Burgess
Partner
T: +44 20 7006 1727
M: +44 79 0490 7575
E: clare.burgess@cliffordchance.com



Timothy Cleary
Partner
T: +44 20 7006 1449
M: +44 79 8495 6439
E: timothy.cleary@cliffordchance.com



Chris Davies
Global Practice Area Leader for TPE
T: +44 20 7006 8942
M: +44 77 1754 2645
E: chris.davies@cliffordchance.com



Anne Drakeford
Partner
T: +44 20 7006 8568
M: +44 79 4905 5459
E: anne.drakeford@cliffordchance.com



William Glaister
Partner
T: +44 20 7006 4775
M: +44 78 8158 8898
E: william.glaister@cliffordchance.com



Bruce Kahl
Partner
T: +44 20 7006 2419
M: +44 79 0016 7071
E: bruce.kahl@cliffordchance.com



Louise Keary
Partner
T: +44 20 7006 1249
M: +44 77 1769 3934
E: louise.keary@cliffordchance.com



Jessica Littlewood
Partner
T: +44 20 7006 2692
M: +44 79 1988 0907
E: jessica.littlewood@cliffordchance.com



Owen Lysak
Partner
T: +44 20 7006 2904
M: +44 79 6239 6519
E: owen.lysak@cliffordchance.com



Emma Matebalavu
Partner
T: +44 20 7006 4828
M: +44 79 0016 7181
E: emma.matebalavu@cliffordchance.com



Dan Neidle
Partner
T: +44 20 7006 8811
M: +44 79 8459 6314
E: dan.neidle@cliffordchance.com

Global



Lee Askenazi
Partner, New York
T: +1 212 878 8230
M: +1 646 894 7345
E: lee.askenazi@cliffordchance.com



Daniel Badea
Managing Partner,
Bucharest
T: +40 216666 101
M: +40 722205 607
E: daniel.badea@cliffordchance.com



Hyun Suk Kim
Partner, Seoul
T: +82 2 6353 8118
M: +82 1 0279 59841
E: hyun.kim@cliffordchance.com



Jeff Berman
Partner, New York
T: +1 212 878 3460
M: +1 914 960 2996
E: jeffrey.berman@cliffordchance.com



José Manuel Cuenca
Partner, Madrid
T: +34 91590 7535
M: +34 65977 9911
E: josemanuel.cuenca@cliffordchance.com



Lounia Czupper
Partner, Brussels
T: +32 2533 5987
M: +32 4962 39987
E: lounia.czupper@cliffordchance.com



Fergus Evans
Office Managing Partner,
Bangkok
T: +66 2401 8810
M: +66 8183 45101
E: fergus.evans@cliffordchance.com



David Felsenthal
Partner, New York
T: +1 212 878 3452
M: +1 646 329 2676
E: david.felsenthal@cliffordchance.com



Eduardo García
Partner, Madrid
T: +34 91590 9411
M: +34 64914 8805
E: eduardo.garcia@cliffordchance.com



Frank Graaf
Partner, Amsterdam
T: +31 20711 9150
M: +31 62123 8601
E: frank.graaf@cliffordchance.com



Arthur Iliev
Partner, Moscow
T: +7 495258 5021
M: +7 985763 2492
E: arthur.iliev@cliffordchance.com



Steve Jacoby
Partner, Luxembourg
T: +352 485050 219
M: +352 621303 470
E: steve.jacoby@cliffordchance.com



Caroline Jury
Partner, Sydney
T: +61 289 228 035
M: +61 401 456 738
E: caroline.jury@cliffordchance.com



Steven Kolyer
Partner, New York
T: +1 212 878 8473
M: +1 631 948 4800
E: steven.kolyer@cliffordchance.com



Oliver Kronat
Partner, Frankfurt
T: +49 697199 4575
M: +49 160530 9086
E: oliver.kronat@cliffordchance.com



Frédéric Lacroix
Partner, Paris
T: +33 14405 5241
M: +33 68814 4673
E: frederick.lacroix@cliffordchance.com

Global



Leng-Fong Lai
Partner, Tokyo
T: +81 35561 6625
M: +81 80138 59804
E: leng-fong.lai@cliffordchance.com



Paul Landless
Partner, Singapore
T: +65 6410 2235
M: +65 91268871
E: paul.landless@cliffordchance.com



Jonathan Lewis
Partner, Paris
T: +33 14405 5281
M: +33 68775 2499
E: jonathan.lewis@cliffordchance.com



Maggie Lo
Partner, Hong Kong
T: +86 106535 2212
M: +86 139108 51406
E: maggie.lo@cliffordchance.com



Marc Mehlen
Partner, Luxembourg
T: +352 485050 305
M: +352 621150 708
E: marc.mehlen@cliffordchance.com



Gareth Old
Partner, New York
T: +1 212 878 8539
M: +1 646 436 9277
E: gareth.old@cliffordchance.com



Tanja Svetina
Partner, Milan
T: +39 028063 4375
M: +39 347809 0025
E: tanja.svetina@cliffordchance.com



Stuart Ure
Partner, Dubai
T: +971 45032 659
M: +971 50554 6704
E: stuart.ure@cliffordchance.com



Robert Villani
Partner, New York
T: +1 212 878 8214
M: +1 646 385 6163
E: robert.villani@cliffordchance.com



Pieter van Welzen
Partner, Amsterdam
T: +31 20711 9154
M: +31 65028 5809
E: pieter.vanwelzen@cliffordchance.com



Mete Yegin
Partner, Istanbul
T: +90 212 339 0012
M: +90 530 412 3500
E: mete.yegin@cliffordchance.com



Tiecheng Yang
Partner, Beijing
T: +86 106535 2265
M: +86 139108 95267
E: tiecheng.yang@cliffordchance.com



Daniel Zerbib
Partner, Paris
T: +33 14405 5352
M: +33 61028 3459
E: daniel.zerbib@cliffordchance.com

Other contributors



Simi Arora-Lalani
Senior Associate, London
T: +44 20 7006 8282
M: +44 79 4974 7863
E: simi.arora-lalani@cliffordchance.com



Andrew E. Bryan
Senior PSL, London
T: +44 20 7006 2829
M: +44 79 5012 1431
E: andrew.bryan@cliffordchance.com



Adam Craig
Senior Associate, London
T: +44 20 7006 8862
M: +44 75 3541 4134
E: adam.craig@cliffordchance.com



Katherine Hensby
Senior Associate, London
T: +44 20 7006 8118
M: +44 78 1711 0397
E: katherine.hensby@cliffordchance.com



Rebecca Hoskins
Professional Support
Lawyer, New York
T: +1 212 878 3118
M: +1 917 861 1507
E: rebecca.hoskins@cliffordchance.com



Megha Kalbag
Associate, New York
T: +1 212 878 8516
E: megha.kalbag@cliffordchance.com



Julia Machin
Managing Senior PSL,
London
T: +44 20 7006 2370
M: +44 79 4925 0928
E: julia.machin@cliffordchance.com



James Pedley
Senior Associate, London
T: +44 20 7006 4921
M: +44 79 3174 1904
E: james.pedley@cliffordchance.com



Thomas Picton
Senior Associate, London
T: +44 20 7006 4991
M: +44 79 5135 5881
E: thomas.picton@cliffordchance.com



Allein Sabel
Associate, New York
T: +1 212 878 3371
E: allein.sabel@cliffordchance.com

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Simi Arora-Lalani

Lee Askenazi

Jeff Berman

Andrew E. Bryan

Timothy Cleary

Adam Craig

Katherine Hensby

Rebecca Hoskins

Kevin Ingram

Megha Kalbag

Owen Lysak

Julia Machin

Gareth Old

James Pedley

Thomas Picton

Allein Sabel

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C H A N C E

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London, E14 5JJ

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