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GREAT FUND INSIGHTS

Insights for fund managers – ESA's opinion on the jurisdictional scope of application of the EU securitisation regulation

Speed read

On Friday 26 March 2021 a joint opinion on the jurisdictional scope of the obligations of the EU Securitisation Regulation[1] (**EUSR**) was published (**Joint Opinion**, linked here) by the Joint Committee of the European Supervisory Authorities (**ESAs**, ie EBA, ESMA, EIOPA). The Joint Opinion is important because it contains the views of the ESAs on the EUSR's jurisdictional scope on third country (ie non-EU) transactions and non-EU entities and the interplay between the EUSR and the Alternative Investment Fund Managers Directive (**AIFMD**) on which fund managers have been seeking clarity since December 2017 when the EUSR was first published.

The two key EUSR provisions needing clarity are (i) those on when an alternative investment fund manager (**AIFM**) is in-scope in respect of its alternative investment funds (**AIFs**) which have exposure to securitisations through the definition of "institutional investor" set out in Article 2(12)(d) and (ii) to who can an "institutional investor" delegate the Article 5 due diligence requirements.

The Joint Opinion is non-binding and is now subject to the European Commission forming its own view on the issues raised in it. The ESAs have invited the European Commission: (i) to consider clarifying certain aspects by issuing a statement with interpretative guidance, where such guidance can be provided based on the existing text of the EUSR and (ii) to address other issues via legislative amendments. With regard to the latter, note that the European Commission is carrying out a wider review of the EUSR regime, on which it will report (with legislative proposals) in early 2022.

Therefore, while the Joint Opinion provides insights on the approach recommended by the ESAs, it will be some time until there is certainty on the interpretation of the various issues raised by the ESAs in the Joint Opinion. In the meantime, AIFMs will need to be mindful of this Joint Opinion when determining issues of interpretation regarding the areas of uncertainty highlighted in this bulletin.

From the perspective of the UK Securitisation Regulation regime (which applies from the end of the Brexit transition period to UK-regulated institutional investors investing in UK and non-UK securitisations, as well as to securitisations involving UK originators or original lenders, UK sponsors and UK issuers), it should be noted that any non-binding EU measures (such as this Joint Opinion) issued after the end of the Brexit transition period do not form part of the UK Securitisation Regulation regime. While the UK Securitisation Regulation regime largely mirrors the EUSR regime in some (but not all) aspects, it remains to be seen whether UK regulators will consider it appropriate or indeed relevant, to pursue the recommendations and views expressed by the ESAs in the Joint Opinion.

This bulletin focuses on the relevance of the Joint Opinion to AIFMs solely from the perspective of the application of the EUSR regime.

The application and relevance of the EUSR for AIFMS

The EUSR regime applied in the EU Member States[2] from 1 January 2019 so that:

(i) pre-1 January 2019 securitisations are grandfathered (provided no new securities are issued and no new securitisation position is otherwise created on/after 1 January 2019), meaning that in-scope AIFMs in respect of their AIFs in such transactions are required to apply investor due diligence and risk retention requirements applied under the pre-1 January 2019 AIFMD regime (Article 17 of Level 1 AIFMD and Articles 50-56 of Level 2 AIFMD Delegated Regulation); and

(ii) securitisations done on/after 1 January 2019 (and pre-1 January 2019 securitisations that lost the benefit of grandfathering, because new securities are issued or a new securitisation position is otherwise created on/after 1 January 2019) require that in-scope AIFMs in respect of their relevant AIFs comply with certain (directly applicable to them) recast investor due diligence requirements set out in Article 5 of the EUSR[3] when they have exposure to securitisations and are also subject to the amended (under Article 41) Article 17 of the Level 1 AIFMD. The latter provides that where an AIF of an in-scope AIFM is exposed to a securitisation that no longer meets the requirements provided for in the EUSR, the AIFM shall, in the best interests of the investors in the relevant AIF, act and take corrective action, if appropriate.

In-scope AIFMs for these purposes are those that fall within the EUSR definition of "institutional investor" set out in Article 2(12)(d) of the EUSR (ie "*an alternative investment fund manager (AIFM) is defined in point (b) of Article 4(1) of Directive 2011/61/EU that manages and/or markets alternative investment funds in the Union*" (our emphasis)). It is this underlined language that has created significant uncertainty for non-EU AIFMs as to whether they were in-scope AIFMs.

This was on the basis that the AIFMD definition of an AIFM is not geographically limited and so it was then not clear whether, where a non-EU AIFM had marketed a single AIF in the EU, it was: (i) in-scope across all of its AIFs where any of those AIFs had an exposure to a securitisation; (ii) in-scope just for that single marketed AIF; or (iii) not in scope because (EUSR amended) Article 17 of the Level 1 AIFMD did not apply where a non-EU AIFM was marketing an AIF into the EU and there was no supervision or sanction structure for non-EU AIFMs under the EUSR. Part of the confusion was that prior to the EUSR coming into force, the predecessor rules on securitisations in Article 17 of Level 1 AIFMD only applied to AIFMs that managed AIFs in the EU, and in the development of the EUSR there had been no discussions about how it might apply to non-EU AIFMs (ie being in-scope simply because they had marketed an AIF in the EU).

Practical implications of the Joint Opinion

Of key importance from a practical standpoint are the views expressed in the Joint Opinion by the ESAs on (i) when an AIFM is in-scope through the definition of "institutional investor" set out in Article 2(12)(d) and (ii) to whom an "institutional investor" can delegate the Article 5 due diligence requirements under Article 5(5).

(i) "Institutional investor" definition under Article 2(12)(d) of the EUSR and application to non-EU AIFMs

The ESAs recognise that a literal reading of Article 2(12)(d) of the EUSR might suggest that if an AIFM (as defined in Article 4(1)(b) the AIFMD) manages and/or markets one or more AIFs in the EU, it will qualify as an "institutional investor" for the purposes of the EUSR, meaning that non-EU AIFMs that market AIFs under the AIFMD national private placement regimes (**NPPRs**) would fall within the definition of "institutional investors", even where the marketing activities in the EU are limited. The Joint Opinion further acknowledges that this seems to be inconsistent with the requirements of Article 17 of the AIFMD (as amended)[4] and the supervisory requirements of the EUSR, which do not provide for EU supervision of the compliance of non-EU AIFMs. Therefore, the Joint Opinion recommends for the European Commission to clarify the application of the EUSR to non-EU AIFMs to avoid divergences in the application of existing requirements.

The Joint Opinion then rather unhelpfully recommends for the EUSR and the AIFMD to be amended to ensure that non-EU AIFMs comply with Article 5 of the EUSR and Article 17 of the AIFMD (and to include in Article 42[5] of the AIFMD a cross-reference to Article 17 thereby making it apply where marketing using NPPRs) with respect to those AIFs that they market in the EU.

The Joint Opinion goes on to suggest such amendments should also clarify the relevant EU Competent Authorities and required supervisory and administrative powers which are necessary to enforce applicable obligations against non-EU AIFMs. Unfortunately, no further details are provided by the ESAs as to what such enforcement powers might entail, but the Joint Opinion notes that the goal is to ensure an appropriate level of protection for EU investors investing in AIFs marketed by non-EU AIFMs. See section 2.1 of the Joint Opinion for further details.

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(ii) "Institutional investor" definition under Article 2(12)(d) of the EUSR and application to sub-threshold AIFMs

The Joint Opinion notes that the definition of "institutional investor" in Article 2(12)(d) of the EUSR generally refers to AIFMs, as defined in the AIFMD, without any reference to the different types of EU AIFMs and that, simultaneously, there is no explicit exclusion of sub-threshold AIFMs from the definition of "institutional investor". The "sub-threshold AIFMs" for these purposes are EU AIFMs below the thresholds set out in Article 3(2) of the AIFMD which are largely exempt from the AIFMD requirements.

The Joint Opinion recommends to the European Commission to amend Article 2(12)(d) of the EUSR to clarify whether sub-threshold AIFMs fall within the definition of "institutional investor" and also note that a separate AIFMD review is currently underway, which, among other things, analyses the question concerning the appropriate regulation and supervision of sub-threshold AIFMs.

The ESAs note that they take the view, as set out in ESMA's letter to the European Commission of 18 August 2020 on the AIFMD review (linked here), that consideration should be given to the power of the EU Member States to apply additional requirements under their national laws to sub-threshold AIFMs while ensuring coherence between the AIFMD and the EUSR. See section 2.2 of the Joint Opinion for further details.

(iii) Article 5(5) and application of managing investor requirements of the EUSR to AIFMs

In practice, certain "institutional investors" may delegate investment management decisions to a third party managing investor. Article 5(5) of the EUSR addresses such a scenario and provides for the application of the Article 5 due diligence obligations (and to whom sanctions for failure to comply with it may be applied) when an institutional investor appoints another third party institutional investor as an investment manager who may through its discretionary agency cause that institutional investor to be exposed to a securitisation. The due diligence delegation rule provided under Article 5(5) has two distinct elements: the first part that sets out the general permissibility of delegation; and the second part that explains its restrictive consequences, resulting in a clear distinction between conditions and legal consequences.

According to Article 5(5) of the EUSR, a third party managing "institutional investor" can, instead of its appointing client "institutional investor", be subject to the applicable sanctions which may be imposed by the relevant Competent Authority in the relevant EU Member States[6], if it fails to fulfil such due diligence obligations on behalf of its appointing client "institutional investor". An example of this would be where an EU insurance company (an "institutional investor") appoints an EU AIFM (another "institutional investor") to act as its investment manager and thereby the EU AIFM would under Article 5(5) be subject to sanctions under the EUSR instead of the insurance company where as a third party managing "institutional investor" it breached the Article 5 due diligence requirements. It may separately be in breach of its contractual obligations to its appointing client "institutional investor".

Where an EU AIFM is the appointing client "institutional investor", the Joint Opinion notes that application of the sanctions on the managing institutional investor, and not on the AIF which is exposed to the securitisation, raises the question whether it has an impact on the responsibilities under the AIFMD delegation regime. This is because the AIFMD requires that an EU AIFM always retains the ultimate responsibility for the delegated functions. In this regard, the Joint Opinion notes that this is the same for, similar to the AIFMD, the delegation regime of the UCITS Directive in respect of UCITS management companies.

The Joint Opinion also notes that given lack of clarity on the "institutional investor" definition (as discussed above), it is uncertain whether for the purposes of Article 5(5) the institutional investor may give to a non-EU AIFM or sub-threshold AIFM the authority to make investment management decisions and which supervisory powers of EU Competent Authorities would apply in such a case. The ESAs present the view that permitting a sub-threshold or non-EU AIFM to act as "managing party" pursuant to Article 5(5) of the EUSR seems to be inconsistent with the fact that Article 6(4)(a) of the AIFMD requires that external authorised AIFMs need to obtain an additional licence to perform individual portfolio management (so-called discretionary portfolio management), while noting that the AIFMD provisions do not foresee such a possibility for sub-threshold or non-EU AIFMs.

It should also be noted that there are currently divergent interpretations by the National Competent Authorities where investment management functions for an AIF/UCITS (each as an appointing client "institutional investor") are performed by another AIFM or UCITS management company acting as the third party managing "institutional investor" of the AIFM or UCITS management company of the AIF/UCITS[7].

The Joint Opinion recommends the following explicit amendments:

– Article 5(5) of the EUSR to be amended to ensure consistent application and avoid a potential conflict with the AIFMD and UCITS delegation regimes.

– Amendments should clarify that the possibility provided in Article 5(5) of the EUSR to instruct third parties to fulfil the Article 5 due diligence requirements arising under the EUSR is without prejudice to:

  • The AIFMD and UCITS Directive requiring that only AIFMs authorised in accordance with Article 6(4)(a) of the AIFMD and UCITS management companies authorised in accordance with Article 6(3)(a) of the UCITS Directive may perform individual portfolio management services;

  • The responsibilities of authorised AIFMs and UCITS management companies to ensure compliance with the AIFMD and UCITS Directive even where portfolio management functions are delegated to third parties.

– In the case of cross-border delegation (presumably, the ESAs mean in this context only cross-border delegation by "institutional investors" in-scope of the EUSR), the ESAs express the view that there would be merit in amendments to further clarify the allocation of supervisory responsibilities of the "home" and the "host" Competent Authorities, including on the question of which National Competent Authority is responsible for the administrative sanctions procedure vis-à-vis the managing party referred to in Article 5(5) of the EUSR.

Important issues not dealt with in the Joint Opinion

Notwithstanding the commentary of the ESAs in the Joint Opinion, which is not consistently clear or always conclusive on its views, the following important issues still need to be dealt with:

(a) whether delegation by an institutional investor in-scope of the EUSR of its Article 5 due diligence obligations is permitted at all thereunder to a delegate who is not an "institutional investor" as defined in the EUSR. The narrow view is that such delegation is permitted only to other "institutional investors" in-scope of the EUSR and this has been recently adopted explicitly by some EU regulators rather than being the generally applied view of all EU regulators across the board;

(b) whether a more permissive view of the delegation provisions is taken allowing delegation by an institutional investor in-scope of the EUSR to an entity which is not an "institutional investor" as defined in the EUSR, the implications for AIFMs being that such delegation will be solely contractual and the delegating institutional investor remains liable to sanctions as the sanction provisions in Article 5(5) moving the statutory liability to the delegate will not apply; and

(c) whether the delegation of due diligence obligations is permissible to delegates located both in and outside the EU.

A key practical issue for AIFMs is the extent to which they will now need to pre-emptively consider compliance with the EUSR Article 5 due diligence obligations and/or any delegation in relation to existing AIFs and planned AIFs with exposures to securitisations ahead of any final position being taken on these issues.

Allen & Overy has been and continues to be actively involved in the industry's discussions and advocacy efforts, including directly engaging with the relevant regulators, with regard to the EUSR and the UK Securitisation Regulation regimes, and we encourage interested clients to contact us for specific advice.

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References

[1] Regulation (EU) 2017/2402 (linked here).
Note that the EUSR is being amended, the Parliament-adopted text of the amendments (that are part of the EU Capital Markets Recovery Package of measures) was published on 25 March 2021 (linked here) and this amending regulation is expected to enter into force by mid-April 2021. Some of the amendments (such as the special risk retention regime and adjusted application of credit granting standard for NPL securitisations and certain changes to the requirement for third country securitisation special purpose entities) will impact on the due diligence considerations for institutional investors in-scope of the EUSR, but further discussion of this topic is outside the scope of this briefing. Please liaise with your usual A&O contacts if you have further questions on this.

[2] Note that the EUSR has been enacted as a text with relevance for the European Economic Area (the **EEA**, ie EU member states and also Norway, Iceland and Liechtenstein) and it is currently under scrutiny for incorporation into the EEA Agreement (it is currently unclear when this process will be completed). The EEA status is relevant for the purposes of the general scope of application of the EUSR regime, including from the perspective of its application to institutional investors established or supervised in Norway, Iceland and/or Liechtenstein.

[3] Under the recast investor due diligence regime of the EUSR, in-scope AIFMs are required to verify and assess certain matters prior to holding a securitisation position in EU or non-EU securitisations (including compliance with credit granting standards, risk retention, transparency and reporting, with adjusted application when investing in third country (non-EU) securitisations) and, on an ongoing basis, to monitor the transaction, including reporting provided, and have in place written policies, procedures and internal reporting to adequately manage the relevant risks. Compliance of the securitisation with other aspects of the EUSR regime (such as the requirements for third country (non-EU) securitisation special purpose entities and the ban on re-securitisations) will also need to be considered as part of investor due diligence.

[4] Note that under Article 41 of the EU Securitisation Regulation, Article 17 of AIFMD has been replaced by the following: "*Where AIFMs are exposed to a securitisation that no longer meets the requirements provided for in Regulation (EU) 2402/2017 of the European Parliament and the Council, they shall, in the best of interest of investors in the relevant AIFs, act and take corrective actions, if appropriate.*"

[5] Article 42 of the AIFMD provides for minimum requirements that must be met by third country AIFMs marketing via NPPRs, where available.

[6] Those sanctions and remedial measures are set out in the EUSR in Article 32 (which provides for administrative sanctions and remedial measures in the situations set out therein), Article 33 (exercise of the power to impose administrative sanctions and remedial measures) and Article 34 (criminal sanctions). The circumstances in which and how such sanctions will be applied are a matter for the implementing measures of the relevant EU Member State and it is at the discretion of the designated Competent Authorities of the relevant EU Member States as to how they may choose to exercise any of the enforcement powers available to them in the case of any breach of Article 5(5) of the EUSR.

[7] While some considered these cases as discretionary portfolio management and therefore took the view that MiFID rules would need to be applied, others argued that the management of AIFs/UCITS on a delegation basis would not be discretionary portfolio management and the relevant AIFM or UCITS management company performing functions on a delegation basis would be subject to AIFMD/UCITS rules. This issue has been raised in the ESMA letter on the AIFMD review dated 18 August 2020 to the European Commission (linked here). Moreover, sub-threshold and non-EU AIFMs are largely exempt from the scope of the AIFMD. The ESAs have also cited investor protection concerns for sub-threshold and non-EU AIFMs acting as "managing party" pursuant to Article 5(5) of the EUSR.

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