CAPITAL MARKETS | UNITED KINGDOM | 24 APRIL 2017

EUROPEAN CLOs AND BREXIT - WHAT IS IN STORE?

One of the main concerns for market participants in the European Collateralised Loan Obligation ("CLO") market of late has been the scope of the impact of Brexit on existing methods of risk retention currently employed in CLO transactions. In particular, there is a concern that the route of "sponsor" risk retention may no longer be available in the case of deals with UK asset managers, with the result that the investors concerned find that, following Brexit, they are no longer compliant with EU risk retention regulations.

Another concern relates to the extent to which Dutch special purpose vehicles can continue to be used where MiFID passporting is no longer available to UK asset managers.

We set out below our observations on some of the related issues that have begun to be discussed, and our view on the road ahead. Ultimately, we think that there are a number of solutions that may be available to mitigate the risk of future non-compliance, although the view from the market is that participants should wait until there is more clarity as to the future regulatory treatment. For example, whether existing risk retention compliance structures will continue to remain viable via an EU sanctioned grandfathering arrangement.

RISK RETENTION

The problem and consequences of non-compliance/breach

Under the risk retention requirements of the Capital Requirements Regulation (the "CRR"), an "originator, sponsor or original lender" of a securitisation must retain at least a 5% net economic interest in that securitisation. A "sponsor" must be an EU regulated bank or an "investment firm" as defined in the CRR, by reference to certain investment firms authorised under the Markets in Financial Instruments Directive ("MiFID"). In the event that the UK, as a consequence of leaving the EU, is no longer within the scope of MiFID and a passporting regime or third country recognition of the UK is not in place, then a UK asset manager may not be able to continue to act as a retention holder to the extent it was required to hold the retention notes solely as "sponsor" in accordance with the EU retention requirements.

The consequences of a breach are set out in Article 407 of the CRR, which provides that sanctions are imposed on investors who become exposed to a non-compliant securitisation by their "negligence or omission". It is worth making the observation that, assuming an investor has carried out the appropriate due diligence as to risk retention compliance at the outset of its investment in a CLO transaction, there would be extremely limited grounds to allege negligence or omission on its part where subsequent non-compliance were to be attributable solely to intervening circumstances over which an investor has no control, for example, the occurrence of Brexit. That said, the market is looking at structural solutions to compliance, as we indicate below.

Specific solutions

Restructure as "originator" risk retention

Under this proposal, the existing transaction documentation is amended so that the UK asset manager acts as an "originator", for the purposes of the CRR. Currently, the use of originator risk retention is not dependent on EU licensing under the MiFID. In order to qualify as an originator retention holder, the UK asset manager would be obliged to originate a small amount of the assets for each of the CLOs it is managing. This would require provisions requiring the UK asset manager to hold originated assets for a minimum "seasoning period" of at least 21 business days[1] prior to transfer to the CLO. The feasibility of such an option is dependent on whether changes to the mode of risk retention holding are permitted under the underlying EU legislation and how quickly and efficiently they can be implemented under documentation suites for existing CLOs.

Do the regulations permit a change in retention method?

The risk retention rules—per the regulatory technical standards relating to risk retention (the "2014 RTS")[2]—require that "the same retention option and methodology shall be used to calculate the net economic interest during the life of a securitisation transaction, unless exceptional circumstances require a change and that change is not used as a means to reduce the amount of the retained interest"[3]. We do not share the view of some market participants to the effect that exceptional circumstances can only conclusively be proved to exist at the time of Brexit itself. For us, it is likely that the national regulators and the EU authorities[4] will be sympathetic to the view that a UK collateral manager ceasing to qualify as a sponsor is a likely consequence of Brexit that can be reasonably anticipated, and will indeed constitute "exceptional circumstances", justifying a switch from sponsor to originator retention.

Furthermore, in support of a positive position by national regulators and EU authorities is the fact that firstly, the switch from sponsor to originator retention does not involve any change to the entity holding the retention and secondly, such a switch arguably results in an even more close alignment of interest between investors and a UK asset manager as the entity making the key decisions for the CLO. In any event, a wholesale-market-endorsed switch from sponsor to originator risk retention would need to be undertaken in parallel with a close and careful dialogue with the regulatory authorities, which would likely include the European Banking Authority (the "EBA") at a minimum. The fact that an effective solution is in the interests of all market participants will likely drive the solution forward.

Can existing CLO documentation be amended easily?

CLO transactions that were structured (or restructured) following the UK's decision to exit the EU have generally incorporated wording to the effect that it is the sole discretion of UK asset managers to take any action as they may deem necessary or appropriate to comply with applicable EU retention requirements, without any obligation to consult bondholders before the consequent contractual modifications are made. By contrast, it may be more challenging in the context of pre-June 2016 transactions—which do not anticipate the effects of Brexit—to make

---

[1] Some market participants propose 15 days

[2] Commission Delegated Regulation (EU) No 625/2014

[3] Article 10(d), 2014 RTS

[4] Such as the European Banking Authority and/or the European Commission

the necessary modifications to enact originator risk retention without recourse to bondholder consent. While we note that many pre-June 2016 transactions allow issuers to effect modifications to ensure continued compliance with the CRR, it remains to be seen whether trustees will be comfortable permitting material modifications to be made without bondholder consent where specific remedial action following the occurrence of Brexit has not been expressly reserved in the underlying documentation.

Complications with "originator" compliance under proposed STS Regulation

Under the European Commission's proposed "STS Regulation" (intended to harmonise rules on risk retention, transparency and due diligence applying to securitisations and to create a European legal framework to encourage "simple, transparent and standardised" securitisations), there may be further restrictions imposed on entities that can act as the "originator, sponsor or original lender", one proposal being that an originator in a securitisation must be a regulated entity. The result is that an originator retention holder may, in any event, need to be a specified type of EU regulated entity (such as a MiFID investment firm), thereby excluding the originator route as a potential solution to risk retention compliance post-Brexit. Note however that the STS Regulation is some distance from being in a final form having encountered opposition and requests for significant amendments from the European Parliament in late 2016. Further modifications of the existing proposals can be expected during the course of 2017.

Transfers to other EU located asset managers

A UK asset manager may be able to move operations to another EU located sponsor entity in order to ensure compliance with the sponsor retention model. It would be necessary to determine on a case by case basis whether the relevant CLO transaction documents allow for the asset manager to sub-delegate collateral management services, as such flexibility is often provided for in the relevant documentation; alternatively, it may be possible to insert provisions into the relevant transaction documentation allowing such a transfer to take place.

Political and legislative context

The UK's proposed Great Repeal Act (when passed) will mean that both directives implemented by UK legislation and directly applicable EU regulations will continue to be in force as UK legislation. However, merely having the legislation in force as UK domestic legislation is of course not sufficient to take part in the European regulatory regime.

Equivalence

MiFID II and MiFIR[5] come into force from 3 January 2018. Since the UK Brexit referendum, much attention has turned to the third country provisions in the MiFID II and MiFIR as a potential saving provision for existing passporting rights. Article 46(1) of the MiFIR gives third country firms (which may include UK firms post-Brexit) the right to provide investment services to eligible counterparties and per se professional clients without the need to establish a branch or subsidiary in the EU and without being subject to supervision by an EU competent authority. Under equivalence, this may mean that, for example, compliance by a UK asset manager with a sponsor risk retention route enforceable in the UK in accordance with UK provisions "equivalent" to the CRR and meeting the MiFID tests for a "sponsor" will mean that

[5] The Directive on Markets in Financial Instruments repealing Directive 2004/39/EC and the Regulation on Markets in Financial Instruments

the EU risk retention obligations will be deemed to have been met by a UK asset manager seeking to rely on the sponsor risk retention route. However, one of the conditions of equivalence is the existence of a positive equivalence determination from the European Securities and Markets Authority ("ESMA") that the legal and supervisory arrangement of the third country have equivalent effect to the prudential and business conduct requirements under the MiFID II. While there would seem to be no clear reason why a positive equivalence determination should not be achieved in the case of the UK (given the transposal of MiFID rules into UK law via the operation of the Great Repeal Act), the granting of an equivalence determination may be subject to political scrutiny and bargaining in the context of the forthcoming exit negotiations between the UK and the EU. Hence it is not at all useful to assume that equivalence will be available immediately (or indeed available at all) as a route which might enable compliance with EU risk retention. An equivalence determination could also be unilaterally withdrawn by ESMA and it remains to be seen whether market participants will be willing to place trust in the concept of equivalence under such circumstances.

Grandfathering

It is likely that UK collateral managers who, prior to Brexit, were "investment firms" under the MiFID will be subject to a wider grandfathering arrangement, such that risk retention compliant transactions established prior to Brexit in March 2019 (or, as applicable, any later agreed date) would not be deemed to be non-compliant simply by virtue of Brexit having taken place. ESMA and/or the European Banking Authority ("EBA") has endorsed limited grandfathering before in the context of the introduction of the updated risk retention regime under the CRR, notably for securitisations issued prior to 1 January 2011 and which added or substituted new underlying exposures after 31 December 2014 in accordance with certain specified pre-existing contractual conditions. We think it is likely that post-Brexit grandfathering will be granted for entities invested in CLOs that complied with the pre-Brexit risk retention. It remains to be seen whether such grandfathering will be available to new investors acquiring a position in an existing transaction complying with pre-Brexit risk retention, following Brexit.

LOCATION OF CLO SPECIAL PURPOSE VEHICLES

Dutch or Irish SPV?

For a majority of CLO structures, a UK asset manager is required to maintain authorisations relating to the provision of its collateral management services to the CLO SPV. For CLOs using SPVs incorporated in The Netherlands, UK asset managers have been able to passport their FCA authorisation as an “investment firm” under the MiFID into The Netherlands, where the regulator views collateral management services as being provided in The Netherlands and therefore licensable there. Post-Brexit, MiFID passporting will not be available to such UK asset managers.

The Dutch regulator has developed an effective “third country” equivalence regime which permits asset managers authorised in third countries such as the US to provide collateral management services to Dutch SPVs. As such, there is hope that The Netherlands will, for the purposes of domestic licensing, continue to recognise authorisations granted to UK asset managers by the FCA post Brexit. Failing this, there has been talk of wholesale migration of Dutch incorporated SPVs into Ireland, on the basis that the Irish regulator, in evident contrast to the Dutch regulator, views collateral management activities as being carried out from the location of the manager, i.e. for a UK asset manager, from the UK. Any such jurisdictional “switch” would have tax implications, which we outline in “*Change of location of CLO*”, below.

SOME RELATED TAX CONSIDERATIONS

No change in location of CLOs

To the extent that, post-Brexit, either the transaction parties remain the same, or the only change is a transfer by the UK asset manager of its operations to another EU-located sponsor entity, the main tax consideration is likely to be VAT.

Assuming the UK asset manager continues to act, then post-Brexit it will be doing so for VAT purposes from outside the EU. Consequently, the CLO will be treated as receiving services from outside the EU, and any collateral manager will be treated as providing services to a non-EU Member State.

In practice, however, the VAT analysis ought to remain largely the same, namely we would not expect the local VAT analysis for any collateral manager to be materially different than at present, nor should the Dutch VAT analysis change materially in respect of the services provided by the UK asset manager to the CLO.

The continued non-applicability of UK VAT would depend on the UK government not making any relevant amendments to the UK VAT system once no longer required to adhere to EU rules. Where the UK asset manager transfers its operations to another EU Member State, then the VAT analysis should remain broadly the same as applies today.

Change in location of CLO

The tax implications of any change in jurisdiction of the CLO to a more favourable post-Brexit location would need to be considered carefully, the key aim being to replicate the tax treatment currently applicable in The Netherlands so far as possible.

Ireland offers certainty of corporate income tax treatment, and VAT treatment, for CLO vehicles and therefore tax, should not be a barrier to the establishment of an Irish CLO; although it is worth noting that the withholding tax position in The Netherlands (regarding WHT on payments of interest of notes issued by the CLO) is marginally more straightforward than in Ireland since the Dutch domestic exemption is somewhat broader, which may be of assistance in situations where notes are not listed, for example in the case of warehouse arrangements.

More generally, to the extent it became advantageous to move an existing CLO to Ireland, it would need to be confirmed that this could take place on a tax-neutral basis, including so far as any transfer taxes in respect of the underlying assets are concerned. The withholding tax position on the underlying loans would also need to be confirmed, i.e. whether interest on the debt could be paid to the restructured CLO free of WHT to the same extent as under current arrangements.

MARKET APPROACH AND CONCLUSION

The market is adopting a "wait and see" approach. We would suggest instead "watch closely and be ready to respond".

We expect that, in the case of Dutch SPVs and the recognition of FCA authorisations post-Brexit, the Dutch regulator will grant equivalence to such authorisations for the sake of managing compliance with local Dutch licensing of collateral management activities.

As to the effect of Brexit on existing risk retention structures, we expect further clarifications to be provided by national regulators and EU authorities as ESMA digests the implications of Brexit for market participants. Even in an unlikely scenario where grandfathering is not implemented post-Brexit, there remains considerable flexibility in most CLO deal documentation that will allow for a solution to risk retention that has the approval of the regulators, to be implemented relatively quickly prior to the occurrence of Brexit.

Check out our dedicated **Gide / Brexit** LinkedIn page to learn more about the consequences and legal implications of Brexit.

KEY CONTACTS

DIMITRIOS LOGIZIDIS
tel. +44 (0)20 7382 5563
logizidis@gide.com

WILLIAM OLIVER
tel. +44 (0)20 7382 5587
oliver@gide.com

DAVID KLASS
tel. +44 (0)20 7382 5754
klass@gide.com

You can also find this legal update on our website in the News & Insights section: **gide.com**

This newsletter is a free, periodical electronic publication edited by the law firm Gide Loyrette Nouel (the "Law Firm"), and published for Gide's clients and business associates. The newsletter is strictly limited to personal use by its addressees and is intended to provide non-exhaustive, general legal information. The newsletter is not intended to be and should not be construed as providing legal advice. The addressee is solely liable for any use of the information contained herein and the Law Firm shall not be held responsible for any damages, direct, indirect or otherwise, arising from the use of the information by the addressee. In accordance with the French Data Protection Act, you may request access to, rectification of, or deletion of your personal data processed by our Communications department (privacy@gide.com).