

# Clients & Friends Memo

## What does Brexit mean for the European CLO Market?

27 June 2016

### Introduction

In its referendum held on 23 June 2016, the UK voted to leave the European Union (“**Brexit**”). On the following day, David Cameron announced that he will resign as Prime Minister on the election of a new Conservative Party leader and that such leader should be elected prior to the Conservative Party annual conference which starts on 2 October 2016. David Cameron said that he will leave it to his successor formally to notify the European Council of the UK’s intention to withdraw from the European Union.

### Article 50 of the Lisbon Treaty

Under Article 50 of the Treaty on European Union (also known as the “**Lisbon Treaty**”), an EU Member State that intends to withdraw from the EU, such as the UK, is required to notify the European Council of its intention to do so. The EU will then negotiate and conclude an agreement with the UK, setting out the arrangements for its withdrawal. The Treaty on European Union and the Treaty on the Functioning of the European Union (the “**EU Treaties**”) will cease to apply to the UK once the withdrawal agreement has entered into force, or, failing that, two years after the UK’s notification, unless the European Council, in agreement with the UK, unanimously decides to extend this period.

It is worth noting that a legal change to the UK’s relationship with the EU will only be effective once the withdrawal is complete. EU law will remain in force in the UK until then. That period will likely last for at least two years, and possibly a good while longer. There is a question surrounding possible delay in the service of a formal notice under Article 50 of the Lisbon Treaty to allow for preliminary discussions.

Brexit will mean that the EU Treaties will no longer be binding on the UK and that, generally, EU law will cease to apply in the UK. However, many EU laws have been transposed into UK domestic law and these will continue to apply. There is a significant task ahead in unpicking the two legal systems which have become so closely intertwined over the last 43 years and it seems inevitable that this task will continue well into the future, even after the end of the formal relationship between the UK and the EU.

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In the immediate term, there have been falls in the value of, among other things, sterling and the FTSE indices, and market volatility is expected whilst the terms of Brexit are negotiated. For the European CLO market, of key concern will be how UK collateral managers will be regulated within Europe and how that impacts their ability to hold risk retention and manage an EU CLO.

In addition, the EU's proposed securitisation regulation<sup>1</sup> (the "**STS Regulation**") which is currently subject to a series of proposed amendments<sup>2</sup> means that the regulatory status of UK risk retention holders and investors could also fall into focus.

### **The Single Market Passporting Regime**

One of the main consequences for the UK financial services industry that will arise from Brexit will be the effect that it is likely to have on the EU's "passporting" regimes. Under the EU Single Market Directives, firms licensed in one EU jurisdiction can operate on a cross border basis in other Member States, or can establish branches in other Member States, without the need for a separate licence in those states.

This EU passporting regime is extended outside the EU to Norway, Iceland and Liechtenstein (together with the EU states, the European Economic Area ("**EEA**")), who are also part of the European single market. The UK may well seek to retain passporting privileges in the post-Brexit settlement. If, for example, the UK were to be permitted to remain part of the EEA, at least for a transitional period after Brexit, it may be able to continue to take advantage of the "passports". However, there are certain political obstacles to the UK seeking and obtaining EEA status, in main because of the likely requirement that the UK would have to accept the free movement of labour in order to be allowed to remain in the EEA.

While it is true that UK law and regulation will, at the moment of separation (to the extent it is not amended or repealed), be equivalent to EU rules and offer equivalent protections, it will be a matter of negotiation in the process of withdrawing from and defining a new relationship with the EU, as to whether there would be any formal recognition of equivalence.

Therefore, unless the UK can negotiate special provisions with the EU/EEA as regards the continuation of passporting rights, UK financial services firms may, on the UK's withdrawal from the EU, lose the right to passport into EU/EEA states.

### **The Consequences for the European CLO Market**

If the UK were no longer within the scope of the EU Single Market Directives, notably the Markets in Financial Instruments Directive ("**MiFID**"), then it could potentially impact the ability of UK entities to act as collateral managers, and as retention holders, in European CLOs. Other

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<sup>1</sup> Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

<sup>2</sup> Draft Report on the Proposed STS Regulation dated 6 June 2016, as discussed in our Clients and Friends Memorandum dated 10 June 2016.

transaction parties, if they are UK entities, including investors, may also be unable to be involved for similar reasons.

#### ***UK Collateral Managers and MiFID***

CLO SPVs in European securitisation structures are generally established in Ireland or the Netherlands, and frequently have a UK collateral manager authorised as an “investment firm” under MiFID.

There is a difference between Ireland and the Netherlands as regards SPV jurisdictions, in relation to the need for non-EU collateral managers to be authorised. In the case of the Netherlands, a collateral manager needs to be authorised in the Netherlands under MiFID (or passported under MiFID if established in another EEA state).

By contrast, if the collateral manager has no head or registered office or branch in Ireland, it would not generally need to be an authorised investment firm in order to provide CLO services in Ireland. In such circumstances, it is possible that a UK collateral manager could be used. Therefore, in the context of a UK withdrawal, an Irish issuer might be preferred over a Dutch issuer for European CLOs managed by UK collateral managers.

#### ***Holding Risk Retention as “Sponsor” and the Effects of the STS Regulation: Are there Solutions?***

The most significant EU risk retention requirements are contained in the Capital Requirements Regulation<sup>3</sup> (the “CRR”), which requires the “*originator, sponsor or the original lender*” of a securitisation to retain at least a 5% net economic interest in the securitisation. The STS Regulation will keep, and possibly expand, this requirement.

Under the CRR, a sponsor must be an EU regulated bank (i.e. credit institution) or an “investment firm” as defined in the CRR (other than an originator that establishes and manages an asset-backed commercial paper programme or other securitisation transaction or scheme that purchases exposures from third-party entities). The CRR definition of “investment firm”, in turn, refers to certain investment firms authorised under MiFID.

If, following Brexit, the UK is no longer within the scope of MiFID, then it would appear that a UK collateral manager would not be able to act as a “sponsor” for a European CLO, even if the collateral manager were subject to UK financial services regulation. It may, therefore, be necessary to structure such CLOs (including currently established European CLOs, given the on-going nature of the EU risk retention requirements) with a mechanism that permits the collateral manager to “switch” to an “originator” structure (which currently does not require an originator retention holder to be regulated in order to be an eligible retainer under the EU risk retention rules).

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<sup>3</sup> Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

In addition, there may be further restrictions imposed on the entities that can act as the “*originator, sponsor or original lender*” under proposed amendments to the STS Regulation. These provide that the originator, sponsor or original lender in a securitisation will need to be a “*regulated entity*”.<sup>4</sup> Although not explicitly stated, it appears that the intention is that the retention holder will need to be a specified type of EU regulated entity (such as a MiFID investment firm). If the STS Regulation is amended in such a way, this could effectively exclude non-EU entities, such as UK entities following Brexit, from acting as the retention holder (in the event a passporting regime is not agreed between the UK and the EU), and therefore could exclude UK collateral managers from the European CLO market.

Another proposal with potential impact under the amendments proposed to the STS Regulation, is that only “*institutional investors*” (which term refers to specific types of EU regulated entities) will be able to invest in securitisations under this EU regime. Again, if the amendments proposed to the STS Regulation do indeed end up including such restrictions and a passporting regime is not agreed between the UK and the EU, then UK investors may not be able to invest in EU securitisations following Brexit.

**However**, we would emphasise that the proposed amendments to the STS Regulation are still being developed in the EU legislative process. We would also note that the STS Regulation is not intended to be retrospective in its effect.

#### ***Are There any Interim Solutions?***

There are some potential features which clients may consider when structuring a new European CLO in order to mitigate the risk of a UK collateral manager being unable to act as a sponsor retention holder. One option is to structure the EU risk retention so that the UK collateral manager acts as an originator retention holder. This could be done upfront or as a back-up option, should UK collateral managers be no longer able to qualify as sponsor retention holders. This will require UK collateral managers to originate a small proportion of assets for each CLO in order to qualify as an originator retention holder. The key here is that there will be no change to the entity holding the retention, which is generally not permitted by the EU risk retention rules, but it will solely be a change to the capacity in which such UK collateral manager is eligible to retain.

For existing European CLOs, at least for now, there is no immediate need to amend any transactions in order for UK collateral managers to act as sponsor retention holders. The key will be to not only watch how Brexit negotiations proceed, but also how the proposed amendments to the STS Regulation play out. If it becomes clear that there will be a period

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<sup>4</sup> ‘Regulated entity’ is defined by reference to Directive 2002/87/EC. The definition in the original version of the Directive (to which the Proposed Amendment refers) means “a credit institution, an insurance undertaking or an investment firm” and so would appear to exclude entities which are not such EU regulated entities. However, in the amended Directive, “regulated entity” means “a credit institution, an insurance undertaking, a reinsurance undertaking, an investment firm, an asset management company or an alternative investment fund manager”, which terms in the amended Directive include entities whose registered office is outside the EU, but who would be required to be regulated if their registered office were in the EU.

during which UK collateral managers cannot act as sponsor retention holders (either due to Brexit or due to the STS Regulation), transaction parties can consider amending existing transactions to incorporate an originator option. In relation to the STS Regulation, if the EU adopts the proposed amendment that retention holders must be regulated in the EU, it will be key to make any such amendments prior to the applicability of these provisions of the STS Regulation. In many cases European CLO documentation already permits the amendment of transaction documents in order to comply with EU risk retention, though the detailed contractual provisions of each transaction will need to be considered. The Cadwalader team is available to discuss any of these options with clients.

### Conclusion

Brexit will have an impact on financial markets for some time, including the European CLO market. As discussed previously, the amendments proposed to the STS Regulation have the potential to curtail involvement in European CLOs by collateral managers, originators and investors from “third countries”. Brexit adds the risk that the UK is added to that list of “third countries” which is of concern given that the vast majority of these transactions involve a London based collateral manager. It is important to note that the STS Regulation is only at the beginning of the EU legislative process. Even prior to Brexit, industry groups and the law firms representing them (including Cadwalader) have been lobbying the European Parliament to remove the proposed requirement that eligible EU risk retention holders must be EU regulated entities and that only EU institutional investors can invest in EU securitisations. The lobbying effort becomes even more important as the UK begins any exit negotiations. As Brexit continues to unfold over the coming days, weeks and months, it is important to note that, at least for now, EU law still applies, and there are solutions available to CLO market participants to plan for, and address, issues as they present themselves.

Cadwalader will continue to monitor the developments of Brexit and the STS Regulation, and to lobby Members of the European Parliament and regulators through its work with industry groups, such as the Loan Market Association. We would encourage anyone interested in commenting to make their views known to the various industry bodies. Alternatively, please do reach out to one of the Cadwalader contacts below.

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