Clients&FriendsMemo

European Regulators Publish Joint Opinion on the Jurisdictional Scope of the EU Securitisation Regulation

29 March 2021

Background

On 26 March 2021, the European Supervisory Authorities (the "**ESAs**")[1] published a Joint Opinion (the "**Opinion**") on the jurisdictional scope of the obligations of the non-EU parties to securitisations under the Regulation (EU) 2017/2402 (the "**EU Securitisation Regulation**"). References in this memo to articles refer to articles of the EU Securitisation Regulation.

Since the EU Securitisation Regulation was finalised in 2017, market participants have observed that the jurisdictional scope of the obligations under it was unclear. The ESAs are not directly empowered to change EU legislation or offer interpretative guidance on the meaning of the framework text in the EU Securitisation Regulation. Nevertheless, the Opinion sets out the ESA's views on the practical difficulties faced by market participants in connection with the jurisdictional scope of application of various Securitisation Regulation provisions in transactions where there is an element of EU involvement and an element of third country (i.e., non-EU) involvement, including the following four scenarios:

- securitisations where some, but not all, of their sell-side parties i.e. originator, original lender, sponsor and securitisation special purpose entity ("**SSPE**") are located in a third country;
- securitisations where all sell-side parties are located in a third country and EU investors invest in them;
- investments in securitisations by subsidiaries of EU regulated groups, where those subsidiaries are located in a third country; and
- securitisations where one of the parties is a third country investment fund manager.

The key recommendation of the ESAs is that the European Commission ("the **Commission**") should issue interpretative guidance in the areas where legislative change is not required, while in relation to other matters that cannot be dealt with through interpretation of the EU

[1] The ESAs are the European Securities and Markets Authority, the European Banking Authority and the European Insurance and Occupational Pensions Authority.

Securitisation Regulation in its current form, the Opinion includes proposals to amend the EU Securitisation Regulation as part of its scheduled review process.

It is important to note that the Opinion consists of recommendations to the Commission at this time; the views expressed in the Opinion are **not** binding on market participants and do not have immediate effects. These interpretative views are, however, a very good indication of the direction of travel at the EU level, even where some of these recommendations would not result in a more practical or commercial approach for securitisations involving third country participants.

At the same time as the publication of the Opinion, the European Banking Authority (the "**EBA**"), on behalf of the ESAs, published Q&As on cross-sectoral aspects of the EU Securitisation Regulation, clarifying a number of issues in relation to the EU Securitisation Regulation's transparency regime and the criteria for securitisations categorised as Simple, Transparent and Standardised ("**STS**").

The Opinion

Application of Articles 6, 7 and 9 of the EU Securitisation Regulation to Sell-Side Parties

The Opinion confirms the view held in the market that where a securitisation features all its sell-side parties in a third country, the risk retention (Article 6), transparency (Article 7) and credit-granting requirements (Article 9) do not apply *directly* to that securitisation but indirectly through the investor verification laid out in Article 5 (subject to the clarifications described below). In a scenario where there is a mix of sell-side parties, some EU and some located in a third country, the ESAs suggest that the sell-side party (or parties) located in the EU have a direct obligation to comply with the rules. The ESAs' views are as follows:

Article 6 – Risk Retention

Where one or more of the securitisation's originator, original lender or sponsor are located in a third country, the party or parties among them located in the EU should be the sole responsible party for retaining the net economic interest in the transaction.

Article 7 - Transparency

Unlike the risk retention requirement, the transparency requirements are stated to apply jointly among the securitisation's originator, sponsor and SSPE, which must designate one among them to make the required disclosures. Where some of the transaction participants are located in a third country, the party designated to be responsible must be located in the EU. The securitisation transaction documentation should also require the third country party or parties to provide the necessary information and documents to the designated EU party to enable it to comply with the transparency requirements.

Article 9 – Credit-Granting

Where one or more of the securitisation's sponsor, originator or original lender is located in a third country, the party or parties located in the EU should be responsible for ensuring that the exposures to be securitised are subject to the credit-granting criteria and the same processes for approving and renewing credits as non-securitised exposures.

Article 9 imposes obligations on originators, sponsors and original lenders to comply with credit-granting criteria. Article 5(1)(b) imposes an obligation on EU institutional investors to verify that originators or original lenders established in third countries comply with such credit-granting criteria., but does not refer to verification that sponsors comply with such criteria. The ESAs suggest that the Article 5(1)(b) be amended to include a reference to a sponsor's compliance with such criteria.

Application of the Article 5 Due Diligence Obligations to Buy-Side Parties

The Opinion considers two scenarios where the text of the EU Securitisation Regulation means that its application is unclear:

- EU institutional investors that invest in securitisations with a third country nexus ("**third country securitisations**"); and
- third country subsidiaries of EU credit institutions and investment firms ("EU CRR firms") investing in a securitisation with no EU nexus, where Article 14 of Regulation 575/2013 (the "CRR"), as amended by Regulation 2019/876, requires the EU CRR firm to ensure compliance with the Article 5 due diligence requirements.

Due Diligence on Third Country Securitisations

The ESAs observe that while it is clear that EU institutional investors are under an obligation to verify that a securitisation based in a third country has complied with the risk retention and credit-granting requirements, it is less clear whether the investor due diligence requirements can be satisfied in relation to transparency requirements where the prescribed disclosure templates in Regulation (EU) 2020/1224 and Regulation EU 2020/1225 (together, the "**Reporting Templates RTS**")[2] have not been used. The ESAs express the view that this means that it is "*very unlikely, or at least very challenging*", for EU institutional investors to be able to comply with the EU Securitisation Regulation when investing in a third country securitisation in that scenario.

As a solution to this lack of flexibility inherent in Article 5, the ESAs call upon the Commission to assess whether an "equivalence regime" for third country securitisations should be put in place. In order for the third country's laws relating to securitisation disclosures to be deemed "equivalent", the ESAs consider that those laws should impose on the securitisation's sell-side parties an obligation to disclose to institutional investors:

- "the same or substantially similar information" as Article 7;
- with "sufficient" frequency even if frequency is not identical to Article 7; and
- information that should be provided in the form of templates of similar quality and granularity to prescribed by the Reporting Templates RTS.

Following an assessment of a third country's securitisation regime for these purposes by ESMA, the Commission would then declare such a regime to be equivalent, meaning that the

[2] For more information on the Reporting Templates RTS, please see our Clients & Friends memorandum "EU Securitisation Regulation Disclosure Templates Published in the EU Official Journal" published on 3 September 2020.

due diligence obligations in Article 5 relating to transparency would be met where the investor could verify the information described above had been provided. From a practical perspective this will be very challenging as many jurisdictions including, for example the Unites States, do not have a regulatory regime similar to Article 7.

Application of the Due Diligence Requirements to Third Country Subsidiaries of EU CRR Firms

The ESAs consider that the extent of the obligation on the EU CRR firm to ensure compliance by its third country subsidiaries with Article 5 and the consequences of a breach of that obligation are not precisely defined and that there is uncertainty as to whether it is necessary that the third country subsidiary comply with Article 5 to the same extent as if it were itself an EU established institutional investor. The ESAs note the much weaker link of such third country subsidiaries with the EU and the significant compliance burden on and competitive disadvantage for EU-headed groups with operations in third countries compared with local investors in securitisations.

To address this issue, the ESAs suggest amending the CRR so that in addition to an EU CRR firm ensuring full compliance with the due diligence requirements, an additional option of "ring-fencing" the relevant third country subsidiary should be permitted. Furthermore, if such ring fencing is unduly burdensome for the EU CRR firm parent, national regulators would be able to impose investment limits on the subsidiaries investments in third country securitisations. These powers to permit alternatives to full Article 5 compliance would rest with the consolidating supervisor of the EU CRR firm. This would be a welcome change for EU credit institutions with significant operations in third country jurisdictions such as the United Kingdom and the United States.

Application of the EU Securitisation Regulation to Investment Fund Managers

The ESAs highlight the potential inconsistencies between the provision of the EU Securitisation Regulation and the requirements of the Alternative Investment Fund Managers Directive[3] ("**AIFMD**") on Alternative Investment Fund Managers ("**AIFMs**") involved in securitisations. In particular, the interplay between the definition of an institutional investor in the Securitisation Regulation and the obligations on AIFMs to take "corrective action" in respect of non-compliant securitisations in Article 17 of the AIFMD is unclear, especially in respect of which national regulator should ensure compliance with the relevant due diligence obligations.

In the Opinion, the ESAs recommend a number of clarifications and changes including:

- the EU Securitisation Regulation and AIFMD should be amended to ensures that third country AIFMs comply with the due diligence obligations with respect to those AIFs that are marketed in the EU and to clarify whether such third country AIFMs should be regarded as "institutional investors";

- the EU Securitisation Regulation should amended to clarify the powers of EU national regulators to enforce the due diligence requirements in respect of third country AIFMs and to insert a reference to Article 42 of the AIFMD (the provision which sets out the minimum requirements for third country AIFMs marketing funds into the EU);

[3] Directive 2011/61/EU.

- the EU Securitisation Regulation should be amended to clarify whether "sub-threshold"[4] AIFMs fall within the definition of an "institutional investor" subject to the due diligence requirements (the ESAs express the view that they should be in scope);

- clarification around the ability of a fund manager to delegate the due diligence activity to another manager; and

- the definition of a "sponsor" in Article 2 should be amended to clarify that sponsors may only delegate day-to-day active portfolio management involved with a securitisation to a servicer which is an EU authorised investment firm, AIFM or UCITS management company (i.e. not third country AIFMs or sub-threshold AIFMs).

Conclusion

Many of the clarifications recommended in the Opinion will be welcome. However, market participants will likely not welcome the concept of equivalence assessments for third country securitisation transparency regimes, especially where the implication is that EU institutional investors will not be able to invest in securitisations in such third countries until such equivalence has been granted. This could have significant market impact where either:

i. no transparency regime exists; or
ii. if a jurisdiction does in fact have a transparency regime, it is not immediately regarded as equivalent.

The only third country of which we are aware that has a transparency regime for securitisations which is in any way equivalent to that under the EU Securitisation Regulation is the UK. With effect from 1 January 2021 CET, the EU Securitisation Regulation in its then form (which remains its current form) was incorporated into UK domestic law subject to certain, mostly technical, amendments (as so incorporated, the "**UK Securitisation Regulation**").

The UK Securitisation Regulation will not be affected by any interpretative guidance issued by the European Commission pursuant to the Opinion nor will it be affected by any future amendments to the EU Securitisation Regulation. However, as the UK is a third country for the purposes of the EU Securitisation Regulation, such interpretative guidance and amendments will of course be relevant to UK securitisations, particularly as many UK securitisations involve one or more sell-side parties that are in the EU and/or have as investors EU institutional investors. Despite the similarity of the UK and EU regimes, it is possible that an equivalence assessment for the UK transparency regime could be subject to delays or even a refusal by the Commission to grant equivalence in this area.

Market participants will wish to pay close attention to see whether the Commission issues any interpretative guidance as recommended in the Opinion. The formal review process for the EU Securitisation Regulation is expected to begin later this year and market participants will also wish to see how proposals made by the Commission for amendments to the Securitisation Regulation address the issues set out in the Opinion and reflect its recommendations.

[4] "Sub-threshold AIFMs" are smaller EU AIFMs below the thresholds set out Article 3(2) of the AIFMD and are largely exempted from the AIFMD requirements.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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