NOTES FROM THE EDITORS

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In this fall edition of our Structured Finance Bulletin, we discuss structuring and legal considerations for multi-jurisdiction trade receivables financing transactions as well as the latest innovations in CLO structures.

We also revisit the European Union securitization regulations and the application in the United Kingdom of the European Union securitization regulations following Brexit and describe the benefits of structuring lending arrangements as repurchase facilities.

Finally, we take a deep dive into the CFPB’s recent proposed debt collection rulemaking and discuss the Japanese risk retention rules and the SEC’s concept release regarding several exemptions from registration under the Securities Act of 1933.

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# Structured Finance Bulletin

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Trade receivables securitization is one of the primary means through which middle market and investment grade companies alike are able to obtain more efficient and cost-effective financing, manage their balance sheets and diversify their financing sources.\textsuperscript{1} As multinational companies continue to look to trade receivables securitization as an integral solution to their financing and balance sheet needs, this note draws upon these and other transactions to highlight some key distinctions between a typical trade receivables securitization in the United States and a trade receivables securitization involving foreign jurisdictions. Originators, lenders and purchasers of trade receivables will observe that cross-border trade receivables securitization adds complexity, and some comforts of home will not be available outside the United States.

Structure of a Typical Trade Receivables Securitization in the United States

A typical trade receivables securitization in the United States is structured as a two-step transaction: (1) an originator or originators (collectively, the “Originator”) of trade receivables (the “Receivables”) transfers the Receivables to a newly-formed, bankruptcy-remote, special-purpose entity (the “SPE”), which is a wholly-owned subsidiary of the Originator, and (2) the SPE obtains financing for the Receivables from one or more banks, asset-backed commercial paper conduits or other financial institutions (the “Financing Parties”), and such financing can take many forms. Many such transactions have been structured to achieve a sale for accounting purposes under US Generally Accepted Accounting Principles. The Originator
transfers the Receivables to the SPE in a legal true sale or true contribution to the capital of the SPE (in each case, determined primarily based on the intent of the parties and whether the economic consequences of the transaction (such as credit recourse) are consistent with the intent of the parties). Given the characteristically short-term nature of most trade receivables (usually 30-90 days), the Originator transfers the Receivables to the SPE on a daily basis immediately upon origination until all obligations owing by the SPE to the Financing Parties have been paid in full. The daily transfer of the Receivables by the Originator to the SPE helps to offset the risk to the Financing Parties of losing all of their collateral as the Receivables turn over quickly. While sales of Receivables take place daily, the settlement of the purchase price for those Receivables may be on a less frequent basis (such as monthly) for the administrative convenience of the Originator.

Although the Receivables are legally isolated from the Originator’s creditors following the true sale or true contribution of the Receivables by the Originator to the SPE, the Financing Parties nonetheless remain exposed to considerable credit risk of the Originator due to (i) the ability of the Originator to commingle collections on the Receivables with the Originator’s general funds, which are then segregated and used for settlement on a monthly basis; (ii) the Originator’s continued servicing of the Receivables and the management of its relationship with Obligors, including collection activities; and (iii) the presence of potentially significant dilution in the Receivables (such as a reduction or adjustment in the outstanding balance of a Receivable as a result of any defective, rejected, returned, repossessed or foreclosed goods or services, or any revision, cancellation, allowance, rebate, credit memo, discount or other adjustment made by the Originator), each of which are common features in a typical trade receivables securitization in the United States.

Certain provisions of the Uniform Commercial Code (the “UCC”) also inform important aspects of a typical trade receivables securitization in the United States.

SECURITY INTEREST AND UCC FILINGS

Section 1-201(b)(35) of the UCC defines the term security interest to expressly include the interests of a buyer of accounts in addition to the interests of a lender secured by accounts. Section 9-109(a)(3) of the UCC also expressly states that Article 9 of the UCC (Secured Transactions) applies to the sale of accounts. As such, regardless of whether the Financing Parties are lenders secured by the Receivables or purchasers of the Receivables, the Financing Parties need to file a UCC financing statement to perfect their security interest (which includes an ownership interest) in the Receivables. While some may view the need to file a UCC-1 as unnecessarily conservative for a legal true sale, it actually provides US Financing Parties with protection against Originator fraud and mistake risk that is not otherwise mitigated without such an objective notice filing system. Furthermore, in the United States, a receivables purchase and sale
agreement (a “Sale Agreement”) will typically contain a back-up grant of a security interest in the Receivables to mitigate the potential risk of the transfer of the Receivables not being treated as an absolute sale, transfer and assignment of the Receivables notwithstanding the express intent of the parties. This is important and beneficial for the Financing Parties because, without a perfected security interest under the UCC, the Financing Parties would be unsecured creditors in the event the sale of Receivables was not deemed a true sale. While the inclusion of a back-up grant of a security interest in the Receivables under a Sale Agreement may seem contrary to the express intent of the parties, it does not typically cause stress on the true sale analysis for securitization transactions in the United States because US case law regarding true sale tends to hinge on commercial substance over form. Also, as discussed above, under the UCC a sale of accounts is a security interest and the filing of UCC financing statements is required to perfect the Financing Parties interests in the Receivables.

ENFORCEMENT AGAINST OBLIGORS

Section 9-406(a) of the UCC generally provides that an account debtor (i.e., the obligor under a Receivable (the “Obligor”)) may discharge its obligation by paying the assignor (i.e., the Originator) until the Obligor receives notification that the amount due or to become due to the Originator has been assigned and that payment is to be made to the assignee (i.e., the Financing Parties). In the United States, the Financing Parties are typically prohibited under the securitization documents from notifying an Obligor, or requiring that an Obligor be notified, that a Receivable has been assigned until after the occurrence and during the continuance of an event of default, event of termination or similar trigger event under the securitization documents. As a general rule, absent a servicer replacement, the Financing Parties generally do not expect to ever enforce a Receivable directly against the related Obligor and the related Obligor is never notified that the Receivable has been assigned.

RESTRICTIONS ON ASSIGNMENT

Section 9-406(d) of the UCC generally renders ineffective and overrides any express contractual provision in the underlying contract giving rise to a Receivable that prohibits or restricts the assignment of the Receivable or requires the consent of the related Obligor to assign the Receivable. It is important to note that Section 9-406(d) of the UCC overrides such contractual prohibitions, restrictions and consent requirements in favor of the Obligor and it does not override any contractual prohibitions, restrictions or consent requirements in favor of any third parties. Furthermore, Section 9-406(d) of the UCC only overrides express contractual prohibitions, restrictions and consent requirements and does not override any provisions requiring notice of the assignment of a Receivable or any provision which may have the practical effect of restricting the assignment of a Receivable (e.g.,
confidentiality obligations). While the Originator and the Financing Parties can legally rely on the broad override provided by Section 9-406(d) of the UCC, the Originator should consider whether the assignment of a Receivable will have any negative effects on its business relationship with the related Obligor should the related Obligor become aware of the assignment.

With the clear provisions of the UCC and a robust history of case law, the United States is a favorable jurisdiction for trade receivables securitizations. A cross-border trade receivables securitization may or may not be implemented with the same ease and convenience, depending on the jurisdiction and market practice therein. With each jurisdiction added to a securitization, whether at the Originator or the Obligor level, the parties will have to contend with layers of complexity, and common assumptions with respect to structural components of a domestic trade receivables securitization may not prove feasible or practical. This article presents an overview of key considerations when structuring a cross-border trade receivables securitization, including specific insight from our partners in England, Germany, France and Mexico, and the primary challenges of a cross-border trade receivables securitization when compared with a domestic securitization. Partnering with experienced deal counsel and local counsel, the Originator and the Financing Parties can be flexible and creative to achieve their operational and financial goals. While not as simple or straightforward as a domestic trade receivables securitization, the opportunity and potential for growth for clients can often outweigh the time and cost of structuring a more complex cross-border trade receivables securitization.

Initial Structural Considerations

**CHOICE OF LAW**

Unlike a domestic trade receivables securitization, a cross-border trade receivables transaction requires an in-depth review of all relevant jurisdictions, including (i) the location of the SPE, (ii) the location of the Originator and the governing law of the Sale Agreement between the Originator and the SPE, (iii) the location of the Obligors and the governing law of the Receivables and (iv) the location of any bank accounts, particularly to the extent a security interest will be granted in favor of the Financing Parties or the SPE in those bank accounts. Each additional jurisdiction raises local law and choice-of-law questions, which need to be analyzed and considered in light of the objectives which the Originator and the Financing Parties wish to achieve in structuring the securitization. For example, key questions include what law will apply to determine whether:

- There has been a “true sale” of the Receivables between the Originator and the SPE;
- A Receivable is permitted to be assigned by the Originator to the SPE in the face of a contractual ban;
- Payment by the Obligor to the Originator (rather than the SPE) discharges the Obligor’s payment obligation;
The Financing Parties or the SPE can enforce and sue the Obligor directly for its failure to pay the applicable Receivable; or

- A third-party creditor or insolvency trustee may assert its interest in or rights over the Receivables.

Determining the answers to these questions, and the impact those answers have on the structure and implementation of a trade receivable securitization are critical for both protecting the Financing Parties’ rights in the Receivables and achieving the Originator’s balance sheet and liquidity management objectives. Once all applicable local laws are determined, further analysis should be performed in each such jurisdiction, with the assistance of local counsel, to ensure that all jurisdiction-specific legal formalities are satisfied for the particular legal questions noted above (among others).

**ROME I REGULATION**

In securitization transactions with the Originator or Obligors located in European Union ("EU") countries (other than Denmark), the Rome I Regulation ("Rome I") will be relevant. Rome I provides that the relationship between the assignor and the assignee (i.e., the Originator and the SPE) is governed by the law of the contract between them (i.e., the Sale Agreement) (Article 14(1)). For matters concerning the assignability of any Receivable, the relationship between the SPE and the Financing Parties, as assignee, and the Obligor, enforceability against the Obligor and whether the Obligor’s payment obligations have been discharged, it is necessary to look at the governing law of the Receivable (i.e., the law of the underlying contract under which the Receivable has been generated).

In addition, there is a draft regulation aimed at addressing the effectiveness of the transfer of Receivables as against third parties. This regulation is yet to be finalized but the effect of it could make this legal analysis more complicated, since, while EU parties are generally free to choose the law of a contract, such as a Sale Agreement, the new regulation could make it necessary to comply with the law where the Originator has its habitual residence in assessing whether a valid transfer has been achieved as against third parties (including a liquidator or other insolvency official).

In transactions with EU entities, it is also important to consider the requirements of the Securitisation Regulation and the related technical standards and guidance and, in the case of UK entities following Brexit, the equivalent requirements in the United Kingdom.

**SPE LOCATION**

In the case of securitizations that include European Originators, the SPE is typically located in a European jurisdiction, such as Ireland, Luxembourg or the Netherlands, although this is not always the case. The choice of jurisdiction for the SPE is often driven by the availability of preferential tax treatment, such as double taxation treaties and/or beneficial tax regimes, as well as other factors such as the relevant legal system, the cost of establishing and maintaining the SPE and the location of the parties and the
Receivables. For securitizations with European Originators, the SPE is usually an orphan company (meaning the SPE is owned by a third-party management company), in order to enhance its insolvency remoteness, which may be preferable in certain jurisdictions. Of course, use of an orphan SPE rather than an Originator wholly-owned subsidiary SPE means that overcollateralization cannot be achieved through capital contributions of Receivables. Similar to the United States, the SPE’s liabilities are typically limited by way of certain provisions in its organizational documents and/or under the securitization documents, such as restrictions on its activities to those required under or ancillary to the securitization, requirements to keep separate books, records and accounts and having no employees, as well as the inclusion of limited recourse and non-petition clauses by which the other parties agree to be bound. In some cases, such as in Luxembourg, the SPE may be deemed to be insolvency remote by virtue of compliance with a specific statutory securitization regime.

RESTRICTIONS ON ASSIGNMENT AND CONTRACT DILIGENCE

Unlike in the United States, most jurisdictions will enforce a restriction or ban on assignment to the extent included in the Receivable or its related contract. If there is such a restriction with respect to certain Receivables and the Originator desires to sell those Receivables to the SPE, in most cases the Obligor’s consent will be required. However, the Originator typically does not want to request that Obligors consent to the sale of the Originator’s Receivables for fear of disruption of the business relationship (or providing leverage to Obligors for other concessions). It is common for the Financing Parties or the Originator (in consultation with its counsel) to review and perform diligence with respect to the contracts relating to the Receivables prior to closing a cross-border trade receivable securitization. The purpose of such diligence is to determine the extent to which there are any restrictions on assignment in the underlying contracts and whether such restrictions relate to particular Obligors or to all Obligors. This diligence will determine whether certain Obligors should be removed from the securitization or whether alternative structures need to be implemented or steps need to be taken in order to assign or transfer the benefit of any restricted Receivables to the SPE.

Keep in mind that no two jurisdictions are exactly alike. Each jurisdiction’s legal system has its own nuances and complexities that need to be considered closely with local counsel and with deal counsel. It may not be practical to include some jurisdictions depending on the Originator’s commercial or operational requirements. For example, certain jurisdictions require (i) notice to Obligors of the assignment of their Receivables, (ii) the execution of daily assignment or transfer agreements, (iii) the deposit by the Obligor of all collections into a bank account owned by the SPE or (iv) the replacement of the servicer of the Receivables (the Originator) without cause (including prior to a servicer default), in each case, in order to
achieve a true sale. While these formalities fall on the cumbersome end of the “true sale spectrum,” if they are required under local law, the Originator may determine that it is not in its best interest to include that jurisdiction or those Receivables in the securitization.

Note, however, that these are not common requirements, and most jurisdictions are able to be included in cross-border trade receivable securitizations with some modifications. Jurisdictions frequently included in cross-border trade receivable securitizations include England, Germany, France and Mexico. This article addresses particular insights from Mayer Brown’s leading partners in those jurisdictions for cross-border trade receivables securitizations.

England

ASSIGNMENT AND TRUE SALE
For cross-border trade receivables securitizations with multiple jurisdictions, English law is often used as the governing law for Sale Agreements (including, in some cases, with respect to Receivables governed by a different governing law or sold by an Originator located in a different jurisdiction). Under English law, there is a distinction between a legal assignment and an equitable assignment. In order to be a legal assignment, the assignment must be in writing and signed by the assignor, absolute and unconditional (and not by way of charge only), of the whole of the debt and notified in writing to the debtor. Given that, in the majority of cases, the Obligors are not notified of the sale of the Receivables at the outset of the securitization, most English law sales of Receivables will be equitable assignments, which will be capable of becoming a legal assignment upon notice being given to the Obligor if the relevant trigger event occurs. Until notice is given to the Obligor, (a) the legal title will remain with the Originator, (b) the SPE or the Financing Parties may need to join the Originator in legal proceedings against the Obligor, (c) the Obligor can discharge its payment obligation by paying the Originator, (d) the Obligor can exercise set-off rights against the Originator and (e) a subsequent assignee who does not know of the prior sale and who gives notice to the Obligor may obtain priority over the SPE and the Financing Parties.

However, it is important to note that equitable assignments will still be capable of being a true sale under English law.

True sale under English law, based on an analysis of the relevant case law, is generally achievable. The case of Re George Inglefield Limited set out three essential differences between a transaction of sale and a transaction with a mortgage or charge. In summary, these are that (a) the seller is not entitled to get back the property that it has sold by repaying the debt, in contrast to a security grantor; (b) if the secured property is sold for more than the value of the debt then the security grantor is entitled to the surplus, in contrast to a sale where the purchaser is not required to account to the seller for any profit; and (c) if the secured property is sold for an amount which is less than the debt, then the security provider remains liable for the balance, in contrast to a sale where the seller is not liable for any loss.
However, in the case of Welsh Development Agency v Export Finance Co Limited, the use of these three criteria was implicitly rejected by the court as the sole test, which instead indicated that it is necessary to look at the provisions of the relevant document as a whole to decide whether it amounts to an agreement for the sale of the relevant assets or only a mortgage or charge. A similar approach, focusing on the terms of the documents rather than the economic effect of them, was taken in Orion Finance Ltd v Crown Financial Management Ltd.

In Agnew v Commissioner of Inland Revenue, a two-stage process was favored with respect to a question of legal characterization, relating to whether a security interest was “fixed” or “floating.” This approach required first looking at the intentions of the parties, in order to ascertain the nature of the rights and obligations which the parties intended to grant each other and then a second stage, where the transaction would be categorized as a matter of law. This approach was supported and adopted by the House of Lords in In Re Spectrum Plus Ltd, although both these cases relate to the distinction between fixed and floating charges, and it is not clear to what extent the two-stage categorization process should now be applied to the question of whether a purported sale transaction should be re-characterized as a secured loan.

Consequently, when considering true sale issues, we typically first look at the categorization of the transaction expressed by the parties, and then examine the rights and obligations set out in the Sale Agreement and consider their appropriate characterization to determine if the transaction is a sale or a secured loan.

It is worth noting that an English law governed Sale Agreement would not include a back-up security interest, unlike in the United States. In practice, if the transaction is appropriately structured, the risk of re-characterization as a secured loan under English law is relatively low and provisions such as repurchase obligations in the event of a breach of an asset warranty (such as with respect to the eligibility criteria), deferred purchase price obligations and clean-up calls should be acceptable, provided that care is taken not to include general repurchase provisions.

It is also important to consider whether there are any grounds under which the sale could be “clawed back” in the event of an insolvency of the Originator, for example, whether there is a transaction at an undervalue, a preference or a transaction defrauding creditors, depending on the local insolvency laws. Steps should be taken to confirm that the Originator is solvent, such as searches and a requirement that solvency certificates of the Originator be provided.

RESTRICTIONS ON ASSIGNMENT

Unlike the United States, England does not have a “legal override” provision equivalent to Section 9-406(d) of the UCC. However, in England it may be possible to use a trust mechanism as an alternative solution when dealing with prohibitions and restrictions on assignment, although the wording of the underlying contract will need to be
considered carefully. There also is a limited exception under the Business Contract Terms (Assignment of Receivables) Regulations 2018 for contracts entered into with small-and medium-sized enterprises (as defined therein) on or after December 31, 2018. If there is no such legal override and no alternative solution such as the use of a trust mechanism, then the consent of the Obligor may need to be obtained or the Receivables relating to that contract may need to be excluded from the securitization.

Germany

Trade receivables securitizations with large multinational Originators tend to involve a large number of jurisdictions. For German Originators, the above-described US structure offers advantages to the Originators compared to a classic German structure in which Receivables are sold on a weekly or monthly basis and collections swept shortly after they arrive in the Originator’s account. The implementation of such a structure, however, does raise some legal questions from a German perspective.

DETERMINATION AND IDENTIFICATION OF RECEIVABLES

German Receivables need to be determined or identified for a valid transfer. This is usually done via a list that contains details about the Receivables. These details must make the Receivables distinguishable from one another (e.g., name of Obligor, invoice number, date of invoice, invoiced amount). The concept of daily transfers does not usually allow such a list for practical or operational reasons. The idea of daily transfer is to transfer any and all Receivables coming into existence on each day and as soon as each Receivable comes into existence; not only when these Receivables are set forth on a list, sent to the SPE and accepted by the SPE. Conceptually, such a daily transfer mechanism is known under German law as a global assignment. Under a global assignment agreement, the assigned Receivables are generically described in a manner which makes them distinguishable from one another (e.g., all trade receivables against a certain Obligor or all trade receivables against a certain Obligor arising from a certain contract).

LEGAL TRUE SALE

There are different types of true sale under German law (as for other jurisdictions): (1) accounting true sale, (2) tax true sale and (3) insolvency true sale. From the SPE’s and the Financing Parties’ perspective, the insolvency true sale is decisive, as the asset analysis of the Financing Parties is usually based on full enforcement of the Receivables, whereby the SPE or the Financing Parties can control the enforcement process. If any sale and transfer of Receivables were to be re-characterized as a secured lending under German law, the insolvency administrator could not only charge 9 percent of the enforcement proceeds for determination of the assets and enforcement, but could also decide on the timing and procedure of the enforcement.
In Germany, a legal valid transfer of Receivables is always required for obtaining a true sale. Apart from this, the distinction between true sale and secured lending is discussed only in legal literature. It is a common understanding that the Originator shall not retain credit risk (e.g., via deferred purchase price) in connection with the sale of Receivables in excess of 9 percent. The argument behind this number is that a secured lender paying a purchase price of the nominal value would usually request the security grantor assume more than 9-percent risk retention given that the insolvency administrator would already charge 9 percent.

However, most trade receivables securitizations necessarily require a large portion of the securitization to be in the form of subordinated debt or equity, because all Receivables are automatically sold to the SPE, but the Financing Parties will only fund against certain eligible Receivables net of required reserves (or overcollateralization). To the extent such subordinated debt is held by the Originator or its affiliate, this may cause issues for the accounting true sale, especially if such subordinated debt is disproportionally over-measured in relation to the historical losses of the Receivables portfolio.

It is discussed in legal literature whether it is necessary for achieving an insolvency true sale also to have an accounting true sale. Such discussion is based on a decision of the German Federal Fiscal Court (Bundesfinanzhof), which related to a transaction which was intended by the parties to be a securitization (“true sale”) transaction. The German Federal Fiscal Court considered the relevant transaction as a secured loan transaction on the basis of the credit-related discounts exceeding the historical loss rate. However, following this argument for the insolvency true sale classification would change the securitization market substantially, because the European Central Bank (ECB) is only allowed to accept true sale transactions as collateral for Eurosystem credit operations and has in the past purchased so-called “retained transactions” (i.e., transactions in which issued notes were purchased by the Originator at closing). If these transactions would not qualify as a true sale, they could not qualify as ECB collateral. In addition, risk retention options would be restricted (i.e., regulatory compliance could no longer be achieved through the Originator holding a first loss risk (unless historical losses are unusually high)). In practice, the market has not yet followed this extreme interpretation and is still comfortable with the Originator holding risk retention or the Originator investing in subordinated notes or debt in these transactions. In accordance with the current market practice, the funding of the large piece of subordinated debt or equity by the Originator (or an affiliated entity of the Originator) should therefore still be an option in Germany.

CASH TRANSACTIONS

Besides the qualification of a true sale, each sale of Receivables should also qualify as a “cash transaction” in accordance with section 140 of the German Insolvency Code (Insolvenzordnung). Cash transactions have the advantage of excluding most insolvency
rescission risk. Insolvency administrators can only challenge such transactions in very exceptional circumstances (fraud or intent). Cash transactions are privileged because they should allow a nearly insolvent company to continue its business and potentially support the recovery process. It is in the interest of all parties to allow the financially distressed company to continue its business (to the extent that such business is not reducing the liquidity of the company) and give business partners legal certainty, otherwise these partners would be reluctant to continue their business with high risk of entering into transactions that are potentially voidable. Hence, cash transactions are defined as those transactions where the seller gets “immediate” and “equivalent” consideration.

In the context of trade receivables securitizations this means the following: although the sale of Receivables is generally an instrument to enhance the liquidity of the Originator, in order to qualify as a cash transaction, (a) the purchase price of the Receivables must reflect the Receivables’ values (i.e., the nominal value of such Receivables discounted to reflect the financing component, potential dilutions and credit risk) and (b) such purchase price must be paid immediately to the Originator which means at least on the same day, ideally simultaneously with the transfer of Receivables. The above-described concept of daily (global) transfers of Receivables imposes certain procedural challenges for the parties as the respective purchase price for each Receivable needs to be calculated on a daily basis and made available to the Originator whereby the SPE or the Financing Parties need to find sources of funding for such purchases on a daily basis. In order to avoid daily draw-down on the financing side, the SPE may also use set-off, i.e., using its claim for transfer of the collections and set-off against the purchase price claim. If, and to the extent there are less collections available than purchase price obligations, the SPE may decide to fund such gap, not on a daily, but on a less frequent basis, by allotting the daily purchases. For such allotment the parties have to agree on a procedure to select the allotted Receivables in a generic way. For example, if there are more Receivables than collections available, the purchased and transferred Receivables could be generically selected by taking invoice numbers or prioritizing those Receivables where invoices are booked at an earlier time.

RETENTION OF TITLE

Receivables in a supply chain are often subject to retention of title. There are different forms of retention of title securing the supplier. A retention of title means that the supplier transfers ownership of the delivered goods under the condition of full purchase price payment. Because the supplier’s ownership in these goods can cease to exist before the purchase price is fully paid, either by the buyer using the goods in a production process (i.e., producing new and substantially more valuable goods with some of the supplied components) or by the buyer selling the goods (the supplier would usually allow such on-sale), the supplier often extends the
retention of title to (a) newly produced products or (b) trade receivables arising from such on-sale (so-called extended retention of title). The supplier’s security right over the trade receivables from such on-sale may potentially conflict with a trade receivables securitization of the buyer.

Where such extended retention of title exists, the securitization parties have to get comfortable that such extended retention of title agreement allows the sale of Receivables as contemplated by the securitization documents and, in particular, does not prevent the valid assignment of Receivables free of any adverse claims from the Originator to the SPE. This can be done by obtaining explicit consent from the supplier. However, there is also an argument that under an extended retention of title agreement the buyer is authorized to sell the Receivables if such buyer is authorized (a) to sell the underlying goods which are the subject of the retention of title arrangement, and (b) to collect the relevant Receivable arising from such sale (Einziehungsermächtigung), provided that the sale of Receivables is comparable to the collection of such Receivables. This requires, inter alia, that (i) the sale of the relevant goods is made on a basis which is covered by the contractual arrangements with the relevant supplier and (ii) that as a result of the sale and assignment of the Receivable arising from such sale the seller is, from a legal and economic point of view, in the same position as if it had not sold the Receivable but had itself collected the Receivable from the relevant debtor, i.e., if (i) the seller definitively and irrevocably receives the purchase price on the sale of the Receivable, (ii) the purchase price payable for each Receivable sold and assigned from the seller to the purchaser is materially higher than the portion belonging to and to be paid to the relevant supplier by the relevant debtor and (iii) the purchase price is available to the seller, i.e., the seller is not obliged to transfer the purchase price to a third party or to a pledged account.

In the case of a conflict between a global assignment of Receivables to the SPE and a retention of title (Eigentumsvorbehalt) applied by suppliers of goods, the global assignment only takes priority if (i) the global assignment of Receivables qualifies as a genuine factoring (echtes Factoring), (ii) the Originator acts in its ordinary course of business, (iii) the authorization of the Originator to collect the Receivables is not withdrawn by the supplier of goods, (iv) the selling price for the sale of goods (Verkaufspreis) is not lower than the purchase price (Einkaufspreis) and the financing entity does not act to the detriment of the suppliers of the goods.

RESTRICTIONS ON ASSIGNMENT

German Receivables are sometimes subject to restrictions on assignment explicitly agreed between the Originator and the Obligor. A Receivable that is subject to such restriction cannot generally be validly assigned under German law. However, under an exception contained in Section 354a(1) of the German Commercial Code (Handelsgesetzbuch), the assignment of monetary claims (i.e., claims for the payment of money) governed by German
law is valid despite a prohibition on assignment if the underlying agreement between the contracting parties constitutes a commercial transaction (Handelsgeschäft) provided that the Obligor under such claim is a merchant (Kaufmann). However, that same Section allows the Obligor of an assigned claim to pay and/or otherwise discharge its obligations (including by way of set-off against claims owing by a particular Obligor to the SPE at the time of such set-off) to the Originator, even if it is notified of the assignment of its payment obligation.

However, this sounds more dramatic than it actually is, because under an assignment without any restriction, the Obligor and the Originator often agree on a so-called “silent assignment” (i.e., where the assignment is not disclosed to the Obligor) and until notification of the assignment to the Obligor, the Obligor may use the same set-off or discharge rights as described above. After the disclosure of the assignment the situation is different: the Obligor under such Receivable without restriction is restricted in using set-off or discharge rights (depending on when the counterclaim existed or matured) whereas the Obligor under the Receivable with the restriction and exception under Section 354a of the German Commercial Code has no restriction to use discharge or set-off rights. This risk can be mitigated by a pledge over the account in which the Obligor is instructed to make payments. Where this issue becomes problematic are those situations where the Obligor (i) makes payment into a non-pledged account, (ii) makes payment into a pledged account but at a point of time when the pledgor is not allowed to dispose over its assets (i.e., insolvency proceedings have been opened) or (iii) uses set-off rights.

France

BANKING MONOPOLY

France has banking monopoly rules which, in principle, disallow the performance of credit transactions (i.e., lending or on-going purchase of French unmatured Receivables) in France by anyone other than a French-licensed or EU-passported financial institution, or any French investment fund specifically authorized to lend.

For cross-border securitization transactions involving French Originators, this implies that the SPE will not be authorized to purchase Receivables directly from such French Originators. Depending on the terms and conditions of the envisaged securitization, the French Originators will only be able to sell their Receivables either (i) to a French securitization vehicle (such as a fonds commun de titrisation or FCT), which will then issue units or notes to be subscribed by the SPE; (ii) to an intermediate banking purchaser located outside of France and benefitting from a EU passport to trade in France, which in turn will on-sell them to the SPE; or (iii) on the basis of an exemption under the French banking monopoly rules, to a foreign group affiliate thereof (which affiliate will then on-sell those Receivables to the SPE).
Depending on the above structural features, several means can be used under French law by the French Originators to transfer such Receivables to the relevant assignee (FCT, banking institution, affiliate, etc.):

• Civil law assignment of Receivables under Article 1321 et seq. of the French Civil Code (Code civil), which assignment is valid between the parties (seller and purchaser) and enforceable against third parties as of the date of execution of the assignment agreement, and enforceable against the debtors subject to such debtors consenting to the assignment, receiving notification thereof or acknowledging it;

• Assignment by way of subrogation under Article 1346-1 et seq. of the French Civil Code – subrogation occurs and is valid when a creditor (the seller) receives payment for a debt from a third party and simultaneously expressly subrogates the third party’s rights against the debtor/buyer by delivering a subrogation deed (quittance subrogative);

• Simplified “Dailly” assignment of Receivables under Articles L. 313-23 et seq. of the French Monetary and Financial Code (Code monétaire et financier). Identified or identifiable Receivables can be assigned to specific parties only (see below) by a signed and dated simplified assignment form (acte de cession) which is delivered to the assignee. The assignment occurs (and is valid between the parties and enforceable against third parties) as from the date indicated by the assignee on the assignment form. No separate document per Receivable is required. The Receivables must arise from a “professional” relationship between the seller and the debtor, and the purchaser must be either an EU-passported or French-licensed credit institution, a financing company (société de financement) or certain French investment funds having in either case extended credit to the relevant seller. Note that French law imposes very strict formal requirements for the assignment form (acte de cession) and failure to comply with such requirements will result in no assignment taking place pursuant to Article L. 313-23 of the French Monetary and Financial Code. The assignment form (acte de cession) can be in an electronic format; and

• Assignment of Receivables to French securitization vehicles (such as FCTs) under Article L. 214-169 et seq. of the French Monetary and Financial Code and notably under the form of an assignment by way of a simplified transfer deed (acte de cession) exchanged between the Originator and the FCT pursuant to Article L. 214-169-V-1° of the French Monetary and Financial Code. To the extent any simplified transfer deed (acte de cession) is used for the purposes of Dailly or securitization assignments, transfer of Receivables made through this means becomes valid between the parties and enforceable against third parties as from the date indicated on the simplified transfer deed without any further formalities, irrespective of the law applicable to the Receivables, the law
of the state of residence of the Obligors or the fact that a bankruptcy (whether under French or foreign law) has been initiated against the Originator after the transfer. In addition, the delivery of the simplified transfer deed entails the automatic and immediate transfer to the SPE of all related security and ancillary rights attached to the Receivables at the date of the assignment deed, without any further formalities. Thus, this approach can provide unique protections for the SPE and the Financing Parties, particularly when facing difficult choice-of-law questions.

RESTRICTIONS ON ASSIGNMENT
Former Article L. 442-6, II-(c) of the French Commercial Code (Code de commerce) provided that “clauses or contracts allowing a producer, trader, manufacturer or a person listed in the trade register to carry out the following actions are null and void: (…) (c) prohibit the co-contracting party from transferring the receivables held against it to a third party;” (the “Ban on Assignment Prohibition”). Pursuant to the terms of such provision, any outright ban on assignment was considered to be ineffective under French law.

In order to “reorganize, define, clarify and simplify” the existing French rules on commercial transparency and commercial prohibited practices, ordinance (ordonnance) No. 2019-359 was enacted on April 24, 2019 (the “Ordinance”) and entered into force on April 26, 2019 (for new agreements entered into as at that date), with the exception of certain provisions whose effectiveness has been deferred later in time.

The Ordinance reduced the list mentioned in former Article L. 442-6 II of the French Commercial Code of prohibited provisions or contracts that are to be automatically void, which list included the Ban on Assignment Prohibition. New Article L. 442-3 of the French Commercial Code includes now only two prohibitions that provide for the possibility for one party to benefit: (i) retroactively from discounts, rebates or commercial cooperation agreements; and (ii) automatically from more favorable conditions granted to competing companies by the contracting partner.

At this stage, no detailed legal literature, legal comments or even case law or position from competition authorities (DGCCRF) discussing this reform and the impact of the deletion of the Ban on Assignment Prohibition from the French Commercial Code is available. In the absence of any further French law reform reinstating the Ban on Assignment Prohibition, it will be for the competent French courts or DGCCRF to confirm the above considerations.

In that respect, given the uncertainties raised by this new legislation, it cannot be excluded that a competent French court or the DGCCRF will decide that a practice amounting to an outright ban on assignment can constitute an authorized practice. In the presence of an outright ban on assignment clause, the legal position of the assignor/assignee of receivables would therefore be less robust than under the previous regime and the assignor/assignee would therefore be exposed to a higher risk of challenge to the extent the assignor/assignee do not comply with such provisions.
TRUE SALE

In the French securitization practice, “true sale” has at least three different meanings:

1. Legally speaking, a sale is a “true sale” if:
   - The sale to the SPE is unconditionally and immediately valid, final and enforceable against local and/or foreign third parties (including, where applicable, the Obligors), whether or not such third parties or the Originator’s creditors are formally notified of the sale. In the context of a Dailly or a securitization assignment, such transfer of title is made by operation of law (see above);
   - The transfer cannot be challenged by a court in the event that the Originator becomes insolvent (the “bankruptcy remote” test): in the context of an insolvency affecting the Originator, the transferred assets must be segregated from such the Originator and remain beyond the reach of its creditors, even in the event of bankruptcy or other receivership (see below); and
   - The transfer of assets can be characterized as a sale rather than a secured loan.

2. From an accounting point of view, there will be a “true sale” if the conditions required to remove the assets from the Originator’s balance sheet under the applicable generally accepted accounting principles (IFRS or US GAAP) are met.

3. For regulatory purposes, and most particularly in the case of the Originator which is a licensed financial institution, there will be a “true sale” if the relevant assets sold are removed from the Originator’s balance sheet for banking and prudential purposes.

Where a French Originator is subject to a bankruptcy or insolvency proceeding (such as safeguard (sauvegarde), judicial reorganization (redressement judiciaire) or liquidation proceedings (liquidation judiciaire)), under French law, assignments of assets by the Originator which occurred between (i) the “payment stop date” (date de cessation des paiements) and (ii) the judgment opening the insolvency proceeding may be challenged by the appointed bankruptcy administrator. In most cases, the payment stop date coincides with the date of the opening judgment, but the insolvency court may back-date the payment stop date by up to 18 months prior to this date. The period between the payment stop date and the date of the opening judgment is called the “hardening period” (période suspecte).

Article L. 632-1 of the French Commercial Code enumerates the transactions which are void per se (nullités de droit) if they occurred during the hardening period. These include, notably, gratuitous transfers, transactions entered into unreasonably below market value, payments of debts not yet due, security/guarantee granted for previous debts; or transfers of assets into a French fiducie (trust). In addition, payments of debts which are due or transactions for consideration which occur after the payment stop date may potentially be voided (nullités relatives) if the counterparty of the insolvent party was aware of the insolvent at the time of the transaction (Article L. 632-2 of the French Commercial Code).
However, to mitigate such claw-back issues for French securitization transactions, French securitization law (as codified in Articles L. 214-169 to L. 214-190 and Articles D. 214-216-1 to D. 214-240 of the French Monetary and Financial Code) provides for specific exemptions to applicable bankruptcy laws applying to securitizations and therefore offers a strong and legally effective protection to French securitization vehicles for the assignment of Receivables carried out in the context of a securitization involving such French securitization vehicles:

- Pursuant to Article L. 214-175-III of the French Monetary and Financial Code, French bankruptcy laws are not applicable to French securitization vehicles;
- Pursuant to Article L. 214-169-V-4° of the French Monetary and Financial Code, assignments of Receivables or the granting of a security interest or guarantee in favor of a French securitization vehicle remains effective notwithstanding: (i) a payment stop date of the Originator occurring at the time of such an acquisition, assignment or creation; or (ii) the subsequent opening of a French bankruptcy or insolvency proceeding or any equivalent foreign insolvency proceeding opened against the Originator following such an acquisition, assignment or creation of security interest or guarantee;
- Pursuant to Article L. 214-169-VI of the French Monetary and Financial Code, (i) to the extent Receivables sold to a French securitization vehicle relate to ongoing (leasing or other) agreements, the assignment of such receivables (or creation of security) to a French securitization vehicle remains effective notwithstanding a bankruptcy affecting the Originator; and (ii) the optional avoidance under Article L. 632-2 of the French Commercial Code does not apply to (a) payments made by a French securitization vehicle, or (b) deeds or acts for consideration made by or for the benefit of a French securitization vehicle, where these were made in the context of a securitization transaction under Article L. 214-168 et. seq. of the French Monetary and Financial Code.

**Mexico**

In the past years, Mexico has established a legal framework that adds greater clarity and certainty to domestic and international Receivables purchases and financings. In particular, reforms that took place in the year 2009, whereby the Sole Registry of Security Interests in Movable Assets (Registro Único de Garantías Mobiliarias or “RUG”) was created, and in 2014, known as the “Financial Reform,” whereby several laws and regulations of the entire financial sector were improved to grant and induce more financial transactions in Mexico. These changes have made selling and purchasing (including discount factoring) of Mexican Receivables a much more viable and attractive option and have, as a result, significantly increased investors’ interest.

**EFFECTIVENESS OF SALE BETWEEN THE ORIGINATOR AND THE SPE**

Under Mexican law, each sale of Receivables in accordance with a Sale Agreement is effective following the acceptance of the offer.
of sale by the Originator and payment of the purchase price by the SPE. Mexico will also recognize and uphold the choice of law chosen by the Originator and the SPE to govern the sale of Receivables. Thus, if a sale of Receivables is effective as a “true sale” pursuant to the law that governs the relevant Sale Agreement, then Mexican courts will recognize such sale as a “true sale.”

EFFECTIVENESS OF SALE BETWEEN THE OBLIGORS AND THE SPE

As long as the Obligor has not been notified of the transfer, its payment obligation will be considered discharged if paid to the original creditor (i.e., to the Originator). By contrast, once the Obligor has been notified of the transfer, its payment obligation will only be considered discharged if paid to the SPE. Thus, if after being notified of the transfer, the Obligor pays to the Originator, instead of paying to the SPE, then the Obligor would not be released from its payment obligation. Identification of the SPE in the notification is necessary to achieve the foregoing. Notice of assignment also cuts off the right of the Obligor to set-off payments owing by it on the Receivables against amounts payable to it by the Originator. In order to require the Obligor to pay directly to the SPE, it is customary to include payment instructions (usually irrevocable) providing details of the bank account where payment is expected to be deposited, which may be an Originator account, in the notification of assignment delivered to the relevant Obligor.

Pursuant to Mexican law, this notice may be made in one of the following ways: (i) delivery of the Receivable with a legend of the sale and an acknowledgment of receipt by the Obligor; (ii) communication by certified mail with an acknowledgment of receipt, including telegram, telex or fax, with a password, along with evidence of the receipt by the Obligor; (iii) notice to the Obligor made by a public broker or notary public (in this case, the written acknowledgment of receipt by the Obligor is not necessary); or (iv) through “data message” sent pursuant to the Mexican Commercial Code (Código de Comercio), which requires the prior designation by the receiver (i.e., the Obligor) of a “system” or “means” to receive data messages (e.g., the prior written designation of a certain email address by the Obligor to receive notifications of assignment via email, or pdf email, encrypted email, data room or electronic member website, etc.).

It is not uncommon for the Obligor to be located outside of Mexico, in which case, the notification of assignment may be done by any of the aforementioned means or by courier with acknowledgment of receipt or by the means established in accordance with the provisions of the treaties or international agreements signed by Mexico.

Given the lack of precedent for electronic communications, the market standard has been for notice to be made through a public broker or notary in order to limit the potential for challenges that notice had not been properly provided. Nevertheless, as discussed below, electronic communications have started to become more popular where Receivables are purchased through the use of technology-managed platforms.
In cases where not all Receivables will be purchased by the SPE, the question arises if notification of the assignment of each purchased Receivable (or batch of purchased Receivables) must be provided to the Obligor or if a single initial notification may suffice. A conservative approach suggests that the Obligor should be notified of the sale on each sale date. Alternatives include monthly notices containing the batch of all Receivables purchased on a specific period of time, or a single initial notification of assignment stating that a legend will be added on each invoice that evidences a purchased Receivable so that the Obligor may know that such Receivable has been assigned to the SPE under the Sale Agreement.

When the parties to the Sale Agreement agree that the Originator will remain as servicer of the Receivables vis-a-vis the Obligors, then the question arises if the notice of assignment discussed above is necessary. A conservative approach suggests that the Obligor should be notified of the existence of the Sale Agreement and provided with payment instructions (usually mentioning that payments shall continue to be made as usual unless otherwise instructed). In this specific case, identification of the SPE in the notification would not be necessary. In these cases, where the Originator remains as servicer of the Receivables, the Originator will be deemed to hold the collection proceeds in trust (depositario) on behalf of the SPE. To mitigate any risks of diversion of the collection proceeds, it is highly advisable to implement an account control agreement over the account into which such proceeds are deposited.

The first option for an account control agreement under Mexican law is to create a Mexican trust (contrato de fideicomiso): the Originator enters into a trust agreement as settlor with a trustee institution (fiduciario). The trustee then opens the collection account and transfers periodically the proceeds from the collection pursuant to the trust’s purpose set forth in the relevant trust agreement. The beneficiary of the trust (fideicomisario) is the SPE, who receives the collection proceeds after the trustee has paid any applicable costs and expenses. A second option is the use of an irrevocable mandate agreement whereby the Originator opens a bank account and acts as principal providing instructions to the bank who acts as attorney-in-fact, and the SPE acts as beneficiary. Not all banks offer this service, known to some as “cuenta mandatada” (mandated account). In addition, it is common to perfect a pledge (prenda sin transmisión de posesión) over all of the Originator’s rights related to the collection account in favor of the SPE or Financing Parties, in order for the SPE or the Financing Parties to have a registered security interest in case of a bankruptcy scenario (opposable vis-à-vis other creditors of the Originator). Such pledge would need to be formalized by a public broker or notary and filed with the RUG.

**EFFECTIVENESS OF SALE BETWEEN THIRD PARTIES AND THE SPE**

In Mexico, the granting of a backup security interest is generally viewed as inconsistent and potentially harmful to the expressly stated
intention of a sale. However, it is important to perform a filing under the RUG system (as described below) in order to ensure that the sale will be effective against third parties, particularly against creditors of the Originator when it becomes subject to an insolvency proceeding.\(^{18}\)

The RUG is an online electronic central registry used throughout Mexico since 2010, to facilitate the registration of security interests over personal property. It uses a single national database under the custody of the Ministry of Economy (Secretaría de Economía) where all registrable security interests can be filed. In 2014, amendments to the RUG mandated that the assignment of rights, including Receivables (and factoring transactions) must also be recorded in the RUG in order for the sales to be effective against third-party creditors of the Originator.\(^{19}\) Recording in the RUG serves as a notice to third parties that the sale took place and, accordingly, gives the SPE priority over (i) any future creditors of or purchasers from the Originator, and (ii) prior creditors that omitted filing with the RUG their security interest or assignment of rights.

Recordings in the RUG are fast, easy and economical. No fees are charged for the filing. However, public brokers and notaries will charge for the service of filing on behalf of the SPE, which is essential since foreign entities are not able to file directly in the RUG unless such person first registers before the Ministry of Economy (Secretaría de Economía) in Mexico. As a result, it is customary in cross-border transactions that a Mexican public broker or notary performs the filing using its own electronic signature provided by the Ministry of Economy on behalf of the filing party.\(^{20}\)

Similar to the considerations regarding a notification of the assignment of each purchased Receivable on each sale date mentioned above, RUG filings should be made for each sale on each sale date in order to protect the SPE from the Originator’s creditors who could challenge a specific unregistered assignment of Receivables. Furthermore, when filing with the RUG, it is highly advisable to (i) perform a previous search for the Receivables that are intended to be purchased to confirm that they are free and clear of any security interests and that they have not been factored in favor of a third party, and (ii) request the public broker or notary to describe, in as much detail as possible, the purchased Receivables, including, for example, the relevant invoice numbers.

While frequent RUG filing requirements may seem cumbersome or impractical, it is worth re-iterating that these requirements are only required to protect the Financing Parties from claims of third-party creditors. While the filing protects Financing Parties from fraud or mistake risk similar to the UCC, it is not required in order to achieve a true sale of the Receivables under Mexican law. Thus, the parties may wish to structure the transaction such that RUG filings are made on a less-frequent basis, rather than daily, to balance the Financing Parties’ risk of third-party claims with the administrative burden and expense on the Originator.
OTHER BANKRUPTCY ISSUES

Common legal opinion points regarding bankruptcy issues include that the transfer of Receivables to the SPE is, as a matter of Mexican law, properly characterized as a sale by way of assignment (cesion de derechos), factoring (factoraje), or other transfer and, therefore, (i) such Receivable should not be considered as property of the Originator’s bankruptcy estate (masa concursal), as defined in Article 4, paragraph V, of the Mexican Bankruptcy Law (Ley de Concursos Mercantiles, the “Mexican Bankruptcy Law”), and (ii) Article 43, paragraph VIII, of the Mexican Bankruptcy Law would not operate to stay payments by the Originator of collections made after the bankruptcy (concurso mercantil) declaration of the Originator with respect to the Receivables sold or assigned in accordance with the Sale Agreement; provided, that, for purposes of being enforceable before third parties, the sale or assignment of the Receivables is filed with the RUG; provided, further, that the following conditions are complied with: (y) the transfer of the Receivables does not constitute a per se fraudulent transaction, according to Articles 113 and 114 of the Mexican Bankruptcy Law, and (z) the transfer of the Receivables does not constitute a case of constructive fraud or cannot be presumed to be fraudulent according to Article 115 and 117 of the Mexican Bankruptcy Law.

RESTRICTIONS ON ASSIGNMENT

As a general rule, the Obligor’s consent is not required for the sale, assignment or factoring of a Receivable in Mexico. However, if the contract with the Obligor includes a restriction on assignment, such restriction will be enforced in Mexico and the Obligor’s consent will need to be obtained in order to assign its Receivables.

Practical Application of Cross-Border Complexities

As illustrated above, the features of a cross-border trade receivables securitization may look different from a standard US structure. Both creativity and flexibility from the Financing Parties and the Originator are essential to structuring a transaction that meets the objectives of all parties involved. This section focuses on a few US-style features mentioned above and the challenges parties face when attempting to incorporate these same features into a cross-border trade receivables securitization.

LOCATION AND OWNERSHIP OF THE SPE

In the United States, it is common for the SPE to be a wholly-owned subsidiary of the Originator. This provides significant flexibility with respect to the securitization documents, because capital contributions and true contributions of Receivables can be utilized. However, in cross-border securitizations, the SPE is usually an orphan SPE. This eliminates the possibility of contributing Receivables to the SPE, or providing capital contributions to the SPE for liquidity purposes. Furthermore, an orphan SPE may be wholly-owned by a management company, who will need to be involved in the review of the securitization documents, as well as the execution and delivery of the SPE’s signature pages at the
initial closing and for any maintenance such as amendments or waivers. The management company will also charge certain fees and expenses associated with managing and owning the SPE or a corporate services provider may need to be appointed. While orphan SPEs are typically not difficult to implement and structure, they do add a layer of complexity to cross-border securitizations that are not found in their domestic counterparts.

CASH MANAGEMENT AND SERVICING
As noted above, a typical US structure will allow the Originators to commingle collections on the Receivables for a specific period of time (typically intra-month), with settlement occurring on a monthly basis. While the purchase price for Receivables is due and payable on a daily basis, and Receivables are in fact sold on a daily basis, it is customary for settlement of the purchase price to actually occur periodically (such as once a month) for administrative ease. Furthermore, the Servicer will continue to service the Receivables and manage the relationship with its Obligors, including collection activities.

In a cross-border transaction, however, you may not be able to achieve a true sale in an applicable jurisdiction unless the collections on the Receivables are deposited into the SPE’s account. This adds a layer of complexity, as new accounts will need to be established, and the Obligors will need to be notified of the change in their payment instructions. This often can be included in the Obligor’s invoice; however, that is not always an option for every jurisdiction. The Financing Parties may also want to consider whether account control agreements should be in place over the SPE’s accounts.

While it may be feasible for settlement to occur on a monthly basis, in jurisdictions such as Germany, the payment of the purchase price cannot be delayed and ideally should be made on a daily basis at least on the same day as the Receivables transfer. These daily cash flows could create an administrative and operational burden for the Originator or, at a minimum, a restructure of the Originator’s operations.

Perhaps the most surprising requirement in at least one jurisdiction is the unilateral replacement of the servicer of the Receivables (typically the Originator or its parent company) without cause. For the Originator, this may be a “deal-breaker” as it would effectively result in the Financing Parties having the ability to take control of the Originator’s relationship with its Obligors, even when the servicer has not defaulted and no events of default or other trigger events under the securitization documents have occurred. Of course, it is in the Financing Parties’ best interest if the Originator continues to maintain its own relationships with its Obligors, but the Originator’s concern with such a replacement requirement nonetheless is understandable. If a jurisdiction with this requirement represents a small portion of the securitization portfolio as a whole, or if such requirement is limited only to that jurisdiction, oftentimes the Originator will determine this requirement does not prevent the inclusion of the jurisdiction or the related Receivables in the securitization.
OBLIGOR NOTICE AND CONSENT

Obligor notice and consent is perhaps one of the most sensitive and negotiated points in a trade receivables transaction. Understandably, the Originator does not want to disturb or change its sometimes long-standing relationship with its Obligors. Sending notices or obtaining consents from Obligors regarding the transfer of their Receivables to the SPE could confuse the Obligors or tarnish the Originator’s relationship with them. From a Financing Party’s perspective, provided that the Originator has not defaulted and the Originator is complying with the securitization documents, it is in the Financing Party’s best interest for the Originator to maintain these relationships. As mentioned, in the United States the Financing Parties are usually only able to notify Obligors of the assignment of Receivables after certain trigger events, usually events of default or servicer defaults. While Obligor notice would cut off the Obligor’s right to discharge its debt to the Originator as well as other defenses and set-off rights, the Financing Parties are typically comfortable taking this risk until such trigger events occur, at which time notices may be sent.

However, a local jurisdiction may require notice to or consent from Obligors not only for the SPE to exercise rights or remedies vis-a-vis the Obligor, but in order to achieve a true sale. Furthermore, notice may be required only once to the Obligor, but in some cases, it must be provided for each sale of each Receivable, which could easily annoy the Obligor and strain its relationship with the Originator. For a Financing Party in a cross-border trade receivables transaction, a legal true sale is an essential component of the structure. If the Originator is uncomfortable providing notice to its Obligors, which is particularly understandable if such notices are happening frequently, the applicable jurisdiction may not be tenable for the cross-border transaction.

Furthermore, as stressed throughout this article, outside the United States, consent of the Obligor is typically required to the extent there are restrictions on assignment in the underlying contracts. While there are some structural alternatives (such as trusts in England or Australia) or exceptions (such as in Germany), it is important to note that in many jurisdictions, the only solution is obtaining the Obligor’s consent. If the Originator does not agree to this approach, those Receivables may need to be excluded from the securitization. Fortunately, this is achievable through minor changes to the securitization documents. However, the Originator and the Financing Parties should consider the aggregate amount of Obligors and Receivables that will be excluded, to determine whether their economic and commercial goals in entering into the transaction are still achieved in light of such exclusions.

OPERATION OF TRANSFERS

In the United States, it is typical to sell all Receivables of the Originator automatically upon origination, other than specific Receivables designated in the securitization documents as excluded Receivables (usually
relating to certain Obligors as noted above). This is an important feature to ensure that the Financing Parties continue having replenishing collateral as collections on prior Receivables are held and commingled by the Originator pending settlement. However, in other jurisdictions, automatic sales are unusual, and it is more common to sell Receivables periodically, which are identified on a particular list (akin to a factoring transaction in the United States). Providing such a list can result in additional administrative or operational burden for the Originator. For example, even in Germany, when a global assignment is used, it is still customary to provide a list of Obligors, which needs to be updated each time a new Obligor is added or removed from the list. Furthermore, certain jurisdictions may require additional details for the “identification” of Receivables than in the United States, such as invoice numbers, descriptions of the underlying contract, Obligor addresses and other detailed information. Other jurisdictions (such as Mexico) may require the filing of frequent registrations or the execution and delivery of assignment agreements for each sale of Receivables. To the extent it is not possible for the Originator to perform these daily administrative tasks, the parties may want to consider a structure that involves less frequent transfers of Receivables (such as weekly or monthly), particularly for the relevant jurisdiction.

While a simple transfer of Receivables between the Originator and the SPE is ideal, in jurisdictions such as France and other monopoly jurisdictions, it is unfortunately not possible and a new structure needs to be set up for that jurisdiction to ensure the Receivables can be included in the securitization. When including these jurisdictions, structural changes may need to be made not only in the Sale Agreement, but also to the securitization documents generally, which may not contemplate an “intermediate sale” or a subrogation structure. If the Receivables in that jurisdiction represent a meaningful portion of the Receivables portfolio as a whole, such structural changes are usually worth the time and expense and will provide the securitization program with additional flexibility for the inclusion of future jurisdictions.

LEGAL OPINIONS AND MEMORANDA

A discussion of cross-border trade receivables securitizations would be incomplete without mention of legal opinions, which provide both the Originator and the Financing Parties with legal comfort regarding enforceability, true sale, choice of law and tax matters (among others). For the law governing the applicable Sale Agreement, it is customary to receive a true sale and enforceability opinion from counsel in that jurisdiction, particularly if the Originator wishes to receive off-balance sheet treatment. For each Originator jurisdiction, customary corporate opinions are typically provided, as well as tax and no-conflict opinions. An opinion from the SPE’s jurisdiction is likewise customary. While these opinion practices are typical, each transaction should be discussed and reviewed carefully among the parties to determine the
appropriate opinion and memoranda coverage for the relevant transaction.

When looking at issues such as enforcement against Obligors and eliminating set-off rights and defenses, a minority approach is to obtain opinions from each Obligor jurisdiction, as well as the jurisdiction that governs the law of the applicable Receivable. This request may be limited to all such jurisdictions, or only those that make up a sizeable portion of the pool of Receivables. A more common approach is to obtain a legal memorandum from local counsel detailing the practical steps that need to be taken in such jurisdiction to remove such defenses and rights (such as providing notice to the Obligors). A legal memo may also briefly discuss tax questions and enforcement mechanics for bringing foreign judgments into a local court in the relevant jurisdiction. Benefits of legal memoranda, particularly in Obligor jurisdictions, include (i) memoranda are usually less expensive than legal opinions and (ii) memoranda will address factual matters that may not be included in a legal opinion, such as the detailed process of enforcement and bringing judgments into local legal systems.

It is worth noting that not all jurisdictions have years of case law or history surrounding what constitutes a “true sale”. Indeed, in many jurisdictions, the concept does not even exist. Therefore, it is important to obtain and review legal opinions and memos early in the process of structuring the transaction, to obtain a full understanding of the legal framework in the applicable jurisdiction. In some jurisdictions, there is such limited case law, that the legal opinion may simply assume “economic risk has been transferred” (in other words, the legal standard for a true sale). This is not particularly helpful from a legal perspective, as the opinion has been essentially assumed; however, the parties may be comfortable with such coverage to the extent the applicable local law Receivables do not represent a large portion of the Receivables portfolio, or if there are certain trigger events incorporated into the securitization documents that would result in the removal of such Receivables from the securitization. Legal opinion custom in local jurisdictions varies greatly, and what is typical or customary in the United States is often not the case in other jurisdictions. Working with local counsel and deal counsel together to reach a common ground, with respect to legal opinions or otherwise, is imperative for both the Financing Parties and the Originator in a cross-border trade receivables securitization.

Conclusion

Undoubtedly, a multi-jurisdictional trade receivables transaction involves detailed consideration of legal and tax issues in a range of countries. Selecting a law firm that is very familiar with analyzing such issues and has helped implement and structure transactions that include jurisdictions across the globe is a valuable initial step for navigating through complex multi-jurisdictional legal questions and finding the best solutions for the particular transaction.
Endnotes

1 Mayer Brown has a premier trade receivables securitization practice with extensive experience around the world in both well-established and emerging markets. For more information regarding Mayer Brown’s trade receivables and supply chain finance practice, please see https://www.mayerbrown.com/en/capabilities/practices/banking--finance/receivables-supply-chain-finance?tab=overview.


6 Section 136 Law of Property Act 1925.

7 It is worth mentioning that all these limitations (other than (a) and (e)) are applicable to US Receivables sales prior to Obligor notice as well.

8 Published in the Federal Official Gazette (“DOF”) on August 27, 2009.

9 Published in the DOF on January 10, 2014.


11 Article 13, paragraph I, of the CCF provides that legal situations validly created in the states of the Republic or in a foreign State, in accordance with their law, must be recognized.

12 Article 428 of the LGTOC.

13 Article 427 of the LGTOC.

14 Article 427, first paragraph, of the LGTOC.

15 Articles 381 to 399 of the LGTOC.

16 Article 273 of the Commercial Code.

17 Articles 346 to 380 of the LGTOC.

18 Article 426 of the LGTOC.

19 Articles 32 bis 1 to 32 bis 9 of the Commercial Code.

20 Articles 18 to 32 bis of the Commercial Code.
While Aristotle may have coined the phrase “the whole is greater than the sum of its parts”, we doubt that he was thinking about CLOs. We hear this phrase repeated often in team sports. Take a bunch of talented (but not elite) basketball players, add a terrific coach (e.g., Jay Wright) and the result is two national championships in three years.

But sometimes the opposite is true: the sum of the parts is greater than the whole. This can happen when a company is acquired and then sold off in pieces that are more valuable than the purchase price of the company. Recently, some CLO market participants have suggested the same may be true for CLO debt when structured with specific features that are described in this article.

CLO Call Feature

In a typical CLO structure, a pool of loans is aggregated and notes backed by the pool are sold to investors in debt and equity tranches reflecting varying levels of risk/reward. The debt tranches are typically floating rate instruments. Unlike many other securitized products, CLOs are actively managed by a collateral manager that buys and sells loans in and out of the collateral pool (subject to satisfaction of certain tests agreed upon in advance) throughout a reinvestment period (typically four to five years) in order to build value for the CLO.

Typically, CLOs have a call feature which is available to the equity investors and collateral manager after a two to three year non-call period. This call feature, which provides the flexibility to refinance some or all of the CLO debt tranches with less expensive debt, is usually exercised, and a related refinancing occurs, when CLO liability spreads tighten – namely, at times when debt investors who are repaid may only (all else equal) purchase similarly rated debt yielding lesser returns. As a result, a CLO refinancing is typically undesirable for debt investors. If CLO liability spreads widen, there is no economic reason to exercise the call and, as a result, a refinancing will not occur and the CLO debt investors are left with the returns they agreed to at the time of the CLO closing,
even though the market has shifted and they could obtain better returns from similarly rated debt in the current new-issue market.

**MASCOT Structure**

Recently, a new structure has emerged in the CLO market called MASCOT (Modifiable and Splittable/Combinable Tranches) which is intended to partially mitigate the negative impact to holders of CLO debt associated with the call feature described above. A CLO note with a MASCOT structure provides a CLO debt investor with the post-closing flexibility to split its CLO note into parts: an interest-only MASCOT note which pays only interest at a fixed rate (solely from CLO interest proceeds) and a principal and interest MASCOT note which pays all of the principal of the pre-split note plus the portion of the pre-split note interest that is not stripped off to the related interest-only MASCOT note. This concept is closely analogous to one used in the residential mortgage bond market in which MACRs (Modifiable and Combinable REMICs) offer similar flexibility. The aggregate of the amounts paid to the subparts (or splits) is equal to the amount that would be paid to the pre-split note. The splits can subsequently be reconsolidated into the pre-split note or reconfigured into various other combinations that have been determined at the time of closing. Each potential interest-only MASCOT note and principal and interest MASCOT note is assigned a CUSIP and a rating by a nationally recognized statistical rating organization at the time of closing regardless of whether any such split MASCOT notes are actually issued at closing. In fact, a recent CLO offering included a possible twenty-nine (29) pre-rated MASCOT combinations.

If a holder continues to hold its original note intact (or holds both original parts of its split MASCOT note), its value is unchanged. The sum of the parts is equal to the whole. However, even though the amount of principal and interest payable on the pre-split note and the aggregate of the principal and interest payable on the split notes is the same, under certain circumstances the investor may be able to increase the value of its note by splitting it apart and selling off one or both parts, such that the sum of the parts would be greater than the whole.

A typical fixed rate bond increases in value as interest rates decline because the currently above market interest rate of the bond makes it more valuable. And this is true to a limited extent with an interest-only MASCOT note. But CLOs (like mortgage bonds) have a characteristic called negative convexity as they have a greater tendency to be repaid when interest rates decline (or spreads tighten). As a result of this competing force, fixed rate bonds with negative convexity generally experience less of an increase in price as interest rates fall or spreads tighten than a typical fixed rate bond. So an interest-only MASCOT note is intended to behave differently than a typical fixed rate bond because MASCOTs are tied to the original CLO and its call feature. If interest rates decline (or spreads tighten) enough and the...
non-call period has ended, the interest-only MASCOT note has a higher likelihood of being called in a refinancing of the original class of debt from which it is derived. In this case the interest-only MASCOT note is refinanced away.

However, the benefit of the MASCOT structure may help investors partially mitigate and/or isolate some of this negative convexity risk, which may include trading such risk to investors who see particular investment opportunities in such risk. An interest-only MASCOT note becomes more valuable the longer it exists and isn’t refinanced away because the value of the entitlement to interest payments increases the longer the interest payments are required to be made. So an interest-only MASCOT note will increase in value as spreads widen, which can make an interest-only bond desirable as a partial hedge for the negative convexity of a principal and interest bond.

Certain Considerations
Of course, the MASCOT structure raises documentation and operational considerations, a few of which are mentioned here. First, the voting rights of holders of MASCOT notes (particularly holders of the interest-only MASCOT notes in connection with proposed indenture amendments) will need to be considered, as collateral managers will have an interest in ensuring that the MASCOT structure doesn’t impede the administration of the transaction or optionality around refinancings and redemptions. Second, ERISA restrictions will need to be considered: because of the difficulty of tracking compliance with the 25 percent limitation under the Plan Asset Regulations as holders split and reconstitute notes, ERISA restricted classes that are MASCOT eligible may need to restrict or prohibit investment by benefit plan investors. Third, the CLO trustee must track all original notes and potential combinations. Finally, CLOs typically issue deferrable interest notes that capitalize deferred interest, which introduces some technical documentation complexity in relation to the interest-only MASCOT notes, which have a notional amount rather than an entitlement to repayment of principal.

In addition, the tax treatment of MASCOT notes needs to be considered and may impact value. While the splitting of a MASCOT note should not itself be a taxable event, the sale by a holder of less than all of the split notes may require allocation of basis among the split MASCOT notes, recognition of gain or loss with respect to the sold note and/or treatment of the retained split MASCOT note as having original issue discount.

Conclusion
If investors attribute sufficient value to the benefits of the MASCOT structure to justify the additional complexity, and CLO participants are able to satisfactorily resolve any related documentary and operational considerations, one would expect (all else equal) to see tighter spreads on MASCOT classes at closing than for non-MASCOT CLO notes.

Whether, and the extent to which, the sum of the MASCOT parts is greater than the whole in the case of CLO debt remains to be seen.
Onshoring the EU Securitisation Regulation – How Will it Apply in the UK in the Event of a No-Deal Brexit?

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Introduction
The EU Securitisation Regulation (the “EU Securitisation Regulation”) became applicable in the United Kingdom (the “UK”) from 1 January 2019 to all securitisations, other than securitisations existing prior to that date to the extent that they are grandfathered.

With the UK currently scheduled to leave the European Union (the “EU”) on 31 October 2019 (“Exit Day”), contingency plans are ongoing to provide for the possibility that a negotiated deal will not be reached with the EU (a “no-deal Brexit”). In particular, significant efforts are being made to convert the existing body of EU legislation into UK law and ensure that the resulting UK legislation is effective and functional, in a process known as “onshoring” (as discussed further below).

A no-deal Brexit will occur unless the UK:
• agrees an extension with the EU before Exit Day;
• reaches an agreement with the EU on the terms of the UK’s departure (it is likely that this would need to include transitional arrangements during an implementation period); or
• unilaterally revokes its Article 50 notice.

This Legal Update considers how the EU Securitisation Regulation will apply in the UK as a result of the onshoring process, in the event of a “no-deal Brexit”.

The EU Securitisation Regulation
The EU Securitisation Regulation has consolidated and amended the previous rules in relation to securitisation transactions and covers two main areas.

Firstly, it sets out provisions in relation to all securitisations which are within its scope, consolidating and adding to the rules that previously applied to particular types of regulated entities. These provisions include
requirements for securitisation special purpose entities ("SSPEs"), due diligence, risk retention and transparency obligations, credit-granting standards and a ban on resecuritisation, together with the relevant definitions.

Secondly, it sets out a framework for simple, transparent and standardised ("STS") securitisations. Securitisations which meet the applicable STS criteria, together with certain additional requirements introduced under the EU Regulation which was introduced at the same time as the EU Securitisation Regulation and which amends the Capital Requirements Regulation (the "CRR"), will allow EU banks investing in such securitisations to benefit from lower regulatory capital requirements compared to securitisations which are not STS. STS securitisations will also benefit from other favourable regulatory treatment.

In addition, the EU Securitisation Regulation includes provisions dealing with sanctions and penalties for non-compliance, supervision by regulatory authorities, when securitisations entered into before 1 January 2019 would fall within its scope and transitional arrangements.

Certain of the requirements of the EU Securitisation Regulation are in the process of being set out in more detail in various technical standards, including with respect to risk retention and transparency.

Please see our separate Legal Update, “The EU Securitisation Regulation – Where are we now?”, for a more detailed discussion of the EU Securitisation Regulation.

The Securitisation Regulations 2018

Since it is an EU Regulation, the EU Securitisation Regulation is currently directly applicable in the UK. However, EU Member States are required to put certain additional measures in place in order to implement certain of its requirements on a national level.

On 1 January 2018, the Securitisation Regulations 2018 (the “UK Securitisation Regulations”) came into force. The UK Securitisation Regulations are intended to ensure that the EU Securitisation Regulation is effective and enforceable in the UK.

They include provisions dealing with the following points:

- designation of the Prudential Regulation Authority (the “PRA”) and the Financial Conduct Authority (the “FCA”) as competent authorities under the EU Securitisation Regulation responsible for supervising compliance by the applicable entities established in the UK with various requirements of the EU Securitisation Regulation and allowing for the imposition of certain disciplinary measures and procedures in the event of breach;
- authorisation of Third Party Verifiers (defined below) with respect to the STS criteria and maintenance of a register of such Third Party Verifiers; and
- the requirement for originators, sponsors and SSPEs of private securitisations, that are established in the UK, to make available the information required under
the transparency provisions of the EU Securitisation Regulation. This has also been supplemented by a direction published by the FCA and the PRA on 31 January 2019.¹

Since the UK Securitisation Regulations are already in force, they will continue to apply irrespective of whether there is a no-deal Brexit.

**The European Union (Withdrawal) Act 2018**

The formalities of the legislative process to deal with the possibility of a no-deal Brexit are broadly as follows:

- on Exit Day, the European Union (Withdrawal) Act 2018 (the “EU Withdrawal Act”) will repeal the European Communities Act 1972, thus ending the supremacy of EU law in the UK;
- at the same time the EU Withdrawal Act will convert existing EU laws into so-called “retained” domestic law, in order to provide continuity and certainty; and
- powers to make secondary legislation, including powers to amend such retained laws to ensure that they continue to operate appropriately in the UK, are also set out in the EU Withdrawal Act. These powers allow UK regulations to be made in order to prevent, remedy or mitigate any failure of retained EU law to operate effectively, or any other deficiency in retained EU law, arising from the withdrawal of the UK from the EU.¹⁰

**The Securitisation (Amendment) (EU Exit) Regulations 2019**

The Securitisation (Amendment) (EU Exit) Regulations 2019 (the “Securitisation Onshoring Regulations”) were made on 25 March 2019 and will come into force on Exit Day. They are part of the extensive package of secondary legislation prepared using the onshoring powers in the EU Withdrawal Act. Their stated purpose is to address deficiencies in the EU Securitisation Regulation, as well as to amend certain related legislation, in order to ensure that the EU Securitisation Regulation and such related legislation continue to operate effectively once the UK leaves the EU. Some key aspects of the Securitisation Onshoring Regulations are considered below.

**GENERAL AMENDMENTS**

The Securitisation Onshoring Regulations make a number of general amendments to ensure that the EU Securitisation Regulation is workable in a UK context following Brexit. So, for example, references to “the Union” have been amended to “the United Kingdom,” references to Member States have been removed or replaced, and references to “ESMA” (the European Supervisory and Markets Authority (“ESMA”)), the “EBA” (the European Banking Authority (the “EBA”)) and “EIOPA” (the European Insurance and Occupational Pensions Authority) have been removed, with responsibility generally being assumed by the FCA and/or the PRA.
As a more general point, individual pieces of the vast body of onshoring legislation (including the Securitisation Onshoring Regulations) cross-refer variously to EU legislation that is intended to be onshored, as well as to pieces of EU legislation in their original form, creating a potentially confusing patchwork of legislative cross-references.

**DEFINITION OF “SPONSOR”**

Under the EU Securitisation Regulation, the definition of “sponsor” applies to credit institutions and investment firms, provided that they meet the requirements of the definition. That definition makes it clear that a credit institution can be a sponsor whether it is located in the EU or not. However, it is not clear from the wording whether an investment firm needs to be located in the EU in order to be a sponsor, since the definition of “sponsor” indicates that it must be an investment firm as defined in MiFID II, but it is unclear whether that means it must be regulated thereunder (in line with the interpretation under the previous regime), and therefore located in the EU. Market participants are currently hoping for clarification from the European supervisory authorities on this point.

Although the above point is yet to be clarified in an EU context, the Securitisation Onshoring Regulations amend the definition of “sponsor” with the result that an investment firm will be capable of being a sponsor regardless of whether it is located in the UK or in a third country (provided that it otherwise meets the definition of “sponsor”). The Securitisation Onshoring Regulations also make a further amendment to the definition of “sponsor” as it will apply in the UK after Exit Day. Under the EU Securitisation Regulation definition, if the sponsor delegates day-to-day active portfolio management of a securitisation to another entity, this entity needs to be regulated under the applicable EU Directive, and therefore it appears that such entity would need to be established in the EU.

Under the revised definition of “sponsor” in the Securitisation Onshoring Regulations, active portfolio management can be delegated to an asset manager which is authorised in the jurisdiction in which it is established, thus broadening the jurisdictional scope.

**DUE DILIGENCE AND TRANSPARENCY**

Article 5 of the EU Securitisation Regulation sets out due diligence requirements for institutional investors. Article 5(1)(e) provides that an institutional investor (other than an originator, sponsor or original lender) must verify that “the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article”. The jurisdictional scope of this requirement is not explicitly stated in Article 5(1)(e). While it is generally agreed that Article 7 should not apply directly to non-EU entities, it is not clear from the wording of Article 5(1)(e) whether institutional investors, as part of their due diligence obligations, need to verify that originators, sponsors and SSPEs which are not established
in the EU have provided the relevant information in accordance with the Article 7 requirements. There are arguments that this should not be necessary, as discussed in more detail in our Legal Updates “The EU Securitisation Regulation – Where are we now?” and “The Impact of the EU Securitization Regulation on US Entities,” but there are different views in the market on this point and it is hoped that some guidance will be provided soon. In the Securitisation Onshoring Regulations, this provision has been amended and split into two limbs, Article 5(1)(e) and Article 5(1)(f).

Article 5(1)(e) relates to originators, sponsors and SSPEs which are established in the UK and requires institutional investors to verify that such entities have made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article.

Article 5(1)(f) relates to originators, sponsors and SSPEs which are established in a third country and requires institutional investors to verify that such entities have made available information which is substantially the same as would have been made available, and with the frequency and modalities which are substantially the same as those with which it would have made information available, in each case in accordance with Article 5(1)(e) of the Securitisation Onshoring Regulations if such entities had been established in the UK.

Although this amendment was presumably intended to clarify the due diligence requirements, it could be argued that it goes beyond the powers in the EU Withdrawal Act to prevent, remedy or mitigate any failure of Article 5(1)(e) of the EU Securitisation Regulation to operate effectively or any other deficiency in that Article which in either case occurs as a result of Brexit. It is currently not clear what is intended by the words “substantially the same as” and the extent to which originators, sponsors and SSPEs which are not established in the UK might be able to provide information which is not fully in compliance with Article 7 or the applicable reporting templates in order for a UK institutional investor to be able to comply with its due diligence obligations under Article 5(1)(f) of the Securitisation Onshoring Regulations. If the intention is for there to be substantive, rather than full, compliance with the Article 7 reporting requirements, that would be viewed positively by many institutional investors when assessing compliance by non-UK entities, given that such entities may not be willing to complete the reporting templates. However, it will be important that those investors are able to ascertain exactly what that means in practice.

**STS**

Under the EU Securitisation Regulation, a securitisation can only be STS if the originator, sponsor and the SSPE are established in the EU. This requirement needs to be amended in order for a securitisation where any of those entities are established in the UK to be considered STS in the UK following Brexit.

Essentially, there will be two parallel STS regimes, one in the EU under the EU Securitisation Regulation (the “EU STS Regime”) and one in the UK as a result of the
Securitisation Onshoring Regulations (the “UK STS Regime”). A securitisation with a UK originator, sponsor or SSPE will not be capable of being STS under the EU STS Regime after Brexit. This also applies to securitisations with a UK originator, sponsor or SSPE which met the STS criteria under the EU Securitisation Regulation prior to Brexit. However, some of those securitisations could continue to be STS under the UK STS Regime, as explained further below.

The EU Securitisation Regulation sets out a separate set of requirements for non-ABCP and ABCP securitisations (although a lot of the criteria overlap or are similar). The Securitisation Onshoring Regulations do not change this general approach, but they do modify Article 18 of the EU Securitisation Regulation which provides that the originator, sponsor and the SSPE must be established in the EU.

In the case of non-ABCP securitisations, the Securitisation Onshoring Regulations provide that for such securitisations to be considered STS under the UK STS Regime, the originator and the sponsor need to be established in the UK. This requirement does not apply to the SSPE, which should prove useful, since securitisations with SSPEs in other commonly chosen jurisdictions, such as Ireland, Luxembourg or the Netherlands, would not be precluded from being STS under the UK STS Regime.

In the case of an ABCP programme, the sponsor will need to be established in the UK in order for such ABCP programme to be considered to be STS under the UK STS Regime.

In the case of an ABCP transaction, such transaction can only be considered to be STS under the UK STS Regime if the sponsor of the ABCP programme is established in the UK.

For ABCP transactions and programmes, it is not stated that the SSPE or the originator would have to be in the UK, and the draft Explanatory Memorandum relating to the Securitisation Onshoring Regulations indicates that the originators and SSPEs in ABCP securitisations will not need to be located in the UK. This flexibility is likely to be welcomed by market participants.

In addition, in order to avoid the immediate impact of securitisations which are STS under the EU STS Regime no longer being considered to be STS under the UK STS Regime after Exit Day, some transitional provisions have been included. As a result, securitisations which have been notified as being STS under the EU STS Regime before Exit Day, or within a period of two years thereafter, will continue to be recognised as STS in the UK. It is currently unclear, however, whether the EU will offer similar recognition to securitisations which meet the requirements of the UK STS Regime on a reciprocal basis, but this would be helpful. The EU Securitisation Regulation contemplates a future assessment of a possible equivalence regime for third countries, but this is not scheduled until 2022. 
STS securitisations under the UK STS Regime will need to be notified to the FCA using the requisite template. The Securitisation Onshoring Regulations provide that the FCA may make technical standards with respect to the information required for STS notification, and the FCA has released a consultation paper setting out draft technical standards on the content and format of STS notifications. The FCA is required to publish such STS notifications on its website and maintain a list of such STS securitisations.

**THIRD PARTY VERIFIERS**

The EU Securitisation Regulation provides that the originator, sponsor or SSPE may appoint a third party (a “Third Party Verifier”) to check whether a securitisation complies with the STS criteria (although this will not affect the liability of the originator, sponsor or SSPE). Under the Securitisation Onshoring Regulations, such Third Party Verifiers will need to be authorised by the FCA, who may make technical standards setting out the information to be provided in connection with the application for authorisation. The FCA has begun work on establishing rules within its Handbook for Third Party Verifiers, but no technical standards have been issued to date.

**REPOSITORIES**

Under the EU Securitisation Regulation it is expected that information required to be disclosed under Article 7, with respect to public deals, will be provided to registered securitisation repositories. The Securitisation Onshoring Regulations provide that securitisation repositories will need to be established in the UK and will be required to register with the FCA. The FCA may make technical standards in relation to the procedures required to be carried out by securitisation repositories to verify information made available under Article 7 and the application for registration. The FCA will be required to publish a list of registered securitisation repositories on its website. Again, the FCA has begun work on Handbook provisions for securitisation repositories, but no technical standards have been issued to date.

**SUPERVISION**

The Securitisation Onshoring Regulations amend the provisions of Article 29 of the EU Securitisation Regulation, which deal with the designation of competent authorities, to provide for supervision by the PRA, the FCA and the Pensions Regulator, as applicable, of institutional investors with respect to their due diligence obligations under Article 5 and of sponsors, originators, original lenders and SSPEs with Articles 6, 7, 8 and 9, which relate to the risk retention requirements, the transparency requirements, the ban on resecuritisation and the criteria for credit-granting respectively.

**So What Happens Next?**

While the rules relating to securitisation in the EU and in the UK will be similar in the event of a no-deal Brexit, there remain some areas of uncertainty under both regimes. However, the
Securitisation Onshoring Regulations should provide some certainty as to how the EU Securitisation Regulation will be applied in the UK following a no-deal Brexit, and in particular the amendments to the definition of “sponsor” and the STS regime are likely to be welcomed by market participants.

It is not clear how the EU Securitisation Regulation will be onshored or otherwise applied in the UK in the event that there is a Brexit deal, but it may be that the Securitisation Onshoring Regulations are indicative of the likely policy in this respect, although transitional arrangements would probably be required in that case and it is difficult to predict how the EU Securitisation Regulation will ultimately be applied in the UK.

As mentioned previously, there are a number of technical standards which have not yet been finalised with respect to the EU Securitisation Regulation. These include the technical standards with respect to risk retention and transparency. In the event that any technical standards come into force before Exit Day then they will form part of UK law (subject to any amendments that may be made in the UK). If such technical standards do not come into force before Exit Day then they will not apply in the UK and a UK version of the technical standards will presumably be introduced. However, it remains to be seen how closely these will track the draft technical standards under the EU Securitisation Regulation and when they will come into effect.

There is also the question of the extent to which any existing guidance with respect to the EU Securitisation Regulation will be adopted in the UK. ESMA have produced a useful set of questions and answers on the Securitisation Regulation (the “ESMA Q&As”), dealing with questions relating to STS notifications, and to the disclosure requirements and templates, which ESMA have been updating periodically and intend to continue to do so. In addition, the EBA have published guidelines with respect to the STS criteria for non-ABCP and ABCP securitisations (the “EBA Guidelines”), which are very helpful in clarifying the STS requirements. The ESMA Q&As and the EBA guidelines are not EU Regulations and are non-binding. Consequently they are not expected to be part of the legislative onshoring process.

However, market participants often rely heavily on such guidance and it is likely to be particularly important given the fact that the EU Securitisation Regulation is a new Regulation and there are numerous questions about how to interpret its requirements and the related technical standards. It will therefore be important that similar guidance is provided in the UK. It is also likely to be preferable if any UK guidance is consistent with that of ESMA and the EBA, and does not differ significantly, for example by way of so-called gold-plating.

While the securitisation regime under the EU Securitisation Regulation and the onshored...
version which would come into force in a no-deal scenario pursuant to the EU Withdrawal Act and the Securitisation Onshoring Regulations are for the most part aligned, it is likely that, in time, the EU and the UK rules will diverge following subsequent review and interpretation, the addition of further guidance and future regulatory and political developments. This will be particularly significant for parties who are involved in cross-border securitisation transactions with entities in both the UK and EU Member States.

Conclusion

While the outcome of Brexit remains uncertain, it will be important for market participants involved in securitisations with UK entities to monitor closely any further regulatory developments with respect to the EU Securitisation Regulation and consider how it will apply in the UK, in particular in the no-deal Brexit scenario.

Endnotes


6 An entity will be established in the UK if it is constituted under the law of a part of the UK with a head office, and if there is a registered office, that office, in the UK, and where at least part of the securitisation business of such entity is carried on in the UK.

7 A “private securitisation” is defined as a securitisation where no prospectus has to be drawn up in compliance with Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.


10 See Section 8 (Dealing with deficiencies arising from withdrawal) of the EU Withdrawal Act.
Article 2(5) of the EU Securitisation Regulation defines “sponsor” to mean “a credit institution, whether located in the Union or not, as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013, or an investment firm as defined in point (1) of Article 4(1) of Directive 2014/65/EU other than an originator, that:

a) establishes and manages an asset-backed commercial paper programme or other securitisation that purchases exposures from third-party entities, or

(b) establishes an asset-backed commercial paper programme or other securitisation that purchases exposures from third-party entities and delegates the day-to-day active portfolio management involved in that securitisation to an entity authorised to perform such activity in accordance with Directive 2009/65/EC, Directive 2011/61/EU or Directive 2014/65/EU”.

Directive 2014/65/EU.

The Securitisation Onshoring Regulations define “sponsor” to mean “a credit institution, whether located in the Union or not, as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013, or an investment firm as defined in paragraph 1A of Article 2 of Regulation 600/2014/EU, whether located in the United Kingdom or in a third country, which:

(a) is not an originator; and

(b) either:

(i) establishes and manages an asset-backed commercial paper programme or other securitisation that purchases exposures from third-party entities; or

(ii) establishes an asset-backed commercial paper programme or other securitisation that purchases exposures from third party entities and delegates the day-to-day active portfolio management involved in that securitisation to an entity which is authorised to manage assets belonging to another person in accordance with the laws of the country in which the entity is established”.


See Article 46(e) of the EU Securitisation Regulation.


In summary, the revised Article 29 in the Securitisation Onshoring Regulations provides as follows:

(a) the PRA will supervise compliance with the due diligence obligations in Article 5 by institutional investors which are insurance or reinsurance undertakings (Article 29(1)(a)) or which are CRR firms which are PRA-authorised persons (Article 29(1)(e)(i));

(b) the FCA will supervise compliance with the due diligence obligations in Article 5 by institutional investors which are AIFMs (alternative investment fund managers) which market or manage AIFs (alternative investment funds) in the UK (Article 29(1)(b)), management companies, UCITS (undertakings for collective investment in transferable securities) which are authorised open ended investment companies (Article 29(1)(c)), and CRR firms which are not PRA-authorised persons (Article 29(1)(e)(ii));

(c) the Pensions Regulator will supervise compliance with the due diligence obligations in Article 5 by institutional investors which are occupational pension schemes (Article 29(1)(d));

(d) the PRA will supervise compliance by sponsors which are PRA-authorised persons with Articles 6, 7, 8 and 9, and the FCA will supervise compliance by sponsors which are not PRA-authorised persons with such Articles (Article 29(2));
(e) with respect to compliance with Articles 6, 7, 8 and 9 by originators, original lenders or SSPEs, where such entities are insurance undertakings, reinsurance undertakings, AIFMs, management companies, UCITS which are authorised open ended investment companies, institutions for occupational retirement provision and CRR firms, they will be supervised by the PRA if they are PRA-authorised persons, by the Pensions Regulator if they are institutions for occupational retirement provision and in any other case will be supervised by the FCA (Articles 29(3) and (3A)); and

(f) with respect to compliance with Articles 6, 7, 8 and 9 by originators, original lenders or SSPEs which are not any of the entities referred to in paragraph (e), the Treasury is required to designate competent authorities to supervise compliance.

The terms “insurance undertaking”, “reinsurance undertaking”, “CRR firm”, “PRA-authorised person”, “AIF”, “AIFM”, “management company”, “UCITS”, “authorised open ended investment company” and “occupational pension scheme” are defined in the Securitisation Onshoring Regulations.

The EBA published draft regulatory technical standards in relation to risk retention on 31 July 2018. The previous technical standards put in place under the CRR regime apply in the interim period.

ESMA published a revised draft of regulatory technical standards in relation to the information required to be disclosed and implementing technical standards in relation to the required templates to be used for reporting such information, on 31 January 2019.


The EU Securitisation Regulation – Where Are We Now?

MERRYN CRASKE

The EU Securitisation Regulation1 (the “Securitisation Regulation”) has been applicable since 1 January 2019. The purpose of this Legal Update is to summarise the key aspects of the Securitisation Regulation and related developments up to this time.

Overview

The Securitisation Regulation covers two main areas. Firstly, it sets out provisions in relation to all securitisations which are within the scope of the regulation, consolidating and adding to the rules that previously applied to particular types of regulated entities. These provisions include requirements for securitisation special purpose entities (“SSPEs”), due diligence, risk retention and transparency obligations, credit-granting standards and a ban on resecuritisation, together with the relevant definitions. Secondly, the regulation sets out the criteria and other rules for simple, transparent and standardised (“STS”) securitisations. In addition, the regulation includes provisions dealing with sanctions and penalties for non-compliance, supervision by regulatory authorities, when securitisations entered into before 1 January 2019 would fall within its scope and transitional arrangements.

Development of the Regulations

The Securitisation Regulation was published at the end of December 2017 after a long period of discussion and consultation. A separate regulation2 (the “CRR Amending Regulation”, and together with the Securitisation Regulation, the “EU Securitisation Regulations”) amending certain securitisation-related provisions of the EU Capital Requirements Regulation (the “CRR”)3 was also published at the same time. The CRR Amending Regulation amends the CRR in order to implement a revised hierarchy of approaches for EU banks to use in calculating their regulatory capital requirements for credit exposures to securitisations and to provide lower capital requirements for STS securitisations than for non-STS securitisations. Together with the related secondary legislation, the EU Securitisation Regulations represent a comprehensive revision of the regulatory framework for securitisation in the EU.
Below is a summary of some of the key developments leading up to the EU Securitisation Regulations.

In May 2014, the Bank of England and the European Central Bank published a Discussion Paper entitled “The case for a better functioning securitisation market in the European Union”. In November 2014, the European Commission (the “Commission”), in a published communication to other EU authorities on an investment plan for Europe, indicated that it wanted to revive high quality securitisation markets, without repeating mistakes made before the financial crisis, in order to develop the secondary market, attract a wider investor base and improve the allocation of finance; to do so, it envisaged establishing criteria for simple, transparent and consistent securitisation. That Commission communication was followed, in February 2015, by a Green Paper on capital markets union, in which the Commission stated that it would develop proposals to encourage high-quality securitisation, as part of this project. At the same time, the Commission published a consultation document on establishing a framework for STS securitisation, in which it recognised that securitisation had an important role to play as a funding source and as a method of reallocating risk in the financial markets, and raised a number of questions, including with respect to criteria for identifying high quality securitisations, the harmonisation of the securitisation market and making capital requirements for securitisations more risk-sensitive.

At the international level, as part of Basel III, the Basel Committee on Banking Supervision (“BCBS”) published the revised Basel securitisation framework in December 2014, setting out a revised hierarchy of approaches for the regulatory capital treatment of securitisation transactions, and amended it in July 2016 to include alternative capital treatment for “simple, transparent and comparable” (“STC”) securitisations (the “Revised Basel Securitisation Framework”). The Revised Basel Securitisation Framework includes preferential capital treatment for securitisations which meet the STC criteria, and was supplemented in May 2018 by papers setting out STC criteria and capital treatment for short-term securitisations (i.e. transactions funded via ABCP conduits).

On 30 September 2015, the Commission published its proposals for the EU Securitisation Regulations. These were followed on 30 November 2015 by revised proposals with amendments from the Council of the European Union (the “Council”). The revised proposals were considered in detail by the European Parliament (the “Parliament”) and, following draft reports from parliamentary rapporteurs, further proposed amendments from MEPs and detailed negotiations, the Parliament published reports on 19 December 2016 setting out its compromise amendments to the proposals.

In 2017, the Commission, the Council and the Parliament engaged in a “trilogue” process to agree a common position. Some of the proposed amendments which had caused particular concern for market participants...
were removed or modified and revised draft texts of the EU Securitisation Regulations were agreed in May 2017. Further technical revisions were made during the “jurist-linguist process”, together with (unusually for this late stage in the process, and following concerns expressed by some market participants) some additional changes to the provisions on credit-granting with respect to self-certified residential mortgage loans, and revised texts were approved by the European Parliament on 26 October 2017 and by the Council on 20 November 2017. The EU Securitisation Regulations were published in the Official Journal on 28 December 2017. They came into force on 17 January and have been applicable since 1 January 2019, subject to certain transitional provisions in the Securitisation Regulation for legacy securitisations, as discussed further below.

Key Terms

The Securitisation Regulation has adopted and revised the main securitisation-related definitions which were set out in the CRR and has added some new definitions. Key definitions include the following:

- **Securitisation**: The definition of “securitisation” in the Securitisation Regulation is based on the broad definition in the CRR, which itself was based on the Basel II risk-based capital framework. It refers a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having certain specified characteristics. This means that the Securitisation Regulation has a very broad reach and covers many private and bilateral transactions even where no securities are issued. The Securitisation Regulation adds a new limb to the definition in order to exclude transactions which are used to finance or operate physical assets and classed as “specialised lending” under the CRR.

- **Tranche**: The Securitisation Regulation also carries over the CRR definition of “tranche”, as well as “first loss tranche,” without significant changes. The latter term is used in option (d) of the possible methods of risk retention.

- **Originator**: The Securitisation Regulation adopts the definition of “originator” from the CRR without significant changes. The wording refers to any “entity” which meets the definition, without any reference to the jurisdictional scope.

- **Sponsor**: The definition of “sponsor” has been amended (a) to confirm that any credit institution (as defined in the CRR) may be a “sponsor” whether or not it is established in the EU, (b) to provide that any investment firm, as defined in MiFID (and not only an investment firm subject to regulation under the CRR)
can be a “sponsor”, and (c) to expressly include an entity that otherwise qualifies as a sponsor and delegates day-to-day portfolio management activity to another entity authorised to perform that activity. Although certain provisions of the Securitisation Regulation use the term as if every securitisation had a “sponsor”, it is applicable only in the context of “an asset-backed commercial paper programme or other securitisation that purchases exposures from third-party entities”.

- **Institutional investor**: There is a new definition of “institutional investor” which encompasses credit institutions, investment firms, insurance and reinsurance undertakings, alternative investment fund managers (“AIFMs”), undertakings for collective investment in transferable securities (UCITS) and regulated pension funds and management companies. These entities are subject to the due diligence requirements in Article 5 of the Securitisation Regulation. They include the types of entities which were subject to investor due diligence and “indirect” risk retention requirements under the CRR, the AIFM Regulation and Solvency II as well as UCITS and pension fund investors which were not covered by the previous regulations.

- **SSPE**: The definition of “SSPE” has been amended, among other things, to exclude “an originator or sponsor”. Under Article 4 of the Securitisation Regulation, an SSPE may not be established in certain third countries which are listed as high risk and non-cooperative by the Financial Action Task Force or which have not signed an agreement with a Member State with respect to compliance with certain tax matters.

- **Resecuritisation**: The Securitisation Regulation, like the CRR and Basel II.5, defines “resecuritisation” as “securitisation in which at least one of the underlying exposures is a securitisation exposure”. It omits the previous wording requiring that “the risk associated with an underlying pool of exposures is tranched”. This wording was redundant because the definition of “securitisation” already includes the notion of credit risk tranching. The Securitisation Regulation also omits recitals from Basel II.5 and the CRR which discussed the application of the definition to ABCP programmes and have been helpful to market participants more generally in applying this very broad definition.

### Scope

### GENERAL

Article 1(2) of the Securitisation Regulation sets out the scope of the regulation, stating that it applies to institutional investors, originators, sponsors, original lenders and SSPEs. However, it does not set out the jurisdictional scope. The definitions of originator and original lender are not restricted to EU entities. While the definition of sponsor has been amended to clarify that it includes non-EU credit institutions, it does not state that it extends to non-EU investment
firms and it is hoped that this will be clarified. Our view is that the Securitisation Regulation’s regulatory mandates in principle apply directly only to entities that are established in the EU, except in the circumstances described in the next paragraph.

**ARTICLE 14 OF THE CRR**

One particular issue which has arisen with respect to the jurisdictional scope of the Securitisation Regulation relates to Article 14 of the CRR, as amended by the CRR Amending Regulation. That article previously provided that obligations under Part Five of the CRR (which included the previous risk retention and due diligence rule for credit institutions and investment firms, together with related credit granting standards and transparency requirements for those institutions) were to be applied on a consolidated basis to entities that were subject to “consolidated supervision” with an EU institution subject to regulation under the CRR. Article 1(11) of the CRR Amending Regulation repealed Part Five and provides that references to Part Five of the CRR are to be read as references to Chapter 2 of the Securitisation Regulation, which is much broader, since Chapter 2 not only includes provisions corresponding to Part Five of the CRR, but also adds a “direct” risk retention requirement, additional provisions on credit granting and selection of assets, and much more detailed and prescriptive due diligence and transparency requirements as well as a ban on resecuritisation. Under the amended Article 14, all those provisions could in principle have applied to non-EU consolidated affiliates of CRR institutions, even if the relevant securitisation has no other connection with the EU.

The regulatory technical standards (“RTS”) under Part Five, set out in Regulation (EU) No 625/2014 (the “CRR Part Five RTS”), include a materiality provision which provides some flexibility with respect to risk retention in relation to trading book activities of non-EU affiliates of EU institutions. That wording has been carried across in the final draft RTS in relation to risk retention published by the EBA on 31 July 2018 (the “Draft Risk Retention RTS”) with respect to Article 5 of the Securitisation Regulation. Following concern from market participants, EU lawmakers have adopted an amendment to the CRR (as part of the “CRR II/CRD V” package) which limits the application of Article 14 of the CRR to Article 5 of the Securitisation Regulation, and this amendment will apply from 27 June 2019. Pending this amendment, the EBA, together with the European Securities and Markets Authority (“ESMA”) and the European Insurance and Occupational Pensions Authority (“EIOPA”; together with ESMA and the EBA, the “ESAs”) also recognised the issue in a joint statement published on 30 November 2018 (the “ESAs Joint Statement”), in which they stated that they expected competent authorities to apply their risk-based supervisory powers in their enforcement of the legislation in a proportionate manner, taking into account the then proposed changes to the scope of Article 14.
STS EU ONLY
Jurisdictional scope is specified with respect to STS securitisations. A transaction can only qualify as STS if the originator, sponsor and SSPE are established in the EU, meaning that any securitisation in which any of those parties is not established in the EU cannot be STS. In the case of an STS ABCP programme, each of those parties to each of the transactions within that ABCP programme would have to be established in the EU. Following Brexit, a securitisation that meets all other STS criteria but has a UK originator or SSPE may not qualify as STS in the EU.

Due Diligence
Under Article 5 of the Securitisation Regulation, an institutional investor (other than the originator, sponsor or original lender) is required (a) prior to holding a securitisation position, to verify compliance with credit granting standards and the risk retention and transparency requirements, (b) prior to holding a securitisation position, to carry out a due diligence assessment which enables it to assess the risks involved, and (c) while holding a securitisation position, to establish and perform ongoing monitoring, stress tests and internal reporting and recording.

An institutional investor may delegate its due diligence obligations to an investment manager, who would become subject to the applicable sanctions and/or remedial measures which may be imposed by the relevant supervisory authority in the applicable Member State if it fails to fulfil such obligations, instead of the institutional investor.

VERIFICATION OF COMPLIANCE WITH CREDIT GRANTING STANDARDS AND RISK RETENTION AND TRANSPARENCY REQUIREMENTS
In relation to verifying compliance with credit granting standards, where either (a) the originator or original lender is established in the EU and is not a credit institution or an investment firm, or (b) the originator or original lender is established in a third country, the institutional investor must verify that “the originator or original lender has granted all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply those criteria and processes”. Where the originator or original lender is established in the EU, the institutional investor must verify that credit granting standards are met “in accordance with Article 9(1) of the Securitisation Regulation” (as summarised further below), while in the case where the originator or original lender is established in a third country, the standard is “to ensure that credit-granting is based on a thorough assessment of the obligor’s creditworthiness”. In many cases, the information required by institutional investors will not be much different from the information provided under the previous regime, although some institutional investors may require more information from non-EU originators, sponsors and original lenders than such parties would otherwise expect to provide, as they are not directly subject to the same credit granting
requirements. In the case of a fully-supported ABCP programme, the programme sponsor, rather than institutional investors holding ABCP, must verify compliance by originators and original lenders with credit-granting criteria in accordance with Article 9(1). Where the originator or original lender is established in the EU and is a credit institution or investment firm, it will be subject to credit granting standards under Article 9(1) and, apparently, an institutional investor will not be required to verify compliance.

In relation to verifying compliance with the risk retention requirements, the due diligence requirement corresponds to the “indirect” risk retention requirements set out in the CRR and the AIFM Regulation (the “AIFM Regulation”). However, unlike the CRR and the AIFM Regulation, the Securitisation Regulation requires institutional investors not just to obtain disclosure from the originator, sponsor or original lender that it retains a material net economic interest, but to verify that the relevant party retains such an economic interest and discloses that retention. As with the required verification of compliance with the credit granting standards, Article 5(1) of the Securitisation Regulation distinguishes between risk retention by entities established in the EU (where the net economic interest must be retained “in accordance with Article 6” and disclosed “in accordance with Article 7”) and by entities established in a third country (where the net economic interest must be “determined in accordance with Article 6” and disclosed to institutional investors).

Investors may find this requirement burdensome and difficult to comply with in practice.

While the jurisdictional scope of the due diligence requirements is not clear, the words “where applicable” could be read as implying that it is not necessary to verify compliance with the Article 7 transparency requirements in all cases, for example, in a situation where none of the originator, sponsor and SSPE is established in the EU and where the Article 7 transparency requirements are not directly applicable to them. However, we are aware of different views in the market on this point.

DUE DILIGENCE ASSESSMENT

In addition to verifying whether the credit granting standards, risk retention requirements and disclosure obligations have been complied with, the institutional investor must carry out a due diligence assessment in relation to the transaction, considering at least:

a. the risk characteristics of the securitisation position and the underlying exposures;

b. the structural features that can materially impact the performance of the securitisation position, including the priorities of payment, priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers and
the definitions of default; and

c. with respect to an STS securitisation, the 
compliance of the securitisation with the 
applicable STS requirements. The institu-
tional investor may rely “to an appropriate 
extent” on the STS notification and on the 
information disclosed by the originator, 
sponsor and SSPE, without solely or 
mechanistically relying thereon.

The requirements set out in paragraphs (a) 
and (b) above will be familiar to many investors 
as they are based on the previous rules in the 
CRR and the AIFM Regulation. In the case of 
an institutional investor in commercial paper 
issued by a fully supported ABCP 
programme,45 instead of the matters set out in 
(a) and (b), the investor is required to consider 
the features of the ABCP programme and the 
full liquidity support.46

ONGOING REQUIREMENTS

Written procedures should be established for 
ongoing monitoring of compliance with the 
applicable requirements and where relevant, 
this should including monitoring of exposure 
type, percentage of loans more than 30, 60 
and 90 days past due, default rates, 
prepayment rates, loans in foreclosure, 
recovery rates, repurchases, loan 
modifications, payment holidays, collateral 
type and occupancy, frequency distribution of 
credit scores, industry and geographic 
diversification and frequency distribution of 
loan to value ratios.

Stress tests are also required. For 
securitisations other than a fully supported 
ABCP programme, the stress tests need to be 
on the cash flows and collateral values 
supporting the underlying exposures, or in the 
absence of sufficient data, on the loss 
assumptions, having regard to the nature, 
scale and complexity of the risk of the relevant 
securitisation position. In the case of a fully 
supported ABCP programme, the stress tests 
need to be carried out with respect to the 
solvency and liquidity of the sponsor.

Internal reporting to the institutional investor’s 
management body is required to ensure that 
it is aware of the material risks and that the 
risks are adequately managed.

The institutional investor must be able to 
demonstrate to its supervisors upon request 
that it has a comprehensive and thorough 
derstanding of the securitisation position 
and the underlying exposures and has 
implemented written policies and procedures 
for risk management of the securitisation 
position and for maintaining records, or in the 
case of exposures to a fully supported ABCP 
programme, it must be able to demonstrate 
to its supervisors upon request that it has a 
comprehensive and thorough understanding 
of the credit quality of the sponsor and of the 
terms of the liquidity facility.

The ongoing requirements are based on those 
in Article 406 of the CRR and the 
corresponding provisions of the AIFM 
Regulation, and also have some similarities 
with the relevant provisions of the Delegated 
Regulation in relation to the Solvency II 
Directive47 (the “Solvency II Regulation”).
Risk Retention

Under Article 6 of the Securitisation Regulation, the originator, sponsor or original lender is required to retain on an ongoing basis a material net economic interest in a securitisation of not less than 5%. Under the previous risk retention rules, the onus was on the applicable investor to obtain disclosure that the risk retention requirements had been met. The Securitisation Regulation imposes this new “direct” obligation on the originator, sponsor or original lender to retain the minimum net economic interest, while keeping the “indirect” risk retention obligations on institutional investors to verify risk retention as part of their due diligence requirements under Article 5.

The Securitisation Regulation states that there are to be no multiple applications of the retention requirements (as in the previous rules under the CRR and the AIFM Regulation). The material net economic interest may not be split between different types of retainers (as in the CRR Part Five RTS and the Solvency II Regulation) and may not be subject to any credit risk mitigation or hedging (as in the previous rules under the CRR, the AIFM Regulation and the Solvency II Regulation).

THE SOLE PURPOSE TEST

An entity will not be permitted to be an originator for purposes of the risk retention requirement if it has been established or operates for the sole purpose of securitising exposures. This follows a recommendation by the EBA in its reports of December 2014 (relating to the CRR) and April 2016 (which considered the Commission’s draft of the Securitisation Regulation of 30 December 2015) which identified a “loophole” in the definition of “originator”, whereby an originator SSPE could be established solely for the purpose of meeting the risk retention requirements, and could purchase a third party’s exposures and securitise them within one day, while which it met the legal definition of “originator” would not be within the spirit of the risk retention requirements. The Draft Risk Retention RTS contains further details of the principles that should be considered for the purpose of the sole purpose test.

METHODS OF RISK RETENTION

The required material net economic interest may be held in any of the following ways:

a. not less than 5% of the nominal value of each of the tranches sold or transferred to investors (known as a “vertical slice”);

b. in the case of revolving securitisations or securitisations of revolving exposures, retention of the originator’s interest of not less than 5% of the nominal value of each of the securitised exposures;

c. retention of randomly selected exposures, equivalent to not less than 5% of the nominal value of the securitised exposures, where the number of potentially securitised exposures is not less than 100 at origination;

d. retention of the first loss tranche, and if such retention does not amount to 5% of the nominal value of the securitised exposures, other tranches having the same or a more severe risk profile, and not having
an earlier maturity, than those transferred or sold to investors, resulting in a retention of not less than 5% of the nominal value of the securitised exposures; or

e. retention of a first loss exposure of not less than 5% of every securitised exposure in the securitisation.

The methods of retention are the same as in Article 405 of the CRR, except that paragraph (b) has now been expanded to include revolving securitisations (which under Article 405(1) of the CRR were treated as covered by option (a) (vertical slice) pursuant to Article 5 of the CRR Part Five RTS). There is no “L-shaped” retention option as in the United States. Further details of how the methods of risk retention should be applied and the measurement of the retained interest are contained in the Draft Risk Retention RTS.

Market participants were relieved that the minimum risk retention percentage remains at 5%, since there had been proposals in the Parliament to increase the percentage to up to 10% with a possibility of adjusting it to a maximum of 20% in the future.

However, the Securitisation Regulation does provide for the European Systemic Risk Board (the “ESRB”) to publish reports, in collaboration with the EBA, when the ESRB considers necessary, or at least every 3 years, on the financial stability implications of the securitisation market, and these may include recommendations on whether the risk retention levels should be modified.

The retention may be satisfied on a consolidated basis (i.e. by any entity in the same consolidated group as the originator, sponsor or original lender) in the case of a mixed financial holding company, a parent institution or a financial holding company established in the EU, subject to meeting certain requirements. Otherwise, retention on a consolidated basis is not permitted.

The jurisdictional scope of the risk retention requirements in Article 6 is not specified. The introduction to the original draft of the Securitisation Regulation by the Commission indicated that where none of the originator, sponsor or original lender is established in the EU the indirect approach would continue to apply, suggesting that the direct approach would not apply in this situation. Although this wording has not been not carried across, we believe the logical interpretation, based on general principles and practical limitations, is that the direct risk retention requirements should not apply to non-EU originators, sponsors and original lenders. This interpretation is supported by the EBA’s analysis of responses to the previous consultation in the Draft Risk Retention RTS, where the EBA stated that although the jurisdictional scope of the “direct” retention obligation relates to a general interpretation issue in relation to the Securitisation Regulation and is outside the scope of the Draft Risk Retention RTS, they agreed that a “direct” obligation should apply only to originators, sponsors and original lenders established in the EU. However, because of the due diligence obligations that apply to EU institutional investors under Article 5 of the Securitisation Regulation, in practice non-EU originators,
sponsors and original lenders will still need to ensure that there has been risk retention in accordance with the Securitisation Regulation in order for those EU institutional investors to comply with their due diligence obligations.

At the time of writing, the Draft Risk Retention RTS have not yet been approved and this is now expected to take place later in 2019.

Selection of Assets

Under Article 6(2) of the Securitisation Regulation, originators are not permitted to select assets for the securitisation with the aim of rendering losses on the assets, measured over the life of the transaction up to a maximum of 4 years, higher than the losses over the same period on comparable assets which remain on the originator’s balance sheet. If the performance of the transferred assets is found to be significantly lower than the retained assets, sanctions may be imposed in the event of intentional breach by the originator. This wording is less onerous than the original Parliament proposal, which would have measured losses on securitised assets against losses on retained assets over a one year period and did not take into account the intent of the originator.

The Draft Risk Retention RTS provide that assets may be selected for securitisation with a higher than average risk profile than retained assets as long as this is clearly communicated to investors and competent authorities in advance. In addition, the originator can show that it has not intentionally breached the restrictions on adverse selection of assets if it has established and applied appropriate policies and procedures to ensure than the securitised assets would not reasonably be expected to lead to higher losses than comparable retained assets. However, the restrictions on adverse selection may still raise concerns for originators who may have to prove that they had not deliberately cherry-picked assets with a higher risk of default for the securitisation.

Transparency

DISCLOSURE OBLIGATIONS

The originator, sponsor and SSPE of a securitisation are required under Article 7 of the Securitisation Regulation to make the following information available to the holders of a securitisation position, the relevant competent authorities and, upon request, to potential investors:

a. information on the underlying exposures on a quarterly basis (or in the case of ABCP, on a monthly basis);

b. all underlying documentation that is essential for an understanding of the transaction, including the final offering document or prospectus and the main transaction documents. A detailed description of the priority of payments must be included in the documentation;

c. if the transaction does not have a prospectus complying with the Prospectus Directive, a summary of the transaction with the main features of the transaction,
including the structure, cash flows, waterfall, credit enhancement, liquidity, voting rights and all material triggers and events;

d. in the case of an STS transaction, notification that the securitisation is an STS transaction;

e. investor reports containing (i) all materially relevant data on credit quality and performance of the underlying exposures, (ii) trigger events for changes in the priority of payments or replacement of counterparties, and for non-ABCP transactions, data on the cash flows of the underlying exposures and the liabilities of the securitisation, and (iii) information regarding the risk retention and the method used;

f. inside information which is required to be made public in accordance with the EU Regulation on insider dealing and market manipulation (the “Market Abuse Regulation”); and

g. if paragraph (f) does not apply, any significant event such as a material breach of obligations, structural changes, a change in the risk characteristics, an STS securitisation ceasing to meet the STS requirements or any material amendment to the transaction documents.

In the case of ABCP, certain specified information is to be made available in aggregate form to holders of securitisation positions and, upon request, to potential investors. Loan level data is required to be made available to the sponsor, and upon request, to competent authorities. In Annex 1 (Transparency), found at https://www.mayerbrown.com/-/media/eusecuritisationregulation.pdf, we set out further details on what kinds of information have to be provided when and in what manner.

Originators, sponsors and SSPEs are required to comply with national and EU law in relation to confidential information and processing of personal data as well as confidentiality obligations relating to information relating to the customer, original lender or debtor, unless such confidential information is anonymised or aggregated. This wording was included due to concerns from market participants about potential breaches of confidentiality obligations and data protection laws. However, despite that, the Securitisation Regulation states that competent authorities can request the applicable confidential information. It is also unclear whether commercial terms, e.g. fees and interest rates, can be excluded/redacted.

The originator, the sponsor and the SSPE of a securitisation are required to designate one entity among them to fulfil the disclosure requirements and such entity is required to make such information available by means of a securitisation repository, or if no securitisation repository has been registered, by means of a website that meets certain requirements.

In the case of private securitisations (i.e. those where no prospectus is required to be published in accordance with the Prospectus...
Directive), the requirement to disclose such information by way of a repository or a website is disapplied, but the relevant information must still be disclosed. Market participants had hoped for a more extensive carve-out from the disclosure requirements for private transactions, given that investors in such transactions typically have direct access to the originator and sponsor, if any, and can request whatever information they require, but private transactions remain in scope, including the obligation to report the relevant information in the form of the applicable templates.

The jurisdictional scope of the transparency requirements is not stated but our view is that they should not be directly applicable to non-EU originators and sponsors. However, non-EU entities may be in practice be asked by EU institutional investors to provide the relevant information if and to the extent that those investors determine that it is necessary in order to comply with their due diligence obligations under Article 5, as discussed above.

TECHNICAL STANDARDS AND REPORTING TEMPLATES

The Securitisation Regulation requires ESMA to develop RTS to specify the requirements for the information on the underlying exposures and the investor reports, and implementing technical standards (“ITS”) with respect to the format of the information to be provided, by way of standardised reporting templates. On 19 December 2017 ESMA published a Consultation Paper with respect to the draft RTS and ITS, and this was followed by draft RTS and ITS on 22 August 2018. Market participants had a number of questions and concerns on those draft RTS and ITS, particularly around the templates for ABCP securitisations, the limited availability of so-called “No Data” options, and the application of the templates to private securitisations. The Commission notified ESMA, in a letter dated 30 November 2018, that it would only endorse the draft RTS and ITS once certain amendments were made and requesting it to consider extending the use of the “No Data” options particularly with respect to the ABCP templates. Following this, ESMA published an Opinion on 31 January 2019, including revised RTS (the “Draft Transparency RTS”) and ITS, and a Q&A document intended to provide guidance on the completion of the templates. An updated version of the Q&A document was published by ESMA on 27 May 2019. While the “No Data” options have been extended, market participants still have a number of questions and concerns in connection with the draft templates. At the time of writing, the revised RTS and ITS have not yet been adopted by the Commission and they are expected to be finalised later in 2019.

In the meantime, Article 43(8) of the Securitisation Regulation provides that until the new transparency RTS have been adopted and become applicable, the relevant entities will be required to provide information in line with the requirements under Annexes I to VIII of the relevant Delegated Regulation relating to Article 8b of the Credit Rating Agencies.
Regulation in order to meet their obligations under Article 5(1)(a) and (e) (which deal with information on underlying exposures and investor reports). However, the so-called “CRA3 templates” are different from the forms expected to be required under Article 7, and have been published only for certain types of transactions (excluding, for example, private ABCP transactions and trade receivables securitisations). Although the regulation setting out the CRA3 templates was adopted in 2014 and was to become applicable in 2017, these templates had not been used in line with CRA3, as the website to be established by ESMA had not yet been set up. Some market participants find that using the CRA3 templates is not too difficult, since the templates are similar in form to those used for ECB and Bank of England liquidity purposes, but for some participants it would be onerous and costly to have to comply with the CRA3 templates and then amend their systems and reporting procedures again to apply with the new ESMA templates. In the ESAs Joint Statement, the ESAs recognised the “severe operational challenges” of complying with the CRA3 templates stated that they expected competent authorities to apply their supervisory powers in a proportionate and risk-based manner, taking into account the type and extent of information already being disclosed by reporting entities, considered on a case-by-case basis.

Ban on Resecuritisation

Article 8 of the Securitisation Regulation contains a ban on resecuritisation, stating that “the underlying exposures used in a securitisation shall not include any securitisation positions”. Investments in or other credit exposures to resecuritisations are in any event subject to punitive bank capital requirements under the CRR and following its amendment by the CRR Amending Regulation (the “Amended CRR”). Resecuritisations are also excluded from favourable treatment under the CRR liquidity coverage ratio (the “LCR”) (Level 2B securitisations) and the Solvency II insurance capital rules (Type 1 securitisations), they are subject to credit rating agency “rotation” requirements under the Credit Rating Agencies Regulation, and they are excluded from ABCP issued by ABCP programmes which is eligible for purchase by money market funds under the new EU Money Market Funds Regulation (the “Money Market Funds Regulation”). This provision, which was added by the Parliament, goes further by actually prohibiting such transactions.

There are exclusions from the ban on resecuritisation for certain specified purposes in relation to the winding up of a credit institution, investment firm or financial institution, ensuring the viability of any such entity to avoid its winding up, or the preservation of investors’ interests where underlying exposures are non-performing, and this list may be supplemented by certain RTS.
Helpfully, the Securitisation Regulation also states that fully supported ABCP programmes will not be resecuritisations provided that the individual transactions are not resecuritisations and there is not a second level of tranching at the programme level through the credit enhancement. This means that “partially supported” ABCP programmes generally will not be permitted. While it is unlikely that market participants will intentionally be structuring any transactions as resecuritisations, care should be taken to analyse complex structures to ensure that they would not be characterised as a resecuritisation, given the broad definition of “securitisation” in the Securitisation Regulation.

The ban on resecuritisation excludes any securitisation the securities of which were issued before 1 January 2019. We assume that this means that, for transactions where all securities have been issued before 1 January 2019, those transactions will be excluded from the ban on resecuritisation, so long as no further securities are issued on or after that date. If new securities are issued with respect to any legacy resecuritisation transactions after 1 January 2019, it is possible that both the new securities and any existing securities issued in the same programme and backed by the same pool of assets/transactions would be subject to the ban.

Article 8 does not state how or to whom the ban on resecuritisation applies or what consequences arise from violating the ban, and the jurisdictional scope is not specified. Other than the possibility of RTS to add to the list of exclusions from the ban on resecuritisation (which we do not expect to apply widely) there is no mandate for any RTS with respect to this Article. In the absence of clear legislation or guidelines, EU institutional investors would be advised to avoid investing in resecuritisation positions, even if the originator, sponsor and SSPE are established in third countries, and EU originators and sponsors should avoid creating resecuritisations.

Criteria for Credit Granting

Article 9 of the Securitisation Regulation sets out criteria for credit granting for originators, sponsors and original lenders. Under Article 9(1), such entities are required to apply to securitised exposures the same sound and well-defined criteria which they apply to securitised exposures, as well as the same clearly established processes for approving, amending, renewing and refinancing credits. Credit-granting needs to be based on a thorough assessment of creditworthiness.

Under Article 9(2), with respect to residential loans made after the entry into force of the Mortgage Credit Directive (which requires the verification of information as to the borrower’s creditworthiness), the securitised pool may not include any loan that is marketed and underwritten on the basis that the borrower or any intermediary was made aware that the information provided by the borrower might not be verified by the lender. The prohibition of self-certified mortgage loans was originally included only in the STS
criteria, but in the final compromise text it was applied to all securitisations of residential loans. This caused concern for some market participants since it would have affected existing securitisations which included self-certified mortgage loans in their securitised asset pools and which would otherwise be refinanced from time to time after the effective date of the Securitisation Regulation. As a result of this concern, the wording of the final text was amended to apply only to the applicable residential loans made after the date of entry into force of the Mortgage Credit Directive, i.e. after 20 March 2014. However, the Mortgage Credit Directive was not required to be incorporated into the national laws of the Member States until 21 March 2016. Consequently, it appears that any self-certified loans which were originated between those two dates may not be securitisable.

Under Article 9(3), originators who purchase exposures for their own account and then securitise them (under “limb (b)” of the originator definition) must check that the entity that was involved in the original agreement relating to the exposures has fulfilled the credit granting requirements. There is an exception to this, where the original agreement which created the obligations was entered into before the entry into force of the Mortgage Credit Directive and the originator that purchases and securitises the exposures meets the credit standard that applied to originator institutions under Article 21(2) of the CRR Part Five RTS. That standard requires an originator to apply the same sound and well-defined credit granting criteria as it applies to non-securitised exposures. However, the Article 9(3) requirement could prove difficult for “limb (b)” originators to comply with in practice.

**STS Securitisations**

The Securitisation Regulation provides for securitisations to be designated as STS if they meet all the relevant requirements. If a securitisation is designated as STS and also meets several additional criteria under the Amended CRR, an EU regulated bank that invests in or otherwise takes credit exposure to that securitisation will have a lower capital charge for that exposure than would otherwise apply under the Amended CRR. A transaction qualifying as STS (and for Solvency II and the LCR meeting other criteria) will also benefit from lower capital requirements for insurance and reinsurance undertakings subject to regulation under Solvency II, will be eligible for inclusion in high quality liquid assets by banks for the purposes of the LCR, will be eligible for investment by money market funds subject to the Money Market Funds Regulation and may also benefit from other relatively favourable regulatory treatment. The STS regime is thus meant to encourage EU institutional investors to invest in securitisations and so to foster the growth of a healthy securitisation market.
THE STS CRITERIA

There are separate STS requirements for non-ABCP securitisations and for ABCP securitisations.

For non-ABCP securitisations, the Securitisation Regulation contains separate Articles setting out detailed criteria with respect to simplicity, standardisation and transparency.\textsuperscript{78}

For ABCP securitisations, there are separate requirements which must be met at transaction level, for the sponsor and at programme level.\textsuperscript{79} Except for certain specified requirements,\textsuperscript{80} in relation to which a maximum of 5% of the aggregate amount of the exposures may be “temporarily” non-compliant, all ABCP transactions within an ABCP programme must be STS in order for the programme to be considered STS.

The STS criteria and the additional CRR criteria for non-ABCP and ABCP securitisations are summarised and compared in Annex 2 (STS criteria and additional CRR criteria), found at https://www.mayerbrown.com/-/media/eusecuritisationregulation.pdf.

As mentioned previously, a securitisation can only be STS if the originator, sponsor and SSPE are established in the EU. This means that many multi-jurisdictional securitisations could not qualify as STS as they have originators outside the EU. In addition, transactions with UK entities will no longer be STS under the Securitisation Regulation after Brexit.\textsuperscript{81} It is possible that an equivalence regime will be introduced for third county originators, sponsors and SSPEs at some point in the future, but this is not certain and may not happen for some time.

The Securitisation Regulation requires the EBA to develop RTS specifying which underlying exposures shall be deemed to be homogeneous. The EBA published final draft RTS setting out the conditions for securitisations to be deemed to be homogeneous on 31 July 2018.\textsuperscript{82}

The EBA was also required to publish guidelines with respect to the STS criteria. The EBA published its final guidelines with respect to non-ABCP and ABCP securitisations on 12 December 2018 (the “STS Guidelines”)\textsuperscript{83} and these are expected to be very useful in interpreting the STS criteria.

The complexity, number of requirements, restrictiveness and, in many cases, lack of clarity of the STS criteria, as well as the notification obligations (as discussed below) and the severity of the penalties for non-compliance, may limit the extent to which market participants will want or be able to make use of the STS criteria. This is particularly the case for multi-seller ABCP programmes, where the requirements are much more extensive than for investment in ABCP by money market funds under the Money Market Funds Regulation.\textsuperscript{84} However, a number of STS transactions have been established and we understand that others are in progress.
**STS NOTIFICATION**

The originator and sponsor have a joint obligation to notify ESMA where a transaction meets the STS requirements. In the case of an ABCP programme, the obligation to notify, both with respect to the programme and the transactions within it, falls upon the sponsor. Notification will need to be made using the prescribed template and will need to include an explanation of how each of the applicable STS criteria have been complied with.

ESMA is required to maintain a list of all STS transactions on its official website.

The originator and sponsor are required to notify ESMA if a securitisation is no longer STS-compliant.

The Securitisation Regulation mandates ESMA to develop RTS setting out the information required in the STS notification and ITS setting out the templates.

**THIRD PARTY VERIFICATION AGENTS**

Authorised third parties may be used to verify STS compliance. While the use of a third party verification agent may be very helpful, this will not absolve the originator, sponsor and SSPE from liability with respect to their obligations under the Securitisation Regulation. Third party verification agents will need to be authorised by the applicable competent authority and will need to meet certain conditions set out in Article 28 of the Securitisation Regulation as supplemented by the applicable RTS.

**Administrative Sanctions and Remedial Measures**

Article 32 of the Securitisation Regulation requires EU member states to put in place rules establishing administrative sanctions and remedial measures for failure to comply with certain breaches of the Securitisation Regulation. The administrative sanctions would only apply in the case of negligence or intentional infringement. The relevant administrative sanctions and measures would apply in the case of failure to comply with the risk retention, transparency and credit-granting criteria. In the case of securitisations designated as STS, they could also be imposed for failure to meet the STS requirements, making a misleading notification, failure to provide notification that a securitisation no longer meets the STS requirements or if an authorised third party has failed to provide notification of changes to the information it has provided in order to be authorised. The administrative sanctions and remedial measures are required to be effective, proportionate and dissuasive, and should as a minimum include the power to make public statements in relation to the infringement, orders to cease and desist from the applicable conduct, temporary bans on individuals carrying out management functions, temporary bans on making STS notifications for failure to meet the STS requirements or making a misleading notification as to STS compliance and maximum fines of at least €5 million (including...
for individuals) or up to 10% of total annual net turnover. Member states may also (but are not required to) impose criminal sanctions in addition to, or instead of, such administrative sanctions and remedial measures.

Article 32 does not include penalties for breach of Article 5 by institutional investors. However, the new Article 270a of the Amended CRR provides that an additional risk weight will be imposed where the requirements of Chapter 2 of the Securitisation Regulation are not met in any material respect, which will result in an increase in the regulatory capital which would need to be held against the applicable securitisation position. The additional risk weight is required to be a proportionate additional risk weight of no less than 250% of the risk weight, capped at 1,250%, and such additional risk weight will progressively increase with each subsequent infringement of the due diligence and risk management provision.

Application Date, Secondary Legislation, Further Measures and Transitional Provisions

Application Date

The Securitisation Regulation is directly effective in EU Member States without the need for any implementing legislation and has been applicable to the relevant transactions from the application date of 1 January 2019. It applies to securitisations the securities of which are (or have been) issued on or after 1 January 2019. In the case of securitisations which do not involve the issuance of securities, the Securitisation Regulation states that references to “securitisations the securities of which are been issued” shall be deemed to mean “securitisations the initial securitisation positions of which are created”, but adds a proviso that the Securitisation Regulation “applies to any securitisations that create new securitisation positions on or after 1 January 2019”. It remains unclear how this proviso should be interpreted, as well as what could constitute the creation of a new securitisation position, and, in our experience, market participants appear to be taking a cautious approach, giving a narrow application to grandfathering and a wide interpretation to the events that cause the Securitisation Regulation to apply.

Consequently, while in many cases pre-2019 securitisation transactions will be grandfathered, in many situations they may end up falling within the scope of the Securitisation Regulation. For example, legacy transactions with new issuances will fall within scope even though such transactions were established before the new rules came into effect. Master trust programmes, in which a single issuer issues different series of securities from time to time backed by the same revolving pool of underlying exposures, are understood to be subject to the Securitisation Regulation once they issue a new series after the SR application date. In the case of ABCP programmes, even though
underlying transactions may be grandfathered, Securitisation Regulation requirements apply at the programme level from the date of the first issuance of ABCP following the application date.

SECONDARY LEGISLATION
As mentioned above, the Securitisation Regulation also provides for secondary EU legislation in the form of RTS, ITS, delegated acts or guidelines, and the fact that many of these are not yet in place makes compliance more challenging for the securitisation industry. We have set out in Annex 3 (Technical standards, guidelines and delegated acts pursuant to the Securitisation Regulation), found at https://www.mayerbrown.com/-/media/eusecuritisationregulation.pdf, a table setting out the various pieces of secondary legislation in relation to the Securitisation Regulation. This secondary legislation, once finalised and adopted, will provide some much-needed clarification on certain aspects of the new regulatory regime, but there will remain many questions which will need to be resolved, and it is likely that there will need to be further discussions with the regulators on these points. In the meantime, market practice is developing gradually. For UK entities, the application of the Securitisation Regulation after Brexit will need to be considered.

TRANSITIONAL MEASURES
As regards due diligence requirements, in the case of securitisations the securities of which were issued on or after 1 January 2011 but before 1 January 2019, and in the case of securitisations where the securities were issued before 1 January 2011 where new exposures have been added or substituted after 31 December 2014, the due diligence requirements under the CRR, the AIFM Regulation or the Solvency II Regulation (as applicable), in the versions applicable on 31 December 2018, will apply.

For the risk retention requirements, in the case of securitisations the securities of which were issued before 1 January 2019, credit institutions, investment firms, insurance and reinsurance firms and AIFMs are required to comply with the risk retention requirements in the CRR, the AIFM Regulation or the Solvency II Regulation (as applicable) in the versions applicable on 31 December 2018. In the case of the direct risk retention requirements under Article 6 of the Securitisation Regulation, originators, sponsors and original lenders are required to apply the rules set out in the CRR Part Five RTS with respect to securitisations which fall within the scope of the Securitisation Regulation until the new risk retention RTS apply (even though the previous rules relate to the “indirect” approach).

With respect to the transparency requirements, Article 43(8) of the Securitisation Regulation provides that until the applicable RTS have been adopted, originators, sponsors and SSPEs will be required to provide the information referred to in Articles 7(1)(a) and (e) in line with the requirements under Article 8b of the Credit Rating Agencies Regulation and the relevant Delegated Regulation, as described above.
With respect to eligibility for STS treatment, Article 43(3) of the Securitisation Regulation provides transitional rules to allow non-ABCP legacy transactions to be considered STS provided that they met certain of the STS requirements at the time of issuance and certain other STS requirements at the time of notification. However, this does not extend to ABCP transactions or programmes.

FURTHER MEASURES
The Joint Committee of the ESAs is required to publish reports by 1 January 2021 and every three years after that on certain matters, including the implementation of the STS requirements, material risks that may have materialised, due diligence, transparency and risk retention.

In addition, the European Commission must publish a report by 1 January 2022 on matters such as the effects of the Securitisation Regulation, the securitisation market, the methods of risk retention, disclosure and the possibility of an equivalence regime with respect to STS securitisations for originators, sponsors and SSPEs in third countries.

Furthermore, the EBA, in cooperation with ESMA and EIOPA, is required to publish a report by 2 July 2019 on the feasibility of establishing a framework to allow balance sheet synthetic securitisations to be considered STS.81

Conclusion
The Securitisation Regulation introduces some fundamental changes to the securitisation market. While the risk retention requirements are largely unchanged, there will be a large additional burden on securitisation transactions in other respects, particularly as regards the transparency requirements. In addition, the extent to which investors will make use of the STS regime remains to be seen. There are many outstanding questions to be resolved on the interpretation of the Securitisation Regulation, and many of the secondary regulations, even if in substantially final form and not likely to change, have not yet been adopted or become applicable. While these issues pose challenges for originators and sponsors as well as investors in the securitisation market, market participants are gradually working through these challenges and adjusting their practices to the new system.
Endnotes


11 These included increased risk retention requirements, a proposal that investors had to be “institutional investors”, i.e. certain kinds of regulated entities, a proposal that at least one of the originator, sponsor or original lender had to be a regulated entity as defined in Article 2(4) of Directive 2002/87/EC (i.e. a credit institution, insurance undertaking or investment firm), requirements for investors to disclose information about the size of their investment and to which tranche of the securitisation it related, and a provision allowing for investigation of improper selection of assets if losses on securitised assets were significantly higher than losses on retained assets, without taking into account of the intent of the originator.

12 “‘securitisation’ means a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:

a. payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;

b. the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;

c. the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013.”

SR Article 2(1); cf. CRR Article 4(1)(61) (does not include point (c)).

13 “‘tranche’ means a contractually established segment of the credit risk associated with an exposure or a pool of exposures, where a position
in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments”.

SR Article 2(6); cf. CRR Article 4(1)(67) (the only differences are “number” rather than “pool” of exposures and “each other segment” rather than “another segment”).

14 “first loss tranche” means the most subordinated tranche in a securitisation that is the first tranche to bear losses incurred on the securitised exposures and thereby provides protection to the second loss and, where relevant, higher ranking tranches”.

SR Article 2(18); cf. CRR Article 244(15) (no change).

15 SR Article 6(3)(d).

16 “originator” means an entity which:
(a) itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposures being securitised; or
(b) purchases a third party’s exposures on its own account and then securitises them”.

SR Article 2(6); cf. CRR Article 4(1)(67) (the only difference is “for its own account” rather than “on its own account”).

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18 “original lender” means an entity which, itself or through related entities, directly or indirectly, concluded the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposures being securitised”.

SR Article 2(20). The EBA definition said “originally created” rather than “concluded the original agreement which created”, and added that the original lender “is not the originator”.

19 “sponsor” means a credit institution, whether located in the Union or not, as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013, or an investment firm as defined in point (1) of Article 4(1) of Directive 2014/65/EU other than an originator, that:
(a) establishes and manages an asset-backed commercial paper programme or other securitisation that purchases exposures from third-party entities, or
(b) establishes an asset-backed commercial paper programme or other securitisation that purchases exposures from third-party entities and delegates the day-to-day active portfolio management involved in that securitisation to an entity authorised to perform such activity in accordance with Directive 2009/65/EC, Directive 2011/61/EU or Directive 2014/65/EU”.

SR Article 2(5).

20 “investment firm” is defined by reference to point (1) of Article 4(1) of MiFID (as defined below), to mean “any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis”.


22 “institutional investor” means an investor which is one of the following:
(a) an insurance undertaking as defined in point (1) of Article 13 of Directive 2009/138/EC;
(b) a reinsurance undertaking as defined in point (4) of Article 13 of Directive 2009/138/EC;
(c) an institution for occupational retirement provision falling within the scope of Directive (EU) 2016/2341 of the European Parliament and of the Council in accordance with Article 2 thereof, unless a Member States has chosen not to apply that Directive in whole or in parts to that institution in accordance with Article 5 of that Directive; or an investment manager or an
an authorised entity appointed by an institution for occupational retirement provision pursuant to Article 32 of Directive (EU) 2016/2341;

(d) an alternative investment fund manager (AIFM) as defined in point (b) of Article 4(1) of Directive 2011/61/EU that manages and/or markets alternative investment funds in the Union;

(e) an undertaking for the collective investment in transferable securities (UCITS) management company, as defined in point (b) of Article 2(1) of Directive 2009/65/EC;

(f) an internally managed UCITS, which is an investment company authorised in accordance with Directive 2009/65/EC and which has not designated a management company authorised under that Directive for its management;

(g) a credit institution as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013 for the purposes of that Regulation or an investment firm as defined in point (2) of Article 4(1) of that Regulation”.

SR Article 2(12). Note that “investor” means a natural or legal person holding a securitisation position, and “securitisation position” means an exposure to a securitisation. The term “exposure”, which the Securitisation Regulation uses frequently but does not define, is defined in Article 5 of the CRR (only for purposes of CRR capital requirements for credit risk) as “an asset or an off-balance sheet item”. An “off-balance sheet item”, though not formally defined, includes lending commitments, guarantees, letters of credit and undrawn credit facilities (see CRR Annex 1). While the previous rules for banks and AIFMs referred to those investors becoming “exposed to the credit risk” of a securitisation, those for insurance companies referred to “investing” in securitisation and were understood not to apply, for example, to credit insurance policies covering securitisation positions or a credit risk tranche of an exposure or pool of exposures.

Part Five (Articles 404 through 410) of the CRR (applicable to credit institutions and certain investment firms), Chapter III, Section 5 (Articles 51 through 56) of the AIFM Regulation (as defined below) (applicable to AIFMs), and Articles 254 through 257 of the Solvency II Regulation (as defined below) (applicable to insurance and reinsurance undertakings). These provisions have been deleted or replaced pursuant to the EU Securitisation Regulations, subject to the transitional provisions set out in Article 43(5)-(7) of the Securitisation Regulation.

“Securitisation special purpose entity’ or ‘SSPE’ means a corporation, trust or other entity, other than an originator or sponsor, established for the purpose of carrying out one or more securitisations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator.”

SR Article 2(2); cf. CRR Article 4(1)(66). The CRR definition excludes “an institution” rather than “an originator or sponsor”, and includes an additional requirement that “the holders of the beneficial interests have the right to pledge or exchange those interests without restriction”. That requirement, which appears in the Basel II operational conditions for securitisation, echoes wording in a former US GAAP standard for accounting derecognition (FAS 140), and has been given little attention in practice.

The Financial Action Task Force (FATF) (or Groupe d’Action financière (GAFI)) is an inter-governmental body established in 1989 by member countries, and its objectives are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. Website: http://www.fatf-gafi.org/about/. The FATF currently identifies eleven countries as “high-risk and other monitored jurisdictions”: http://www.fatf-gafi.org/countries/#high-risk.

SR Article 2(4).

BCBS 157 page 2, adding Basel II paragraph 541(i); CRR Article 4(1)(63).

BCBS 157 page 2; CRR recital (64).


30 Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No. 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No. 648/2012, Articles 1(9) and 3(3)(d).


SR Article 18.

32 This exclusion of the originator, sponsor or original lender from these provisions of Article 5 (as from corresponding provisions in the precedent regulations) can be used to support an argument that, for example, the sponsor of an ABCP programme (which, through liquidity facilities provided to the programme SSPE, is exposed to the credit risk of the underlying securitisation transactions funded by the programme) is not required to undertake certain due diligence (except as provided in paragraph 2 of Article 5) or to verify risk retention by the originators with respect to the underlying securitisation transactions. It may be questioned, however, whether this is the intended result and consistent with the purpose of the regulation.

33 SR Article 5(1).
34 SR Article 5(3).
35 SR Article 5(4).
36 SR Article 5(5).
37 SR Article 5(1)(a) and (b).
38 SR Article 5(2). This provision appears incomplete, as it refers only to the requirement in point (a) of Article 5(1), which covers credit granting by an entity established in the EU other than a credit institution or investment firm regulated under the CRR, and does not mention point (b) of Article 5(1), which covers credit granting by an originator or original lender not established in the EU.

39 See SR Article 5(1)(a).
41 SR Article 5(1)(c).
42 SR Article 5(1)(d).
43 SR Article 5(1)(e).
44 SR Article 5(3) last sentence.
SR Article 6(1) last sentence.


The mandate for the risk retention RTS is narrower in some respects than it was previously under the CRR, as it does not cover due diligence, credit granting and ongoing transparency requirements in relation to materially relevant data, although, as discussed below, the Securitisation Regulation requires separate RTS to be put in place with respect to the new transparency requirements.

“‘revolving securitisation’ means a securitisation where the securitisation structure itself revolves by exposures being added to or removed from the pool of exposures irrespective of whether the exposures revolve or not’.

SR Article 2(16).

“‘revolving exposure’ means an exposure whereby borrowers’ outstanding balances are permitted to fluctuate based on their decisions to borrow and repay, up to an agreed limit”.

SR Article 2(15).

SR Article 31(2).

The concept of whether an entity is “established in the EU” is generally considered to apply to a subsidiary, but not to a branch, of a non-EU entity.

“‘first loss tranche’ means the most subordinated tranche in a securitisation that is the first tranche to bear losses incurred on the securitised exposures and thereby provides protection to the second loss and, where relevant, higher ranking tranches”.

SR Article 2(18).

Further details are provided at https://www.mayerbrown.com/-/media/eusecuritisationregulation.pdf.


SR Article 7(1) fourth sub-paragraph.

SR Article 7(1) sixth sub-paragraph.

“‘securitisation repository’ means a legal person that centrally collects and maintains the records of securitisations”.

SR Article 2(23).


ESMA update on reporting structured finance instruments information under the CRA Regulation (27 April 2016).
CRR Article 251 (which deals with the calculation of risk weights under the Standardised Approach), Article 261 (which deals with the calculation of risk weights using the Ratings Based Method) or Article 262 (which deals with the calculation of risk weights using the Supervisory Formula Method). These are consistent with the 2009 amendments to the Basel II bank capital framework (Enhancements to the Basel II framework, July 2009 (BCBS 157)).

Amended CRR Article 269.


Article 6b of the Credit Rating Agencies Regulation.


Amended CRR Articles 260, 262, 264.

Commission Delegated Regulation (EU) 2018/1221 of 1 June 2018 amending Delegated Regulation (EU) 2015/35 as regards the calculation of regulatory capital requirements for securitisations and simple, transparent and standardised securitisations held by insurance and reinsurance undertakings.


SR Articles 20, 21 and 22.

SR Articles 24, 25 and 26.

SR Articles 24(9) (which provides that the transferred exposures must not be in default or to a credit-impaired debtor or guarantor), (10) (which requires at least one payment to have been made under the exposures at the time of transfer (excluding revolving securitisations payable in a single instalment or having a maturity of less than one year) and (11) (which requires that the repayment of the holders of the securitisation positions shall not have been structured to depend predominantly on the sale of assets securing the underlying exposures).

It is likely that there will be a parallel STS regime in the UK after Brexit, as indicated by The Securitisation (Amendment) (EU Exit) Regulations 2019, which are expected to apply in the event of a no-deal Brexit. These are available at https://www.legislation.gov.uk/uksi/2019/660/pdfs/uksi_20190660_en.pdf.


Article 11(1)(b) of the Money Market Funds Regulation allows investment by money market funds in ABCP from fully supported programmes subject to no resecuritisation or synthetic securitisations.

The definition of “securitisation position” is very broad, and could include swaps, liquidity facilities, third party credit enhancement, etc. Even a securitisation with an issuance of securities will probably have additional “securitisation positions” that are not securities.

See above discussion of “Application date” and previous footnote.

Benefits of Protected Contracts: Utilizing Repurchase Facilities and Securities Contracts as an Alternative to Standard Lending Arrangements

In the United States, in a typical plain vanilla lending arrangement, if a counterparty files for bankruptcy, an automatic stay of enforcement actions is imposed that would prevent a lender from (i) foreclosing on the property of the debtor, (ii) terminating contracts with the debtor, (iii) commencing or continuing certain enforcement actions against the debtor or its property and/or (iv) setting off amounts owed under such arrangements (in each case unless a motion is filed and granted in the related bankruptcy case). In addition, provisions in lending contracts that allow for the termination or modification of a contract based on the debtor’s bankruptcy or financial condition (also known as “ipso facto clauses”) are prohibited from being enforced.

However, if a contract is a “protected contract” as designated under Title II of the United States Code, as amended, (the “Bankruptcy Code”), and the party seeking enforcement is a “protected party” (e.g., in the case of securities contracts, a financial institution or a financial participant as defined within the Bankruptcy Code), then the contract will receive “safe harbor” protections that allow the qualifying party to liquidate and close out the protected contract when the counterparty becomes the subject of a bankruptcy case and to do so free from the automatic stay and certain other significant restrictions of the Bankruptcy Code. Specifically, ipso facto clauses, which would not otherwise be enforceable in a typical lending arrangement, can be enforced, and the actions taken by the protected party to enforce the protected contract are not subject to the automatic stay. The safe harbor provisions, therefore, enable counterparties to terminate their financial contracts and exercise contractually agreed-on rights of liquidation, termination
and acceleration (e.g., enforcement through the netting and setoff of then outstanding obligations) promptly upon the bankruptcy of the debtor. Additionally, each of the Bankruptcy Code’s protected contract provisions makes clear that a protected party can freely exercise its rights under any security agreements, guarantees, reimbursement agreements or other credit enhancements that relate to the central protected contract and that those related contracts are each eligible, in their own right, for treatment as protected contracts. As a result, enforcement actions by the protected parties of these related protected contracts are exempt from the automatic stay and can be undertaken without prior approval of the bankruptcy court.

In addition, the Bankruptcy Code shields protected parties from a variety of avoidance powers that are generally available to a bankruptcy trustee (or debtor-in-possession) with respect to transactions engaged in by the debtor prior to commencement of the case. Critically, with respect to securities contracts, under section 546(e) of the Bankruptcy Code, certain payments and other transfers received by the protected party from the debtor in connection with a Repurchase Facility, prior to commencement of the case, may not be avoided. Likewise, because the Bankruptcy Code permits the close-out of the Repurchase Facility, those post-bankruptcy actions also cannot be “avoided” by the trustee (or the debtor-in-possession).

As a consequence, enabled to have more certainty in contract enforcement when a debtor is bankrupt, the counterparty is able to undertake a different calculus in determining the necessary resources to recover on a claim against the bankrupt debtor, the amount recoverable, the timeframe in which the recovery can be achieved and, equally important, the ability to retain the recovery once achieved. As a result of these changes to the protected counterparty’s “calculus,” better pricing as compared to a typical asset-level lending arrangement may be achievable.

Protected contracts entitled to safe harbor treatment under the Bankruptcy Code include commodity contracts, forward contracts, master netting agreements, swaps, repurchase agreements and securities contracts. Repurchase Facilities (as defined below) are the most similar to lending arrangements and can be used as an alternative to a typical lending arrangement if certain characteristics are met.

In a repurchase facility, the “buyer” provides liquidity by “purchasing” certain portfolio assets with an obligation of the “seller” to “repurchase” these same assets on a specified date in the future (each, a “Repurchase Facility”). A Repurchase Facility is similar to a lending facility in that the buyer (or lender) provides financing to the seller (or borrower) for a period of time and expects to receive a rate of return on the amount provided to the seller. The rate of return is typically described as the “price differential” or “spread” and, similar to interest on a loan, is commonly payable periodically prior to repurchase of the applicable asset(s) by the buyer. In addition, Repurchase Facilities are usually treated as
loans for accounting and tax purposes by sellers and buyers.

Unlike most other secured lending arrangements, Repurchase Facilities are considered protected contracts under the Bankruptcy Code and are afforded the safe harbor protections described above. However, not every lending contract can be a repurchase agreement. In fact, in order to fit into the “repurchase agreement” definition under the Bankruptcy Code, an agreement must:

[provide] for the transfer of one or more certificates of deposit, mortgage related securities . . . mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers’ acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers’ acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers’ acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds . . . .

In sum, the underlying asset subject to a Repurchase Facility must be (a) a security or mortgage loan or an interest therein and (b) sold with an automatic obligation to resell such asset within one year.

In addition, there are other protected contracts that can be utilized in a manner similar to secured lending arrangements. “Securities contracts” under the Bankruptcy Code are similar to repurchase contracts, with the notable exception that there is no requirement to transfer the asset back to the counterparty. However, the counterparty to a “securities contract” must be a stockbroker, securities clearing agency, financial institution or financial participant. In other words, such entity must be:

an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more [securities contracts, commodity contracts, repos, swaps or master netting agreements] with … any entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the
15-month period preceding the date of the filing of the petition … or is a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).

Consequently, while under the Bankruptcy Code a “securities contract” is more broadly defined than a “repurchase agreement,” the universe of qualifying “buyer” counterparties to a securities contract may be more limited. Regardless, structuring asset-level financing as a “protected contract” (whether a repurchase agreement or securities contract under the Bankruptcy Code) benefits both counterparties by providing the buyer with safe harbor provisions for the enforcement of remedies in connection with a bankruptcy of the seller, and accordingly may provide the seller with more favorable economic terms.

As the market continues to mature, financial institutions will continue to explore new and innovative ways to obtain liquidity from existing pools of assets including obtaining asset-level leverage (particularly for mortgage loans). Since Repurchase Facilities and securities contracts provide yet another cost-effective method for satisfying liquidity needs and optimizing returns for investors, we expect to see continued growth of these financing arrangements in the coming years.
In 1977, gas cost 62 cents per gallon; the first Apple II computers became available for sale; even the most primitive mobile phones were half a decade away from being released to the public; and debt collectors relied on landline phones, the U.S. mail or in-person conversations to collect the debts assigned to them. When Congress passed the Fair Debt Collection Practices Act that year, it could not have envisioned a world where consumers communicate instantly using cellphones, text messages, emails and social media.

No federal agencies promulgated any significant regulations under the FDCPA in the 40 subsequent years. Until the Dodd-Frank Act became effective, no federal agency even had the authority to do so. In the absence of any controlling regulations, courts were free to fashion their own standards and interpretations of the FDCPA. Given the voluminous amount of FDCPA litigation, courts across the country quickly created inconsistent standards and a maze of differing interpretations. Fortunately for entities seeking simple, practical and uniform standards for FDCPA compliance in the modern age, the Consumer Financial Protection Bureau issued its proposed Regulation F under the FDCPA on May 7, 2019.

In the first part of this article, we provide a brief overview of the FDCPA and discuss the proposed rule’s definitions and procedures for electronic communications. The second part of the article will discuss the proposed rule’s provisions regarding call frequency, validation of debt, and other unfair or deceptive debt collection practices.

We do not rehash all 538 pages of the bureau’s proposal, but instead summarize some of the most significant developments that FDCPA-regulated entities should review when considering whether to provide comments to the bureau regarding the proposed rule.
Overview of the FDCPA

Before we discuss the content of the proposed rule, we briefly remind our readers of the basic structure of the FDCPA.

Congress passed the FDCPA in 1977 in order to combat “[d]isruptive dinnertime calls, downright deceit, and more.”1 The FDCPA applies to “debt collectors,” who are generally third-party entities (i.e., not original creditors) who either (1) regularly collect debts on behalf of others or (2) obtained defaulted debts, but only if the entity’s “principal purpose” is the collection of debts.2

In general, the FDCPA prohibits a debt collector from using unlawful, abusive, deceptive or unfair collection tactics in connection with the collection of debts. The FDCPA contains an extensive (but not exclusive) list of practices that are prohibited under this standard.

They include tactics such as calling a debtor at unreasonable hours; calling a debtor at work when the debt collector knows that the debtor’s employer does not allow the debtor to receive calls; letting the phone ring incessantly in order to harass the debtor’ threatening to take actions that the collector does not intend to or cannot legally take; communicating with unauthorized third parties about the debt; and making any collection-related communication that would tend to confuse the “least sophisticated consumer.” The FDCPA also imposes several affirmative disclosure requirements on debt collectors, including with respect to debt validation notices, “mini-Miranda” notices and self-identification.

The proposed rule generally restates the FDCPA definition of a “debt collector” with only minor changes.3 Even if a collector is not covered by the FDCPA, the bureau views the practices prohibited by the FDCPA as potentially unfair, deceptive, and/or abusive acts or practices, or UDAAPs, that could violate the Dodd-Frank Act when undertaken by any person engaged in collection activities.4 As a result, even entities such as first-party collectors, or servicers of performing mortgage loans that later become delinquent, should review the proposed rule and consider revising their practices as a matter of best practices and UDAAP risk control.

Definitions

The proposed rule clarifies a number of terms used in the FDCPA that have been the root of significant litigation and enforcement actions since the passage of the FDCPA. We explain the proposed rule’s clarifications below.

COMMUNICATION AND LIMITED-CONTENT MESSAGES

The FDCPA prohibits a debt collector from communicating with third parties about the consumer’s debt, unless the third party is the consumer’s lawyer, a consumer reporting agency, the creditor or the creditor’s lawyer, or the debt collector’s lawyer.4 In addition, a debt collector communicating with a consumer must provide the so-called “mini-Miranda” notice to inform the consumer that the communication is from a debt collector.4
As a result, debt collectors frequently were tripped up by inadvertently having a communication overheard by a third party, especially if the debt collector chose to leave voicemails for debtors after an unsuccessful attempt to establish contact with the consumer. If a debt collector left a voicemail identifying itself as a debt collector and implied or revealed the existence of the consumer’s debt, it could unknowingly violate the FDCPA if the debtor lived with a roommate or other third parties who might have access to the voicemail box. On the other hand, if the voicemail was considered to be a communication in connection with the collection of the debt, the collector would violate the FDCPA if it did not identify itself and disclose that it is a debt collector.

Several federal appeals courts have reached the conclusion that contacts from a debt collector that do not refer to or imply the existence of a debt, and do not reveal information about the debtor’s debts, are not “communications” for purposes of the FDCPA. However, the law remained unsettled and, as recently as 2017, the Federal Trade Commission entered into a stipulated judgment with a debt collector to settle allegations that the collector left voicemails in a manner that could reveal the existence and status of the consumer’s debt to an unauthorized third party. The bureau ultimately believed this conflict led collectors to err on the side of not leaving voicemails, which in turn led to more frequent call attempts so that collectors could ensure they established live, right-party contact.

The proposed rule resolves this conflict by clarifying that a debt collector does not convey information regarding a debt “directly or indirectly to any person” if the debt collector provides only a “limited-content message.” A limited-content message must include only the expressly required content set forth in the proposed rule, and nothing more (except the optional content described below). The proposed rule requires that a limited-content message include all of the following:

- The consumer’s name;
- A request that the consumer reply to the message;
- The name or names of one or more natural persons whom the consumer can contact to reply to the debt collector;
- A telephone number that the consumer can use to reply to the debt collector; and
- If applicable, a clear and conspicuous statement describing one or more ways the consumer can opt out of further attempts to communicate by the debt collector to that telephone number (discussed in further detail below in the “Opt Out” section).

In addition to the required content, a debt collector leaving a limited-content message may also opt to include a salutation, the date and time of the message, a generic statement that the message relates to an account, or suggested dates and times for the consumer to reply to the message. If a collector includes information in a message that exceeds the permitted information and
conveys information about the debt, such as information revealing that the message relates to the collection of a debt (such as the consumer’s account number), the collector loses the protection of the limited-content message exception.\textsuperscript{13}

As the name of the debt collector is not among the required or optional content, a collector may lose the protection of the limited-content message exception if a message included the collector’s name. Consistent with this view, the bureau noted that email cannot be used to transmit a limited-content message because email messages “typically require additional information (e.g., a sender’s email address) that may in some circumstances convey information about a debt.”\textsuperscript{14}

Although a limited-content message is not a “communication” under the proposed rule, it is nonetheless considered an attempt to communicate, and is subject to the restrictions in the proposed rule regarding attempts to communicate with a consumer regarding a debt (such as the seven-call limit discussed below).\textsuperscript{15}

First, debt collectors were hampered in resolving the debts of a deceased person with an estate or executor, since discussing the deceased person’s debts would be prohibited by the FDCPA.\textsuperscript{17} Second, the bureau’s Regulation X mortgage servicing rules require a mortgage servicer to promptly communicate with successors-in-interest regarding a mortgage loan upon death of the borrower.\textsuperscript{18}

If the mortgage loan was in default when the servicer obtained servicing, the servicer would be mandated by Regulation X to communicate with a successor-in-interest, but would be prohibited by the FDCPA, since successors-in-interest are not among the limited list of persons with whom a collector may convey information about a debt.

Acknowledging this conflict, the bureau previously issued an interpretive rule providing a safe harbor from FDCPA liability when servicers communicate with a successor-in-interest in compliance with Regulation X.\textsuperscript{19}

The proposed rule formally resolves this conflict by adopting a definition of “consumer” that includes the executor, administrator or personal representative of the debtor’s estate, if the debtor is deceased, as well as a confirmed successor-in-interest as defined in Regulation X and Regulation Z.\textsuperscript{20} As a result, mortgage servicers who are subject to the FDCPA would be free to comply with Regulation X without worrying whether they are inadvertently violating the FDCPA.

CONSUMER

As noted above, the FDCPA strictly prohibits communication of a consumer’s debt to third parties besides a limited list of persons.\textsuperscript{14} The limited scope of the exceptions to this prohibition presented several difficulties for debt collectors.
Procedures for Text and Email Communications

Despite setting forth a litany of unfair, deceptive and otherwise prohibited debt collection practices, the FDCPA provides that a debt collector has no civil liability for a violation if the debt collector shows, by preponderance of the evidence, that the violation was not intentional and resulted from a bona fide error, notwithstanding the collector’s maintenance of procedures “reasonably adapted” to avoid such an error.

Recognizing that debt collectors now frequently attempt to contact consumers using text messaging and email, the bureau’s proposed rule clarifies how a collector can maintain procedures for text and email communications that allow the collector to avail itself of the “bona fide error” defense. The proposed rule provides that, for purposes of the “bona fide error” defense, a collector maintains procedures that are “reasonably adapted” to avoid inadvertent communication with an unauthorized third party if its procedures include steps to reasonably confirm and document that:

- The debt collector communicated with the consumer using an email address or, in the case of a text message, a telephone number that the consumer recently used to contact the debt collector for purposes other than opting out of electronic communications;
- If the collector communicates using the consumer’s nonwork email address or telephone number, the creditor notified the consumer clearly and conspicuously other than through the specific nonwork email address or nonwork telephone number that the collector might use that email address or telephone number for email or text communications, the collector provided the notification no more than 30 days before the collector’s first text or email communication, and the notification identified the legal name of the collector and the nonwork email address or telephone number the collector proposed to use, described one or more ways the consumer could opt out of such communications, provided the consumer with a reasonable period in which to opt out, and the opt-out period expired without the consumer opting out;
- The debt collector used a nonwork email address or telephone number that a creditor or prior debt collector obtained from the consumer to communicate about the debt if the creditor or prior debt collector recently sent communications about the debt to that number or address, and the consumer did not request that the creditor or prior debt collector cease communications to that email address or phone number; or
- The debt collector took additional steps to prevent communications using an email address or telephone number that the collector knows has led to a disclosure of the consumer’s debt to an unauthorized party.
The proposed rule also addresses another significant operational difficulty for collectors and FDCPA-covered entities. The FDCPA prohibits a covered entity from attempting to communicate with a customer at a time that is known or should be known by the collector to be inconvenient, or at times other than between 8 a.m. and 9 p.m. local time at the consumer’s location.\(^23\)

In the era of landline telephones, determining the consumer’s local time was easy — the collector could simply verify the local time at the consumer’s listed area code and proceed accordingly. In the modern era, fewer consumers are maintaining landline telephones, and instead are using cellular telephones as a primary source of communication.\(^24\) A consumer’s cellular phone area code may not match their physical location — for example, a consumer with an area code assigned to Los Angeles may reside in New York. A collector calling the consumer at 7 p.m. Los Angeles time would therefore violate the FDCPA, as the call would be received at 10 p.m. New York time — outside of the window permitted by the FDCPA.\(^25\)

The proposed official interpretations to the proposed rule attempts to resolve this complication by providing that a debt collector complies with the FDCPA if, in the absence of knowledge to the contrary, the collector communicates or attempts to communicate with the consumer at a time that would be convenient in all of the locations at which the collector’s information indicates the consumer might be located.\(^26\) In the example above, if the collector’s information reflects that the consumer resides in New York, then the collector should only attempt to call within the time limits applicable to both New York and Los Angeles, rather than just to Los Angeles.\(^27\)

The proposed rule also provides that it is an unfair practice for a collector to communicate, or attempt to communicate, with a consumer using an email address that the collector knows or should know is provided to the consumer by the consumer’s employer.\(^28\) The proposed rule requires the collector to exercise a degree of judgment in determining whether an email is provided by the consumer’s employer. The bureau noted that addresses with certain domains, such as .gov or .mil, are unlikely to be a personal email, or addresses where the domain includes a corporate name that is not commonly associated with personal email addresses, are likely to be work emails.\(^29\)

However, the bureau acknowledged that a collector “neither would know nor should know that an email address is provided to the consumer by the consumer’s employer if the email address’s domain name is one commonly associated with a provider of non-work email addresses.”\(^30\) Notwithstanding the prohibition, a collector may use a work email address if the collector has previously received either consent from the consumer to be contacted at that address, or an email from that email address.\(^31\)
The proposed rule also prohibits a collector from communicating or attempting to communicate with a consumer through social media in connection with the collection of a debt if the social media is viewable by an unauthorized third party.\(^{31}\) This prohibition applies broadly and includes even limited-content messages.\(^{32}\) However, if the social media platform allows a collector to send a private message to the debtor that is not viewable by unauthorized third parties, then a collector may send a private message concerning the debt without violating this prohibition (although the FDCPA may otherwise prohibit the message if the consumer has requested the collector cease communications, for example).\(^{33}\)

**Procedures for Supplying Electronic Disclosures**

The proposed rule creates a process flow for collectors to deliver certain FDCPA-required notices electronically. The proposed rule allows for three disclosures to be provided electronically: the validation of debt notice, the original creditor information that a collector must provide if requested in writing by the debtor, and the validation information that a collector must provide if the debtor disputes his or her debt in writing.\(^{34}\)

If the collector chooses to provide electronic copies of these notices, it must comply with the federal Electronic Signatures in Global and National Commerce Act and provide the disclosures in a form that provides the consumer with actual notice, and that the consumer can keep and access later.\(^{35}\) The proposed rule sets forth the procedures for debt collectors to satisfy the E-Sign Act when supplying electronic disclosures. Importantly, only these three specific notices must meet the notice-and-retainability requirement. Other routine electronic communications that are not expressly required by the FDCPA or proposed rule, such as settlement offers, payment requests and scheduling messages, need not be provided in a form the consumer can keep and access later.\(^{36}\)

The proposed rule provides two ways for a collector to provide disclosures electronically. First, the collector may comply with Section 101(c) of the E-Sign Act after the consumer provides affirmative consent directly to the debt collector.\(^{37}\) Alternatively, the collector may provide the disclosure by sending an electronic communication to an email address or phone number that the creditor or a prior debt collector could have used to provide disclosures under the E-Sign Act.\(^{38}\)

If the collector opts to take the alternative approach, the collector may place the disclosure on a secure website that is accessible by clicking on a hyperlink included within an electronic communication.\(^{39}\) The disclosure must be available on the website for a reasonable period of time in an accessible format that can be saved or printed, and the consumer must receive notice and opportunity to opt out of hyperlinked delivery.\(^{40}\) The collector may also place the disclosure in the body of an email so that the disclosure’s content is viewable within the email itself.\(^{41}\)
No matter which option a debt collector chooses, the proposed rule would require a debt collector to:

- Identify the purpose of the communication by including, in the subject line of an email or in the first line of a text message transmitting the disclosure, the name of the creditor to whom the debt currently is owed or allegedly is owed and one additional piece of information identifying the debt, other than the amount; and
- Permit receipt of notifications of undeliverability from communications providers, monitor for any such notifications, and treat any such notifications as precluding a reasonable expectation of actual notice for that delivery attempt; and
- If providing the validation notice electronically, provide the disclosure in a responsive format that is reasonably expected to be accessible on a screen of any commercially available size and via commercially available screen readers.

Opt Out for Electronic Communications

The proposed rule provides an opt-out right to a consumer receiving electronic or text communications from a debt collector. The proposed rule states that if a debt collector communicates, or attempts to communicate, using text, email or another electronic medium, the collector must include in each communication or attempt a clear and conspicuous statement describing one or more ways the consumer can opt out of further electronic communications to that email address or phone number. The proposed rule prohibits a collector from requiring that the consumer pay any fee to exercise the opt-out right, or to provide any information other than the email address, telephone number for text messages or other electronic address subject to the opt-out right.

Endnotes
6. Id. § 1692e(11).
7. See Scribner v. Works & Lentz, Inc., 655 F. App’x 702, 703-04 (10th Cir. 2016) (call to manager of debtor’s apartment complex; caller did not identify herself or her employer as debt collector or refer to any debt owed by debtor); Brown v. Van Ru Credit Corp., 804 F.3d 740, 743 (6th Cir. 2015) (voicemail left with debtor’s business; voicemail did not mention debtor, his alleged debt, or that caller was debt collector); Marx v. Gen. Revenue Corp., 668 F.3d 1174, 1177 (10th Cir. 2011) (fax to debtor’s work location; fax indicated its purpose was to verify employment and did not reference any debt).
Proposed 12 C.F.R. § 1006.2(b).

Id. § 1006.2(j).

Id.

Comment 2(j) to Proposed 12 C.F.R. § 1006.2.

Notice of Proposed Rule at 63.

Proposed 12 C.F.R. § 1006.2(b).


Notice of Proposed Rule at 73.

12 C.F.R. § 1024.38(b)(1)(vi).


Proposed 12 C.F.R. § 1006.2(e); Comment 6(a)(4) to Proposed 12 C.F.R. § 1006.2.


Proposed 12 C.F.R. § 1006.6(d)(3).


Comment 6(b)(1)(i) to Proposed 12 C.F.R. § 1006.6.

If the consumer were in fact in Los Angeles, then a call at 8 a.m. New York time would be at 5 a.m. in Los Angeles.

Proposed 12 C.F.R. § 1006.22(f)(3).

Comment 22(f)(3)-3 to Proposed 12 C.F.R. § 1006.22.

Id.

Proposed 12 C.F.R. § 1006.22(f)(3).

Id. § 1006.22(f)(4).

Comment 22(f)(4) to Proposed 12 C.F.R. § 1006.22(f)(4).

Id.

Proposed 12 C.F.R. § 1006.42.

Proposed 12 C.F.R. § 1006.42(a)(1).

Notice of Proposed Rule at 301.
The second part of this article discusses the provisions of the Consumer Financial Protection Bureau’s proposed debt collection rule regarding call frequency, validation of debt and other unfair or deceptive debt collection practices. In part one, we discussed the statutory background of the Fair Debt Collection Practices Act definitions under the proposed rule, and procedures for electronic communications.

**Call Frequency Limits**

The FDCPA itself does not provide a bright-line limit to the frequency with which a debt collector may attempt to contact a borrower; the statute provides only that a debt collector may not cause a telephone to ring, or engage any person in telephone conversation repeatedly or continuously “with intent to annoy, abuse, or harass” a person. While some states already cap the number of calls that a collector may place to a consumer residing in that state, no similar rule currently exists at the federal level.

Under the proposed rule, the bureau would prohibit a collector from making more than seven telephone calls to a debtor within seven consecutive days, or within a period of seven consecutive days after having had a telephone conversation with the debtor in connection with the collection of the debt. The limit applies on a per-consumer and per-debt basis.

With respect to the per-consumer limitation, phone calls concerning the same debt to different numbers owned by the same debtor count equally toward the seven-call limit. With respect to the per-debt limitation, if a collector is hired to collect multiple debts owed by a consumer (such as two delinquent credit card accounts, for example), then the collector may call the consumer up to seven times in seven days regarding the first account, and an additional seven times in seven days regarding the second account.

However, the rule provides a special limitation for student loan debts. In the case of student loan debts, all such debts
were serviced under a single account number at the time the debts were obtained by the collector count as a single debt for purposes of the call frequency limits. The bureau noted that “multiple student loan debts are often serviced under a single account number and billed on a single, combined account statement, with a single total amount due and requiring a single payment from the consumer,” and therefore classifying student loan debts as a single debt is “consistent with how the loans were likely serviced before entering collection.”

Certain telephone calls are excluded from the seven-call cap. These are calls made to respond to a request for information from the debtor or made with the debtor’s prior consent given directly to the collector, calls that do not connect to the dialed number (i.e., calls that do not cause the phone to ring — such as calls where the collector receives a busy signal or a notice that the number is no longer in service), or calls with the debtor’s lawyer, a consumer reporting agency, the creditor and creditor’s lawyer, and the collector’s lawyer.

Limited-content messages are not excluded from the cap; even if a collector leaves a limited-content message that does not discuss the consumer’s debt, the message still counts toward the seven-call limit. Finally, the call limits apply only to telephone calls, and do not apply to text message or email communications. There is no set numeric limit on such electronic communications, but as noted above, the consumer must be provided an opt-out right.

Validation of Debt

Few sections of the FDCPA have tripped up more debt collectors than the validation of debt requirement. Section 1692g of the FDCPA contains what appears to be a simple requirement: Within five days of the initial communication in connection with the collection of a debt, a debt collector must provide the consumer a notice containing the amount of the debt, along with information about the creditor, and informing the consumer of their right to dispute the debt.

But the section’s apparent simplicity led to endless litigation, and in the absence of clarifying amendments to the FDCPA or regulations, different courts took conflicting positions as to the required content of a validation of debt notice.

Fortunately for debt collectors seeking a uniform standard, the bureau now is proposing a model-form validation of debt notice along with the proposed rule. And the proposed rule establishes a “safe harbor” providing that a collector who provides a notice that tracks the model form is presumed to comply with the FDCPA requirement to provide a validation of debt notice.

The proposed rule also sets a uniform standard for certain content of the validation of debt notice, to the extent a collector chooses not to use the model form. Adopting the holdings of several circuit courts, the proposed rule requires that a debt collector provide an itemization of the debt owed by the consumer.
This itemization must be in a table format, and reflect interest, fees, payments and credits to the account, and must reflect the amount of the debt as one of four dates (the “itemization date”): the last statement date, the charge-off date, the date the last payment was made on the debt, or the date the transaction gave rise to the debt. If the debt is a credit card account, then the validation notice must reflect the merchant co-brand associated with the credit card. If the debt arises from a consumer financial product or service, as defined in the Dodd-Frank Act, then the notice must also contain the name of the creditor to whom the debt was owed on the itemization date.

The proposed rule creates a limited exception from the requirement to itemize the debt for persons collecting mortgage loan debt where the loan is subject to Regulation Z’s periodic statement requirement. For these loans, a collector instead may provide the most recent Regulation Z periodic statement at the same time as the validation notice, and refer to the periodic statement in the validation notice instead of itemizing the debt.

The FDCPA’s validation of debt section created another land mine for collectors. The FDCPA requires that a collector’s validation notice inform the debtor that unless the debtor notifies the collector that the debt is disputed, the collector will assume it to be valid. The FDCPA fails to specify whether the debtor’s dispute must be written, whereas Congress specifically required that disputes be in writing in order for the borrower to exercise their right to obtain a verification of the debt.

Appeals courts are split on whether a validation notice must inform the debtor that disputes must be in writing. The U.S. Courts of Appeals for the Second, Fourth and Ninth Circuits (as well as a significant number of district courts) hold that as the FDCPA is silent as to the means by which a debtor may dispute the validity of any part of or all of the debt, the statute allows oral disputes. Under this line of cases, a validation notice that states a debtor must dispute a debt in writing arguably violates the FDCPA. However, the Courts of Appeals Third, Sixth and Eleventh Circuits have held that Section 1692g(a)(3) requires that disputes be in writing, and the Eleventh Circuit goes so far as to say that debt collectors may not waive the requirement that disputes must be in writing.

Adopting different validation notices for different circuits is impractical, so the proposed rule finally clarifies the dispute requirement. The bureau’s proposal adopts the position that disputes do not need to be written to be effective, and the model form likewise informs debtors that they may call or write to dispute their debt (although the model form clarifies that only a written dispute is sufficient for the borrower to exercise their right to obtain verification of the debt).

The proposed rule requires validation notices to also contain a statement specifying the end date of the period during which the debtor can dispute their debt, and a statement
explaining how the debtor can dispute their debt electronically if the collector sends a validation notice through electronic media. The proposed rule creates an additional notice requirement for persons collecting consumer financial product or service debt; these collectors must also include in their validation notice a statement referring the customer to additional information on the bureau's website.

To decrease the burden on consumers seeking to dispute their debts, the proposed rule requires collectors to include certain dispute prompts in their validation notice. The prompts must be set aside from other validation notice content and contain distinct headings. These prompts take the form of check boxes to allow the consumer to signal their desire to dispute their debt (and the reason for the dispute), or to obtain information about the original creditor.

The proposed rule provides that if a debtor disputes the validity of the debt, the collector may not engage in any collection activity during the time period from when the collector provides a validation notice, and 30 days after the debtor receives the validation notice. If the debtor invokes their right to request information about the original creditor, the collector must also cease collection activity until the debt collector provides the debtor the name and address of the original creditor.

The proposed rule also adopts a procedure for debt collectors handling duplicative disputes, similar to the procedures in Regulations V and X for duplicative credit reporting disputes or notices of error. If a collector determines that a dispute is substantially the same as a dispute previously submitted by the consumer in writing, for which the debt collector already has satisfied the validation requirements and does not include any new material information to support the dispute, the collector may notify the debtor that the dispute is duplicative, provide a brief statement of reasons for its determination, and refer to its earlier response.

**Time-Barred Debts**

With the proliferation of “debt buyers” purchasing portfolios of charged-off debt in the secondary market, courts and regulators have increasingly focused on collectors’ practices related to debts where the applicable statute of limitations to bring a legal action has expired. Attempting to collect “stale” debts is not a per se violation of the FDCPA, as courts recognize that some consumers may nonetheless feel morally obligated to pay a debt, even if not legally required to do so. The proposed rule maintains the status quo of not expressly prohibiting collectors from attempting to collect time-barred debt, but prohibits collectors from bringing, or threatening to bring, a legal action against a consumer to collect a debt that the collector knows or should know is time-barred.
Debt Collection by Lawyers and Law Firms

The FDCPA prohibits the false representation or implication that any individual is a lawyer, or that any communication is from a lawyer. The bureau takes the position in the preamble to the proposed rule that “debt collection communications sent under a lawyer’s name may violate [15 U.S.C. 1692e(3)] if the lawyer was not meaningfully involved in the preparation of the communication.” The CFPB similarly has taken this position in a number of enforcement actions brought against lawyers involved in debt collection.

The CFPB incorporated this “meaningful involvement” standard into proposed rule § 1006.18. The proposed rule creates a safe harbor from liability for law firms or lawyers submitting pleadings, written motions or other court papers if a lawyer personally drafts or reviews the pleading, motion or paper, and the lawyer reviews supporting information and makes a determination to the best of his or her information, knowledge and belief that the claims, defenses and other legal contentions are warranted by existing law; the factual contentions have evidentiary support; and the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on belief or lack of information.

The standard under the proposed rule largely borrows from Rule 11 of the Federal Rules of Civil Procedure. The bureau looked to the Federal Rules of Civil Procedure as a guide, noting that most FDCPA claims are considered by federal courts, and federal courts that have applied the meaningful lawyer involvement standard to pleadings and other submissions have applied the Rule 11 standard.

Under the proposed rule, “an attorney or law firm who establishes compliance with the factors set forth in proposed § 1006.18(g), including when a court in debt collection litigation determines that the debt collector has complied with a court rule that is substantially similar to the standard in § 1006.18(g), will have complied with [the FDCPA] regarding the lawyer’s meaningful involvement in submissions made in debt collection litigation.” The bureau noted that Federal Rule of Civil Procedure 11 “may provide an appropriate guide for judging whether a submission to the court has complied with § 1006.18(g).”

Shortly after releasing the proposed rule and the “meaningful involvement” standard, the bureau filed a lawsuit against a law firm engaged in debt collection on the grounds that it violated the FDCPA and the Dodd-Frank Act by filing collection lawsuits against consumers that contained lawyers’ names and signatures, even though lawyers allegedly spent only minutes reviewing a file, and complaints and summons were prepared by clerical staff. The bureau alleged that the firm’s lawsuits were prepared without meaningful lawyer involvement and were therefore deceptive and violated the FDCPA.

Law firms and lawyers involved in filing collection lawsuits should monitor the development of the bureau’s “meaningful involvement” standard.
Conclusion

The release of the proposed rule is a step toward resolving the maze of differing standards and inconsistent FDCPA interpretations that developed in the 40 years since Congress passed the FDCPA. The proposed rule suggests that the bureau will bring much-needed clarity and uniform standards to several areas of the FDCPA and adapt its interpretation and enforcement of the FDCPA to modern-day technology.

The proposed rule currently has no legal effect; the bureau will now accept public comments on the rule and consider the comments as it works to issue a final rule. Entities that are subject to the FDCPA — and those that are not but that are involved in debt collection activities — should carefully consider the proposed rule and determine whether they wish to provide comments to the bureau. The bureau will be accepting comments on the proposed rule until Aug. 19, 2019.

Endnotes

2. For example, Massachusetts limits debt collectors to two call attempts in a seven-day period, and Washington’s Collection Agency Act contains a presumption, as a matter of law, that a debt collection communication is made for purposes of harassment if the collector communicates with a debtor more than three times in a single week. See 940 Code Mass. Regs. § 7.04(f); Wash. Rev. Code § 19.16.250(13)(a).
5. See Comment 14(b)(5) to Proposed 12 C.F.R. § 1006.14.
9. Id.
13. The Proposed Rule also authorizes a debt collector to provide a statement in Spanish informing the debtor that he or she may request a Spanish-language validation notice. See Proposed 12 C.F.R. § 1006.34(d)(3)(vi).
15 Proposed 12 C.F.R. § 1006.34(c)(2).
16 Id.
17 Id.
18 Id. § 1006.34(c)(5)
19 Id.
21 Compare 15 U.S.C. § 1692g(a)(3) and (4).
24 Proposed 12 C.F.R. § 1006.38(b).
25 Id. § 1006.34(c)(3).
26 Id.
27 Id. § 1006.34(c)(4).
28 Id.
29 Id. § 1006.34(b)(5).
30 Id. § 1006.38(c).
31 See id. §§ 1022.43(f)(1)(ii); 1024.35(g)(1)(i).
32 Proposed 12 C.F.R. § 1006.38(d)(2)(ii). The Proposed Rule does not eliminate the requirement that a debt collector avoid “overshadowing” the consumer’s right to dispute the debt or request original creditor information.
33 See, e.g., Daugherty v. Convergent Outsourcing, Inc., 836 F.3d 507, 509 (5th Cir. 2016) (“While it is not automatically unlawful for a debt collector to seek payment of a time-barred debt, a collection letter violates the FDCPA when its statements could mislead an unsophisticated consumer to believe that her time-barred debt is legally enforceable, regardless of whether litigation is threatened.”); McMahon v. LVNV Funding, LLC, 744 F.3d 1010, 1020 (7th Cir. 2014) (“We do not hold that it is automatically improper for a debt collector to seek re-payment of time-barred debts; some people might consider full debt re-payment a moral obligation, even though the legal remedy for the debt has been extinguished.”).
34 Proposed 12 C.F.R. § 1006.26(b).
36 Notice of Proposed Rule at 179.
37 Proposed 12 C.F.R. § 1006.18(g).
38 Notice of Proposed Rule at 352-53.
39 Id. at 181.
41 Id.
New Japanese Risk Retention Rule Takes Effect on March 31, 2019

On March 15, 2019, the Japanese Financial Services Agency (the “JFSA”) published the final version of its amendment to the regulatory capital requirements relating to investments by certain types of Japanese financial institutions in securitizations. The amendment adds to such regulatory capital requirements (i) a set of due diligence and information collection requirements for investments by Covered Japanese Institutions (as defined below) in securitizations and (ii) a risk retention rule for such investments. The amendment will take effect on March 31, 2019. To provide guidance regarding these new regulatory requirements, the JFSA published, together with the final version of the amendment, a series of responses to selected comments that it received with respect to its initial proposal of these regulatory changes (the “Responses to Comments”)

1 as well as a series of answers to frequently asked questions concerning the application of these regulatory changes (the “Answers to FAQs”). 4 Because we believe that it should not be overly cumbersome for many Covered Japanese Institutions to comply with the due diligence and information collection component of the amendment (based on the current due diligence practices of large Japanese banks and the type and scope of information that is already customarily reported to investors by US securitizations), this Legal Update focuses on the risk retention rule portion of the amendment (the “Japanese Risk Retention Rule”).

This Legal Update is intended for originators, sponsors and underwriters of non-Japanese securitizations that are marketed to Japanese investors, although Covered Japanese Institutions and other interested parties may also find this Legal Update helpful. 5

The Japanese Risk Retention Rule

The Japanese Risk Retention Rule was adopted in substantially the same form as in the JFSA’s initial proposal, except that, in response to questions and comments submitted to the JFSA regarding the applicability of the rule to securitizations whose underlying assets were transferred by a business entity not meeting the definition
of “originator” (namely, business entities that were not directly or indirectly involved in the organization of the original assets), the JFSA amended the definition of “original assets” to clarify that assets transferred into a securitization by a party other than the originator are also considered “original assets” for purposes of the rule. By so doing, the JFSA eliminated any doubt that securitizations without a classic originator, such as Open Market CLOs, are within the scope of the rule. In adopting the Japanese Risk Retention Rule in substantially the same form as in the JFSA’s initial proposal, the JFSA elected not to exclude from the rule any particular types of securitizations as such or securitizations from any particular jurisdictions as such and instead sought to address concerns raised by commentators and other interested parties through guidance regarding the application of the rule in its Responses to Comments and Answers to FAQs.

As adopted, the Japanese Risk Retention Rule requires banks, bank holding companies, credit unions (shinya kinko), credit cooperatives (shinya kumiai), labor credit unions (rodo kinko), agricultural credit cooperatives (nogyo kyodo kumiai), ultimate parent companies of large securities companies and certain other financial institutions regulated by the JFSA (collectively, “Covered Japanese Institutions”) that invest in “securitization transactions” to apply an increased regulatory capital risk weighting—set at three times higher than that otherwise applied to compliant securitization exposures (subject to a risk weight cap of 1,250 percent)—to securitization exposures that they hold, unless such Covered Japanese Institutions can establish either of the following:

i. that the “originator” of the applicable securitization commits to retain, in horizontal, vertical or, in some cases, L-shaped form, at least 5 percent of the nominal value of the securitized exposures, or

ii. that the securitization’s “original assets” were not inappropriately originated, based on the originator’s involvement in the original assets, the quality of the original assets or any other relevant circumstances.

As was the case in the JFSA’s initial proposal, securitization exposures purchased by Covered Japanese Institutions before March 31, 2019 will be grandfathered, but only while they are held by the Covered Japanese Institution that holds them on March 31, 2019. Subsequent purchasers after that date will not benefit from this grandfathering.

The JFSA’s Responses to Selected Comments and Answers to FAQs

The Responses to Comments and Answers to FAQs that were published by the JFSA together with the final Japanese Risk Retention Rule provide additional guidance, among other things, with respect to (1) the application of the rule to securitizations that are exempted from risk retention pursuant to the risk retention requirements of one or more other jurisdictions, (2) the application of the rule to securitizations that are structured to
comply with the risk retention requirements of one or more other jurisdictions (e.g., securitizations that comply with the US risk retention rules and/or the EU risk retention requirements), (3) instances where the original assets can be deemed not to have been inadequately originated, including based on compliance with risk retention methods other than those prescribed by the rule, (4) the factors that Covered Japanese Institutions should consider when determining, based on an analysis of a securitization’s original assets, that such original assets have not been inadequately originated and (5) when and how to confirm compliance with the rule’s retention requirements. We next discuss the guidance that the JFSA provided with respect to each of these matters.

1. SECURITIZATIONS EXEMPTED FROM RISK RETENTION UNDER THE RISK RETENTION REQUIREMENTS OF OTHER JURISDICTIONS

In its Responses to Comments, the JFSA clarified that Open Market CLOs in the United States and other securitizations for which no party is required to retain credit risk pursuant to their local risk retention requirements are not automatically exempted from the Japanese Risk Retention Rule as such and that, instead, Covered Japanese Institutions will need to examine whether the underlying assets in such securitizations were not inadequately originated “through in-depth analysis.” Similarly, in its Answers to FAQs, the JFSA clarified that if an originator or an equivalent party is not required to retain credit risk for securitization products in the jurisdiction where the products are originated, or if no one is required to retain credit risk for certain securitization products such as Open Market CLOs in the United States, Covered Japanese Institutions will need to determine whether “original assets were not inadequately originated” through in-depth analysis. To that end, in its Answers to FAQs, the JFSA provided a number of examples (which we discuss below under the heading “Instances Where Original Assets Can Be Deemed Not to Have Been Inadequately Originated”) of instances where the original assets can be deemed not to have been inadequately originated based on an in-depth analysis of the quality of the original assets, as well as guidance regarding the type and scope of the in-depth analysis of the quality of the original assets that is necessary for determining that the original assets have not been inadequately originated (which we discuss below under the heading “Factors to Consider in Determining That Original Assets Have Not Been Inadequately Originated”).

2. SECURITIZATIONS THAT SATISFY THE RISK RETENTION REQUIREMENTS OF OTHER JURISDICTIONS

In its Responses to Comments, the JFSA also clarified that securitizations that are structured to comply with the risk retention requirements of one or more other jurisdictions (e.g., securitizations that comply with the US risk retention rules and/or the EU risk retention requirements) are not automatically exempted from the Japanese Risk Retention Rule as such and that, instead, in instances where such securitizations do not satisfy the risk retention
requirement of the rule (e.g., because the retaining party is not the “originator” within the meaning of the rule or because the retention method used is not among the retention methods permitted under the rule), Covered Japanese Institutions will need to determine whether the underlying assets in such transactions were not inadequately originated. The JFSA further clarified, however, that if a risk retention regulation equivalent to the Japanese Risk Retention Rule is implemented in the jurisdiction where a securitization product is formed and such product meets the requirements under such jurisdiction’s risk retention regulation, it may be determined that such product meets the requirements under the Japanese Risk Retention Rule and that where an originator or an equivalent party is directly required to retain credit risk pursuant to a securitization’s “local” credit risk retention rules that is equivalent to the credit risk required to be retained under the Japanese Risk Retention Rule\(^\text{15}\) and that where an originator or equivalent party is directly required to retain credit risk pursuant to a securitization’s “local” credit risk retention rules that is equivalent to the credit risk required to be retained under the Japanese Risk Retention Rule, such securitization may be regarded as compliant with the retention requirements of the Japanese Risk Retention Rule, unless there is a special circumstance in which compliance by the originator or equivalent party with its retention obligations under the risk retention requirements of such other jurisdiction is reasonably doubted.\(^\text{16}\) In addition, the JFSA provided a number of examples (which we discuss below under the heading “Instances Where Original Assets Can Be Deemed Not to Have Been Inadequately Originated”) for instances where the original assets can be deemed not to have been inadequately originated based on retention by the “originator” and/or another transaction party of credit risk equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule.

3. INSTANCES WHERE ORIGINAL ASSETS CAN BE DEEMED NOT TO HAVE BEEN INADEQUATELY ORIGINATED

In its Answers to FAQs, the JFSA provided the following examples for instances where the original assets can be deemed not to have been inadequately originated based on retention by the “originator” and/or another transaction party of credit risk equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule\(^\text{17}\):

- The originator’s parent company or a relevant party other than the originator that was deeply involved in the organization of the securitization product (such as an arranger) retains the credit risk, and it can be confirmed that the aggregate of the credit risk borne by such party and, if applicable, by the originator is equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule.\(^\text{18}\)
- The originator provides credit support to the subordinate tranche of the securitization (e.g., through a guarantee) and it is confirmed that the credit risk borne by the originator is equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule.
- The financial assets that form the underlying assets of the securitization are
randomly selected from an asset pool, and the originator retains 5 percent or more of the total credit risk arising from the aggregate exposure to such asset pool by continuously holding either (i) all of the asset pool except for the financial assets that form the underlying assets of the securitization or (ii) financial assets that were randomly selected from such asset pool simultaneously with the financial assets that form the underlying assets of the securitization.\textsuperscript{19} For financial assets to be deemed to have been randomly selected, the asset pool must in general have 100 or more financial assets and relevant factors that evidence random selection such as the timing of origination of the financial assets, their types, the place of their origination, their maturity date, the ratio of funds borrowed, the types of rights, business sectors and balance due, etc. must be appropriately taken into consideration when selecting the financial assets that will form the original assets of the securitization and the financial assets that will be retained by the originator.

- The securitization is a synthetic securitization in which the originator and the investors are obliged to jointly bear the loss incurred by the original assets, and it is confirmed that the credit risk retained by the originator is equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule.

In its Answers to FAQs, the JFSA also provided the following example of instances where the original assets can be deemed not to have been inadequately originated based on an in-depth analysis of the quality of the original assets\textsuperscript{20}:

- Relying on objective materials such as appraisal reports or engineering reports for securitizations whose original assets are secured by real estate properties (including trust beneficiary rights on real estate properties).

- The party organizing a securitization transaction organizes such transaction by purchasing the securitization’s underlying assets in the market (as opposed to using financial assets that such party holds) and it can be determined that the quality of such financial assets is not inappropriate based on objective materials.\textsuperscript{21}

In its Answers to FAQs, the JFSA also provided the following example of cases in which adequate risk retention interest is deemed to be continuously retained even though the retention requirements set forth in the Japanese Risk Retention Rule are no longer satisfied due to changes after the acquisition of the securitization exposure\textsuperscript{22}:

- The aggregate amount of the exposure held by the originator no longer meets the requirements set forth in the Japanese Risk Retention Rule due to the default of the original assets even though the originator did meet the terms set forth in the Japanese Risk Retention Rule at the time of the acquisition of the securitization product and the originator continues to hold such exposure.
4. FACTORS TO CONSIDER IN DETERMINING THAT ORIGINAL ASSETS HAVE NOT BEEN INADEQUATELY ORIGINATED

In its Answers to FAQs, the JFSA clarified that a determination that the original assets have not been inadequately originated in a securitization transaction must be made on a case-by-case and specific basis, taking into consideration the involvement of the originator in and the quality of such original assets. The JFSA provided the following guidance regarding the type and scope of the in-depth analysis of the quality of the original assets that is necessary for determining that the original assets have not been inadequately originated:

- It is insufficient to determine the quality of the original assets solely based on (i) the external rating of the asset-backed securities, (ii) the market trading prices of the original assets or (iii) the short-term performance of the original assets (especially during a boom period).

- If the original assets are loans, the following should be confirmed and verified: (i) whether the originator’s loan review criteria were appropriate, (ii) whether the covenants in the loan agreements are conducive to investor protection, (iii) whether the type and terms of the collateral securing such loans are appropriate and (iv) whether the collection rights of the originator, the servicer and any other relevant party are adequate. The JFSA clarified that in case it is difficult for a Covered Japanese Institution to confirm and verify the foregoing on a loan-by-loan basis, such Covered Japanese Institution may instead evaluate whether objective and reasonable standards have been implemented for loan acquisition and replacement and whether the loans are being duly acquired and replaced in accordance with such objective and reasonable standards (e.g., through a sample review).

- It is appropriate to conduct risk analysis of the securitization product as a whole through a stress test based on reasonable scenarios and periods.

- A Covered Japanese Institution’s determination that the original assets of a securitization were not inadequately originated must be made in relation to such Covered Japanese Institution’s investment criteria.

In addition, the JFSA clarified in its Responses to Comments that in order to determine that the “original assets were not inadequately originated,” the organization of original assets underlying individual securitization products must be “examined substantially” and that, therefore, it cannot be uniformly judged for Open Market CLOs based solely on the general characteristics of their organization process that their original assets “were not inadequately originated.”

Finally, in response to a comment received by the JFSA suggesting that, it should be acceptable to determine that “the original assets were not inadequately originated” based on the fact that the original assets are priced and traded in the secondary market, the JFSA advised that it is particularly important to conduct an in-depth analysis on the quality of original assets from the...
perspective of credit risk when determining whether “the original assets were not inadequately originated” and that, in this regard, it cannot be said that the mere existence of a market price indicates the adequate formation of the original assets.\footnote{25}

5. WHEN AND HOW TO CONFIRM COMPLIANCE WITH THE RULE’S RETENTION REQUIREMENTS

In its Answers to FAQs, the JFSA clarified that, in general, Covered Japanese Institutions need to establish a due diligence framework and confirm compliance with the retention requirements of the Japanese Risk Retention Rule not only at the time of acquisition of the securitization product but also each time a Covered Japanese Institution is required to calculate the risk weighting of its assets for capital adequacy purposes. The JFSA further clarified that when determining compliance with the retention requirements of the Japanese Risk Retention Rule, it is generally appropriate to receive confirmation from the originator in writing, but it may be acceptable method such as an interview with a related party, if it is practically difficult to receive written confirmation.\footnote{26}

Endnotes

\footnote{1}{The final amendment is available (in Japanese) here: \url{https://www.fsa.go.jp/news/30/ginkou/20190315-1/09.pdf}.}

\footnote{2}{The JFSA published its initial proposal to amend the regulatory capital requirements relating to investments by Covered Japanese Institutions in securitizations in December 2018. The JFSA’s initial proposal is available (in Japanese) here: \url{https://www.fsa.go.jp/news/30/ginkou/20181228_3/01.pdf}.}

\footnote{3}{The JFSA’s Responses to Comments are available (in Japanese) here: \url{https://www.fsa.go.jp/news/30/ginkou/20190315-1/02.pdf}.}

\footnote{4}{The JFSA’s Answers to FAQs are available (in Japanese) here: \url{https://www.fsa.go.jp/news/30/ginkou/20190315-1/42.pdf}.}

\footnote{5}{Important Notice: This Legal Update describes new Japanese regulations whose interpretation is ultimately a matter of Japanese law. Nothing in this Legal Update should be construed as legal advice concerning Japanese law. Furthermore, the new regulations and related guidance were all published in Japanese and this Legal Update is based on an unofficial translation of the regulations and selected guidance. Finally, as is the case with all regulations, we expect that deference will be given to the JFSA, as the drafter and enforcer of these regulations, with respect to their interpretation.}

\footnote{6}{See responses nos. 41 and 44 in Responses to Comments.}

\footnote{7}{The term “Open Market CLO” is used herein as defined in the decision of the U.S. Court of Appeals for the District of Columbia Circuit in the legal action captioned The Loan Syndications and Trading Association v Securities and Exchange Commission and Board of Governors of the Federal Reserve System, No. 1:16-cv-0065.}

\footnote{8}{See responses nos. 31 and 41 in Responses to Comments.}

\footnote{9}{“Securitization Transaction” is defined in Article 1 of the JFSA’s capital adequacy criteria pursuant to Article 14-2 of the Banking Act and generally includes any transaction in which the credit risk associated with an underlying exposure/pool of exposures is tranch into two or more senior/subordinated exposures and all or a part of such
tranched exposures are transferred to one or more
third parties. This is similar to EU risk retention,
which is also keyed off of tranching for purposes
of covered transactions, and different from US risk
retention, which applies to asset-backed securities
as defined in the Securities Exchange Act of 1934,
as amended.

10 “Originator” is defined in Article 1 of the JFSA’s
capital adequacy criteria pursuant to Article 14-2
of the Banking Act, as (i) an institution involved in
the origination of underlying assets directly or
indirectly; or (ii) a sponsor of an ABCP conduit or
other similar program that acquires exposures from
third parties.

11 Under the Japanese Risk Retention Rule, (i) eligible
vertical retention interest means a pro rata portion
of each tranche of securitization exposures, the
total of which is equal to or greater than 5 percent
of the total exposure of the securitized assets, (ii)
eligible horizontal retention interest means an
amount of the first loss tranche equal to or greater
than 5 percent of the total exposure of the
securitized assets and (iii) eligible L-shaped
retention interest, which is only permitted if the
most junior tranche in the applicable securitization
is less than 5 percent of the total exposure of the
securitized assets, means all of the first loss
tranche and a pro rata portion of the more senior
tranches. Regardless of the form or retention, the
retained interest needs to be retained for as long
as investor interests remain outstanding.

12 We note that the direct translation of the JFSA’s
language concerning the creation of the original
assets is the “formation” of such assets (as
opposed to “origination”). However, because the
creation of financial assets is commonly referred to
in the United States as “origination,” we refer to
the creation of the original assets in this Legal
Update as the “origination” of such assets.

13 See responses nos. 41 and 47 in Responses to
Comments.

14 See answer to Article 248-Q5 in Answers to FAQs.

15 See response no. 47 in Responses to Comments.

16 See answer to Article 248-Q5 in Answers to FAQs.

17 See answer to Article 248-Q2 in Answers to FAQs.

18 See also responses nos. 38 and 43 in Responses to
Comments, in which the JFSA clarified that, with
respect to securitizations that comply with the risk
retention requirements of one or more other
jurisdictions but do not comply with the risk
retention requirements of the Japanese Risk
Retention Rule because the retaining party in such
transactions is not the “originator” within the
meaning of the rule, Covered Japanese Institutions
may determine that such transactions are
exempted from the risk retention requirements of
the rule on the basis that the original assets in
such transactions were not “inadequately origi-
nated” if they are able to confirm that the parent
company of the “originator” or another party that
was deeply involved in the organization of such
securitization (such as an arranger) retains the
credit risk in such transaction and that the total
credit risk borne by such party and, if applicable,
by the originator, is equivalent to or higher than
the risk required to be retained under the
Japanese Risk Retention Rule. See also response
no. 47 in Responses to Comments, where in
response to questions and comments submitted to
the JFSA regarding whether CLO managers are
included in the definition of “originator” for
purposes of the rule, the JFSA advised that,
depending on the direct or indirect involvement of
a CLO manager in the origination of underlying
assets, a CLO manager may fall under the
definition of “originator” and that if a CLO
manager is deeply involved in the origination of a
CLO and retains the credit risk equal to or higher
than the risk required under the Japanese Risk
Retention Rule, it may be determined that
“original assets were not inadequately originated”
in light of the purpose of the Article.

19 See also response no. 29 in Responses to
Comments, where, in response to a comment that
Covered Japanese Institutions should be permitted
to determine that the underlying assets in a
securitization transaction “were not inadequately
originated” on the basis that such transaction
complies with the EU risk retention requirements
under the “representative sample method” (which
is not among the permitted retention methods
under the Japanese Risk Retention Rule), the JFSA
advised that taking into account the purpose of
this provision (the risk retention by originators),
even if an originator does not hold a securitization
product itself, if underlying assets of a securitiza-
tion product are randomly selected from an asset
pool that includes multiple claims, it may be
determined that “the original assets were not inadequately originated” if the originator retains credit risk equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule, through continuous holding of such asset pool except for the underlying assets.

20 See answer to Article 248-Q2 in Answers to FAQs.
21 Note that, as discussed below, the JFSA has confirmed that it is insufficient to determine the quality of the original assets solely based on the market trading prices of the original assets.
22 See answer to Article 248-Q2 in Answers to FAQs.
23 See answer to Article 248-Q2 in Answers to FAQs.
24 See response no.42 in Responses to Comments.
25 See response no.46 in Responses to Comments.
26 See answer to Article 248-Q5 in Answers to FAQs.
On June 18, 2019, the US Securities and Exchange Commission (SEC) issued a concept release soliciting “comment on possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections.” Under the Securities Act of 1933, as amended (Securities Act), every offer and sale of securities must be registered with the SEC unless an exemption from registration is available. In the concept release, the SEC specifically notes that the overall framework for exempt offerings has, particularly recently, changed significantly due to the introduction, expansion or revision of various registration exemptions.

The concept release does not contain specific rule proposals. Rather, the SEC is seeking public comment on whether there are:

- Ways to make the exemption framework more consistent, accessible and effective in application;
- Ways to simplify the complexity that now exists in the exempt offering framework;
- Gaps in the exempt offering framework that make it difficult for some companies to rely on an exemption from registration at key stages of their business cycle; and
- Ways to allow issuers to transition from exempt offering types to registered public offerings without undue friction or delay.

Many of the requests for comment focus on smaller issuers and whether the exempt offering framework works for them. The SEC identified 138 separate areas on which it is specifically asking for comment and many of those areas contain multiple sub-requests for information. Rather than comprehensively describing the matters under consideration, this Legal Update highlights some of the more interesting questions raised in the concept release. The comment period is expected to remain open through late September 2019.
Exempt Offering Framework Generally

The concept release provides a helpful overview of the exempt offering framework generally and provides details on the background of many of the exemptions from Securities Act registration. The SEC also addresses the requirements for various exemptions, including how the requirements differ among those exemptions, as well as how those exemptions are being utilized.

The SEC asks a series of questions about the overall exempt offering framework. Areas where the SEC is seeking input on this topic include:

• Whether the existing framework provides appropriate options for different types of issuers to raise capital at key stages of their business cycles;
• Whether the existing framework or the exemptions themselves are too complex either because of the number of exemptions or because of the way they are structured;
• Whether offers should be deregulated;
• How technology impacts decisions to rely on a specific exemption; and
• Whether more investors should be able to participate in exempt offerings.

Accredited Investor Definition

A person who qualifies as an accredited investor is eligible to participate in many exempt offerings that otherwise are generally not available to non-accredited investors.3 The Dodd-Frank Wall Street Reform and Consumer Protection Act directed the SEC to, among other things, review the accredited investor definition as it relates to natural persons every four years to determine whether the definition should be revised for the protection of investors, in the public interest and in light of the economy.

Currently, natural persons are accredited investors if their income exceeds $200,000 in each of the two most recent years (or $300,000 in joint income with the person’s spouse) and they reasonably expect to reach the same income level in the current year, or their net worth exceeds $1,000,000 (individually or jointly with a spouse) excluding the value of their primary residence. In addition, directors, executive officers and general partners of the issuer are accredited investors. The SEC last reviewed the definition in 2015. Areas where the SEC is seeking input on this topic include whether:

• The current definition should be retained;
• The financial thresholds should be adjusted;
• The definition of spouse should be expanded to include spousal equivalents; and
• Other measures of sophistication should be included that would allow a person to qualify as an accredited investor.

In addition, the SEC is seeking comment on whether revisions should be made to other

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aspects of the definition of accredited investor, including whether:

• Other entities should be eligible to qualify as accredited investors in addition to those enumerated in the existing rule; and
• The current $5,000,000 asset test should be replaced by an investments test.

Rule 506 of Regulation D

Section 4(a)(2) of the Securities Act exempts from the registration requirements “transactions by an issuer not involving any public offering.” Whether any specific transaction involved a public offering was left to the interpretation of the courts and the SEC. In order to provide objective standards that issuers could rely on, the SEC adopted Rule 506 under Regulation D of the Securities Act, now Rule 506(b), as a non-exclusive “safe harbor” under Section 4(a)(2). Subsequently the SEC adopted Rule 506(c) as another non-exclusive “safe harbor” under Section 4(a)(2) that eliminates the prohibition on general solicitation, provided that all purchasers of the securities offered are accredited investors and the issuer takes reasonable steps to verify their accredited investor status. Areas where the SEC is seeking input on this topic include whether:

• Rules 506(b) and 506(c) should be combined into one exemption and, if so, what features of the existing rules should be retained;
• It is important to allow non-accredited investors to be able to participate in a Rule 506(b) offering;
• The information requirements of Regulation D should be aligned with those of other exempt offerings;
• The SEC should define general advertising and general solicitation;
• Investment limits should be added for non-accredited investors; and
• Non-accredited investors should be allowed to participate in an offering that involves a general solicitation.

Regulation A

Regulation A was initially adopted by the SEC pursuant to its exemptive authority for offerings up to $5,000,000. In 2015, the SEC amended Regulation A and created two tiers of exempt offerings of up to $50,000,000 and in 2018 expanded eligibility to use Regulation A to include issuers that are subject to the ongoing reporting requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). The Jumpstart Our Business Startups Act (JOBS Act) directed the SEC to, among other things, review the Tier 2 $50,000,000 offering limit every two years. Areas where the SEC is seeking input on this topic include whether:

• There is anything about the Regulation A process that is unduly burdensome;
• The costs associated with conducting a Regulation A offering dissuade issuers from relying on the exemption;
• The Tier 2 offering limit should be increased;
• The eligible categories of issuers and/or
the types of eligible securities should be expanded;

- To eliminate or change the individual investment limits for non-accredited investors in Tier 2 offerings; and
- To permit the use of quick response (QR) codes (machine-readable images that contain data and can direct the user to a website or application) in lieu of hyperlinks to an offering circular.

**Rule 504 of Regulation D**

Rule 504 under Regulation D provides an exemption from Securities Act registration for offerings of up to $5,000,000 in any 12-month period. Certain categories of issuers are not eligible to rely on Rule 504, including issuers that already file public reports under the Exchange Act. Areas where the SEC is seeking input on this topic include whether:

- The Rule 504 exemption is useful to help issuers meet their capital-raising needs and address investor protection concerns;
- The $5,000,000 offering limit should be increased;
- The categories of eligible issuers should be expanded; and
- The exemption is duplicative of the Regulation A Tier 1 exemption.

**Intrastate Offerings**

Section 3(a)(11) of the Securities Act exempts from the registration requirements any offering of securities “offered and sold only to persons resident within a single state or territory, where the issuer of such security is a person resident and doing business within, or if a corporation, incorporated by and doing business within, such state or territory.” In order to provide objective standards that an issuer could rely on, the SEC adopted Rule 147 as a “safe harbor” under Section 3(a)(11), focusing on the local financing of issuers by investors within the issuer’s state or territory. In order to modernize the safe harbor, in 2016 the SEC adopted Rule 147A under its general exemptive authority contained in Section 28 of the Securities Act. For this reason, Rule 147A is able to focus on sales rather than offers and on where the issuer does business as opposed to where it is organized. Areas where the SEC is seeking input on this topic include:

- The extent to which the intrastate exemptions are being used;
- Whether Rules 147 and/or 504 should be eliminated; and
- Whether the current wording of the rules captures the intrastate intention of the exemptions.

**Regulation Crowdfunding**

Regulation Crowdfunding was adopted by the SEC to implement the provisions of Title III of the JOBS Act. Eligible issuers are currently entitled to raise up to $1,070,000 in any 12-month period in reliance on the exemption. Areas where the SEC is seeking input on this topic include whether:

- The requirements of Regulation Crowdfunding appropriately address
capital formation and investor protection concerns;

• The costs associated with conducting a Regulation Crowdfunding offering dissuade issuers from relying on the exemption or intermediaries from facilitating offerings;

• Changes should be made to Regulation Crowdfunding, such as increasing the offering limit;

• The issuer eligibility requirements should be expanded; and

• The exemption under Section 12(g) of the Exchange Act for securities issued in a Regulation Crowdfunding offering should be modified to conform to the exemption for Regulation A Tier 2 securities.

Potential Micro-offering Exemption

In the concept release, the SEC noted that some commentators have expressed concerns that smaller issuers continue to face difficulties in accessing capital. The release notes that concerns have been raised with respect to issuers that are too small or seeking to raise too small an amount of capital to effectively conduct an offering under existing exemptions. Areas where the SEC is seeking input on this topic include:

• Whether a micro-offering exemption should be created;

• What conditions are necessary to rely on a micro-offering exemption if one is created;

• Whether securities issued in a micro-offering should be considered “restricted” securities; and

• Whether securities issued in a micro-offering should be “covered securities” for blue sky purposes.

Integration

A concern of frequent issuers of privately-placed securities is whether multiple securities transactions should be integrated and considered part of the same offering. If multiple securities transactions are considered part of the same offering, the issue becomes whether an exemption from registration is still available for the integrated offerings as a whole. There is not a bright line test for determining whether offerings should be integrated. The determination requires an analysis of specific facts and circumstances. For example, in Rule 502(a) under Regulation D, the SEC identified five factors to consider in determining whether offerings should be integrated.\(^4\) In addition, the SEC has created a number of “safe harbors” from integration, including with respect to Regulation A offerings, Regulation Crowdfunding offerings and intrastate offerings pursuant to Rule 147 or 147A, where the SEC explicitly identified the types of offerings that would not be integrated with the offerings in question, as well as in the circumstances set forth in Rules 152 (a transaction not involving a public offering will not be integrated with a subsequent public offering) and 155 (when an abandoned offering will not be integrated with a subsequent offering). Areas where
the SEC is seeking input on this topic include whether:

- One integration doctrine should apply to all exempt offerings;
- The six-month period in the five-factor test of Rule 502(a) should be shortened; and
- The SEC should adopt additional integration safe harbors.

### Pooled Investment Funds

An important source of funding for some investors includes pooled investment funds, such as registered investment companies, business development companies and private funds. Certain pooled funds, such as registered investment companies and business development companies, are deemed accredited investors without regard to the amount of assets or other qualifications of the fund. On the other hand, private funds, which raise funds in one or more exempt offerings, are accredited investors only if they meet the eligibility criteria. As a result, it may be difficult for non-accredited retail investors to invest in a private fund to gain access to most exempt offerings. Areas where the SEC is seeking input on this topic include:

- The extent to which issuers view pooled investment funds as an important source of capital for exempt offerings;
- How recent market trends have affected retail investor access to issuers that do not seek to raise capital in the public markets;
- Whether there are regulatory provisions or practices that discourage participation by registered investment companies in exempt offerings; and
- Whether all types of pooled funds should be able to qualify as accredited investors without regard to satisfying any quantitative requirements.

### Secondary Trading

In most exempt offerings, the securities issued are considered “restricted” and therefore not freely tradeable upon purchase. In addition, there may not be an exemption from applicable state laws for resales of securities acquired in exempt offerings. In the concept release, the SEC highlights the fact that potential investors are reluctant to invest in exempt offerings unless they know there will be an exit opportunity. As a result, there is a concern that many persons are unwilling to invest in, or at least have significant exposure to, securities sold in exempt offerings. Areas where the SEC is seeking input on this topic include:

- Whether concerns about secondary market liquidity have a significant effect on issuers’ decision-making with regard to primary capital-raising options;
- Whether secondary market liquidity affects the decision-making of individual investors;
- Whether issuers of exempt securities are concerned that secondary trading could lead to a high number of record holders, resulting in a requirement to register under Section 12(g) of the Exchange Act;
• Whether Rule 144 should be revised to reduce the holding period requirement;
• Whether the SEC should expand the number of offerings that qualify for federal preemption of blue sky laws; and
• What other steps could be taken to enhance secondary trading liquidity of securities issued in exempt transactions.

Practical Considerations
Although changes to the exempt offering framework may not be imminent, the concept release provides an opportunity for issuers and investors to provide input on issues they have faced in this area either on a regular basis or under particular circumstances. This is the time for interested parties to become part of the conversation.

Interested persons should consider submitting comments to the SEC either in response to one or more of the specific questions raised in the concept release or to raise any other concerns that they may have with regard to the exempt offering framework.

In addition to requesting public comments, the concept release contains extensive discussion on the background of many of the exempt offering provisions. Therefore, the release itself provides a resource that can be consulted on issues as they arise in the future.

Endnotes
2 Various definitions of the term accredited investor are contained in Section 2(a)(15) of the Securities Act, as well as in Rule 215 and in Rule 501(a) of Regulation D, each promulgated under the Securities Act.
3 The term has other uses including in determining whether a company is required to register under Section 12(g) of the Exchange Act, who an emerging growth company can communicate with when it is “testing-the-waters” and which FINRA member firms must file private offering documents with FINRA.
4 The five factors identified in Rule 502(a) are whether: (i) the sales are part of a single plan of financing, (ii) the sales involve issuance of the same class of securities, (iii) the sales have been made at or about the same time, (iv) the same type of consideration is being received, and (v) the sales are being made for the same general purpose.
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  *Legal 500 USA 2019*

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  *IFLR1000 2019*

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  *Asset-Backed Alert 2018*

- Ranked Band 1 for Capital Markets: Securitization
  *Chambers Global 2019*

- “They are one of the best firms in this space.”
  *Chambers Global 2018*
class MirrorX(bpy.types.Operator):
    """This adds an X mirror to the selected objects."
    bl_idname = "object.mirror_mirror_x"
    bl_label = "Mirror X"

    @classmethod
    def poll(cls, context):
        return context.active_object is not None
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