GLOBAL FINANCIAL MARKETS INSIGHT

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AQR AND STRESS TEST RESULTS – A PERIOD OF REFLECTION FOR THE EUROPEAN BANKING SECTOR

OTC EQUITY DERIVATIVE TRANSACTIONS REFERENCING LISTED COMPANIES' SHARES

COMMISSION DELEGATED REGULATION ON LIQUIDITY COVERAGE

INTERCREDITOR ARRANGEMENTS IN RESPECT OF WHOLE LOAN TRANSACTIONS

PRINCIPAL WITH PRINCIPLES – AN OVERVIEW OF "GREEN" BONDS"

CONNECTING TO ASIA'S BOND MARKETS

ISLAMIC BONDS (SUKUK), AND WHY EVERYONE IS TALKING ABOUT THEM…

U.S. CREDIT RISK RETENTION RULES: WILL CLOS SURVIVE

HAS THE EUROPEAN HIGH YIELD MARKET COME OF AGE? OUR OBSERVATIONS FROM AFME'S 9TH ANNUAL HIGH YIELD CONFERENCE

THE EUROPEAN CENTRAL BANK'S PURCHASE PROGRAMMES

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Contents

'Global Financial Markets Insight' is DLA Piper's Financial Markets newsletter designed to keep you informed of products, techniques and developments in the financial market.

Welcome

As 2014 comes to a close the Financial Markets will look back on the year with mixed views. It has been a year driven by policy uncertainty and the impact of regulatory change. Policy uncertainty continues in the approach to stimulating growth in the EU and the global economy: The finalisation of the implementation of the EU ABS Purchase Programme and the Covered Bond Purchase programme failed to generate enthusiasm and an EU Bond Purchase Programme continues to be discussed but not delivered. The results of the EU comprehensive assessment including the Asset Quality Review were published with only a small number of EU banks failing the capital requirements. Rather than engender a sense of security in the EU banking sector it has highlighted how difficult the sector is likely to be going forward as higher capital requirements, increasing non-performing exposures, increasing fines and penalties, expensive IT and property infrastructure and a low margin environment combine to effect return on capital and make the model for some banks and certain asset holdings unsustainable. Recent announcements (in the UK) that limit the ability of banks to offset losses against future profits and the need to finalise a liquidation regime will add costs and pressure. This is likely to generate increasing opportunities for portfolio purchasers and platform service providers but is unlikely to stimulate lending to the SME community. In the US the Final Rules on introduction of a retention requirement requiring CLO managers to retain an economic interest in securitised exposures will hit recent growth in CLOs reducing a source of welcome liquidity and revenue capacity.

Markets do however continue to evolve. We are seeing continued activity in the high yield market and Abengoa's recent bond presented a new twist with the issue of its first green high yield bond. Interest and activity continue to develop in Islamic bond products and Asia is developing a more integrated capital market. The securitisation market continues to be active in certain categories and for the reasons explained above portfolio sales are likely to continue to grow. 2014 also saw the return of a number of CMBS deals and expectations are that the number of CMBS deals will increase in 2015. We also expect to see the further development of the European private placement market as institutional investors take an increasing role in direct negotiation of bond terms and significant stakes in European assets to generate tailored profiles and enhanced yields.

The widely held view is that there are significant pools of capital available to be invested but there is an increasing shortage of investable assets. 2015 is likely to see new financial products, developing markets and new opportunities as well as risks. It is hoped that policy makers and regulators will recognise that growth requires an active capital market and increased availability of capital through a liquid risk transfer and capital transformation mechanism and set the balance at an appropriate level.

Wishing everyone a happy and successful end to 2014.

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AQR AND STRESS TEST RESULTS

A PERIOD OF REFLECTION FOR THE EUROPEAN BANKING SECTOR

In this article, we examine the outcome of the Asset Quality Review (AQR) announced in October 2014 to get a better understanding of the state of play in the European banking sector, the regulatory attitude towards banks and the likely role of portfolio sales and servicing platform restructuring as a consequence for European financial markets.

Whilst most of the euro zone banks survived the comprehensive assessment it served to highlight problems in the current environment for the European financial sector. With an onslaught of painful regulatory reforms and self -inflicted damage (particularly LIBOR and FX manipulation) the prospect for a European economic rebound being led by the European banking sector is increasingly unlikely in the short term. Increased capital, higher non-performing exposures, higher operating costs and a low margin environment all point to a difficult time ahead. An increasing number of new entrants are now driving increasing activity in portfolio sales and outsourcing of IT and servicing platforms as banks attempt to improve their risk and operating fundamentals.

Out of the many and varied regulatory policies and market events three of the most significant to be announced this quarter are:

(i) a US$4.3 billion settlement announced for a number of leading banks relating to fixing foreign exchange markets (on top of already existing fines for LIBOR manipulation and swaps misselling)

(ii) the FSB's announcement to require the most significant financial institutions to hold enough capital so that they would not again require public sector financial support

(iii) the results of the comprehensive assessment of euro sector banks following the AQR

In their own way, each of these events are likely to have significant impacts on the outlook of the European banking sector beyond the initial monetary amounts involved. Management and shareholders are likely to take greater interest and responsibility in reviewing the complex workings of these organisations as a result of the announcements.

Whilst the outcome of the AQR was not as dramatic as the media may have liked, with less banks failing the stress tests than originally envisaged, the outcome is likely to have significant effects on banking assets within the European financial sector. The review constituted the most comprehensive assessment to date of European banks' asset and capital positions. The assessment combined stress tests with an analysis of asset quality to establish a baseline capital adequacy position for banks in the euro area.

The review provides significant operational data for when the European Central Bank (ECB) assumes banking supervision tasks as of 4 November under the single supervisory mechanism (SSM) and marks an accumulation of efforts across various European regulatory bodies including the European Banking Authority, ECB and competent authorities

of participating member states. The comprehensive assessment covered 130 banks. The review identified capital shortfalls for 25 banks totalling €25 billion and adjustments to asset values amounting to €48 billion. An additional €136 billion was identified in non-performing exposures. The comprehensive assessment was made up of two parts:

1) The AQR aimed to review the carrying value of assets as at 31 December 2013 and used uniform methodologies and definitions across participating banks to achieve a consistent understanding of banks capital positions across the sector. The exercise was based on the Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRD IV). Banks are required to have a common equity tier 1 (CET1) ratio of 8%.
2) The stress tests examine banks resilience from a solvency perspective in two hypothetical scenarios:
   - under the baseline scenario banks were required to maintain a minimum CET 1 ratio of 8%;
   - under the adverse scenario banks were required to maintain a minimum CET 1 ratio of 5.5%.

The aim was to establish banks' performance on a common basis. Examples of where adjustments were made even though banks were not breaking any rules would include impairment triggers, calculation of individual specific provisions and collateral valuations. Balance sheets were assumed to remain static over the horizon period through which the stress tests were applied.

A detailed asset review was performed for over 800 specific portfolios making up 57% of the banks' risk weighted assets. This included detailed analysis of more than 119,000 borrowers, the assessment of the valuation of about 170,000 collateral items, the building of 765 models to challenge the banks' own estimates and over 100 models to assess their credit valuation adjustment calculations.

Under the adverse scenario, the banks' aggregate available capital is projected to be depleted by €215.5 billion and risk weighted assets to increase by about €860 billion by 2016 (resulting in around €262.7 billion capital impact in total through the adverse scenario). That more banks did not fail the review highlights the amount of capital raising since the onset of the financial crisis. Between the onset of the financial crisis in 2008 and December 2013, this is put at an excess of €200 billion by participating banks and since December 2013 a further €57.1 billion.

Breakdown of banks with a capital shortfall	
Banks to still raise capital	
Oesterreichischer Volksbanken-Verbund (AT)	
Dexia (BE)	
permanent tsb (IE)	
Hellenic Bank (CY)	
Banca Popolare di Milano[1] (IT)	
Banca Popolare di Vicenza[1] (IT)	
Monte del Paschi di Siena (IT)	
Banca Carige (IT)	
Banco Comercial Português (PT)	
Banks with ECB acknowledgement of their action plans	
Eurobank (GR)	
National Bank of Greece (GR)	
Nova Kreditna Banka Marlbor3 (SI)	
Nova Ljubijanska banka3 (SI)	
Banks that already raised capital	
AXA Bank Europe (BE)	
Bank of Cyprus (CY)	
Cooperative Central Bank (CY)	
Münchener Hypothekenbank (DE)	
Liberbank (ES)	
C.R.H. – Caisse de Refinancement de l'Habitat (FR)	
Piraeus Bank (GR)	
Veneto Banca (IT)	
Banco Popolare (IT)	
Credito Valtellinese (IT)	
Banco Popolare di Sondrio (IT)	
Banco Popolare del l'Emilia Romagna (IT)	
Total	**25**

Whilst the initial focus of banks participating in the comprehensive assessments has been on meeting the capital requirements including under the stress tests and raising capital where required, the post AQR phase must now focus on the structure of the banking sector and how these banks put the extensive capital already raised and to be raised to work. The events of the last quarter must focus the attention of management on the banking model and underlying asset profile of each business.

In looking at the on-going business, it is likely that bank management and shareholders will need to address a number of fundamental questions to improve organisational structures. Key questions to be addressed can be broken down into three types – the immediate question, the short term question and the long term question. These are:

Immediate

- What is the risk and return profile of the organisation and can it be improved?

Short Term

- Which assets are generating a return commensurate with the cost of capital involved and what to do with those that are not?
- How can cost to income ratio be improved at both the asset and organisational management level?
- How can non-core assets be disposed of without further adverse effects on core capital positions?

Long Term

- How can the banks generate better profitability from a lower regulatory capital base?

[1] Capital intervention for Banca Popolare di Milano and Banca Popolare di Vicenza has already been acknowledged by the Bank of Italy

The AQR highlighted that many banks were not adequately recognising/reporting that a significant number of loans fell into the non-performing bucket. Some 18 per cent of loans analysed under the AQR were reclassified from performing to non-performing exposures (NPE). Increasing NPEs naturally reduces the CET1 ratio. In an adverse scenario, corporate exposures are particularly affected, which highlights the continued unwillingness to expand funding to SMEs. Banks carrying high proportions of NPE loans or loans that are likely to become NPEs are expected to see continued pressure with deteriorating profitability as NPE ratios increase. It is likely that these banks need to sell large proportions of NPEs or loans that may become NPEs to establish a stronger financial base. In addition to managing NPEs, banks need to look at base infrastructure costs where existing platforms are expensive and out of date. IT and branch networks push up costs and bring down return on equity. Managing property and servicing platforms is a continuing and expensive process.

A failure to upgrade IT infrastructure will act as a continuing drag on profitability and with additional capital and a low interest rate environment depressing margin spreads, this is a recipe for deteriorating performance and depressed returns reducing further the appetite for investors to support continued expansion of lending to the real economy in Europe.

The restructuring of the European banking market is already underway. It is estimated that over €100 billion of existing loan assets will change hands through 2014 in the form of large scale portfolio sales. European jurisdictions have seen several significant portfolios sold. Examples include IBRC and Ulster Bank's residential and commercial real estate portfolio sales in Ireland, Catalonya Bank SA's €6.5 billion secured retail portfolio sale and Commerzbank's sale of its €4.4 billion loan portfolio in Spain. Italy has already seen a number of significant portfolio sales with Unicredit being one of the most active sellers including its €910 million sale of portfolio assets to Mariner, a US infrastructure fund. With a number of Italian banks failing the stress tests it is likely that the Italian market will remain active through 2015 and beyond. The UK has also seen a number of large portfolio sales with Lloyds and RBS being active asset sellers.

In some cases, as part of the asset sale process, and in others, as a cost rationalisation measure, there has also been a significant amount of interest in servicing requirements, with numerous platforms having been transferred or outsourced, as banks seek to rationalise business models or upgrade servicing capabilities. A capability to manage portfolio assets and make the most from non-performing and performing assets is increasingly big business with buyers and sellers of portfolios looking at various incentive, joint ventures or outsourcing models to maximise recovery values whilst minimising costs and exposure to infrastructure systems. This trend is likely to continue whilst participants seek out an optimum operating model.

What is clear from experience to date is that banks are under pressure to improve return on equity across Europe for a number of reasons and increasing capital requirements will increase pressure on those that do not take advantage of incoming new financing channels. Different portfolio solutions will apply in different cases. In some cases, a straight forward portfolio sale will work, whilst for others, more complex structures with a degree of structuring will improve recovery values and potential return on equity. The increasing number of funds, institutions, alternative capital providers and servicing platforms makes for an interesting mix of opportunity. These may provide an essential opportunity for balance sheet restructuring for those banks that are able to take advantage.

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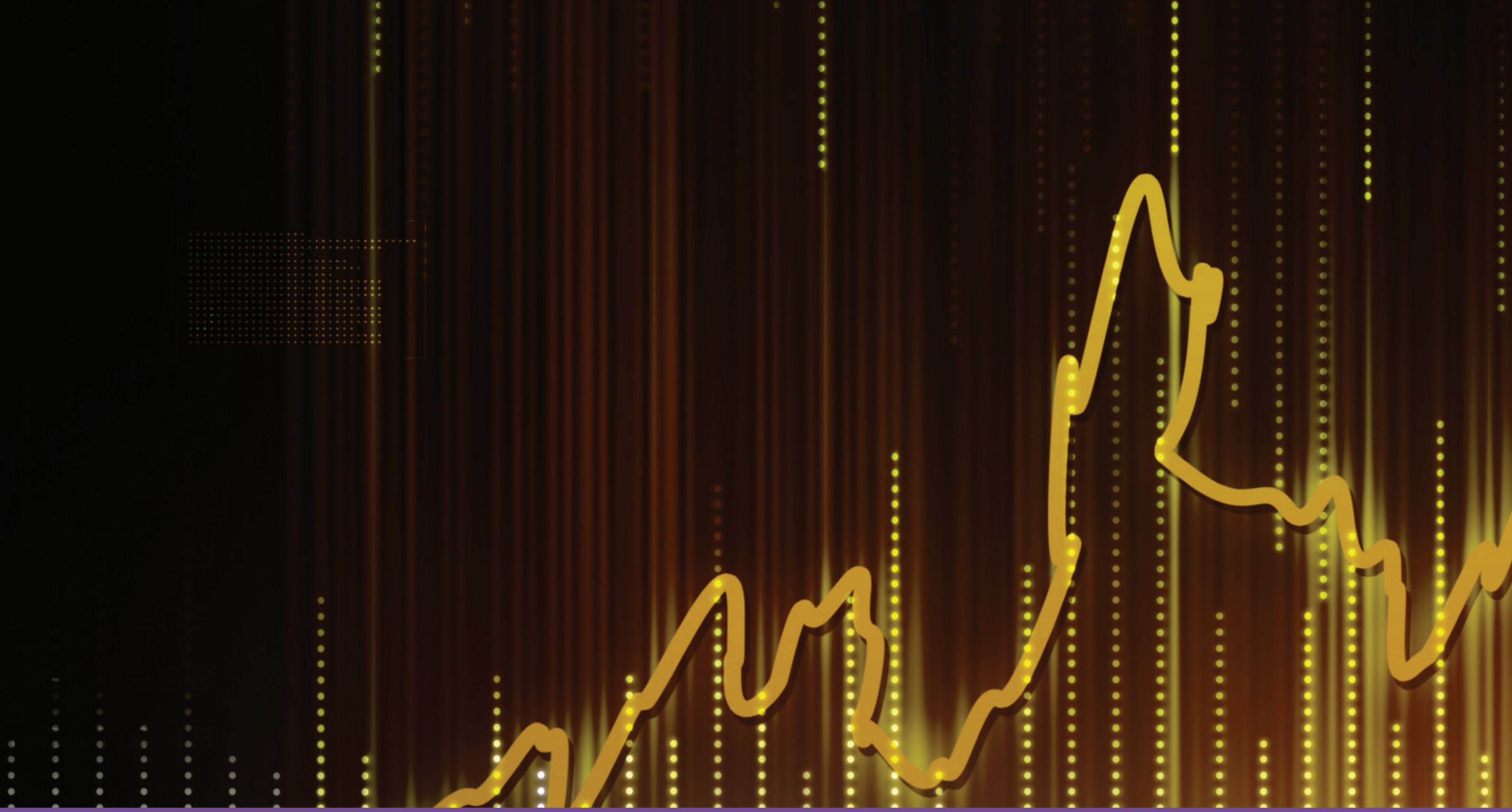

OTC EQUITY DERIVATIVE TRANSACTIONS REFERENCING LISTED COMPANIES SHARES

EQUITY DERIVATIVES PROVIDE A POWERFUL TOOL FOR MANAGING RISK IN RELATION TO SHARES BUT CARE MUST BE TAKEN TO COMPLY WITH CERTAIN RULES UNDER SPANISH LAW AND PRACTICE

This article provides a summary description of certain issues/considerations that need to be taken into account in relation to equity derivatives transactions (EDTs) with respect to Spanish listed shares.

Our analysis highlights the key corporate and securities laws implications which need to be considered in relation to transactions of this kind. This article does not attempt to provide detail on each and every aspect of corporate or securities laws which may be applicable to EDTs. Further analysis may be required depending on specific structures put into place.

DESCRIPTION OF CERTAIN DERIVATIVE TRANSACTIONS

The law and practice discussed in this article relates to EDTs which may present any of the following features, or a combination of each of these:

1. **An equity swap –** an agreement under which one party makes periodic payments to the other party determined by reference to the value of the company's shares in consideration of the agreement of the second party to make periodic payments to the first party determined by reference to either a notional principal amount and a rate of interest or an equity index. Final settlement of an equity swap can be either by payment of a cash settlement amount or by delivery of physical shares.
2. **A cash-settled equity option –** an option under which one party pays a premium to the other party in consideration of the right, upon exercise of the option, to receive, provided certain contingencies are satisfied, a payment which is determined by reference to the company's shares. The most likely contingency would be that the value of the company's shares exceeds (in the case of a call option) or is less than (in the case of put option) an agreed level (the strike price).
3. **A physically-settled equity option –** an option under which one party pays a premium to the other party in consideration of the right upon exercise of the option to purchase from the second party (a call option) or sell to the second party (a put option) a specified quantity of the company's shares. Delivery of the relevant shares would probably be made against payment of the agreed strike price for the shares.

In any of the above transactions (or combination of transactions) there will be two parties: (i) the Equity Derivative Provider (EDP) and (ii) the Spanish listed company (SLC).

CERTAIN BACKGROUND ASSUMPTIONS RELEVANT TO THE LEGAL REVIEW OF EDTs

This article (and indeed any analysis of legal implications surrounding entering into EDTs) will need to assume certain facts. Typically these will include the following:

(a) an EDT and the ancillary transactions to it will not be entered into by the parties with the aim of concealing or in any way disguising a treasury stock acquisition by counterparties or with the purpose of avoiding the application of mandatory provisions of Spanish law

(b) the EDP will not be acting as a fiduciary or intermediary of the SLC in relation to the EDT

(c) the EDT will be entered into by the SLC as a hedging transaction in order to cover its obligations under another principal transaction

(d) the EDT will not act as a hedging transaction of a previous transaction over shares in the SLC entered into by either party

(e) both the EDP and the SLC will be exposed to the fluctuation of the SLC shares price. As such, one will typically expect that the EDP will hedge its exposure over the SLC shares by stock borrowing and/or purchasing shares in the market. The assumption here will be that this will be done with third parties not related to or acting as intermediaries of either the SLC and/or the EDP

(f) the EDT will have no element to it that could be regarded as a dividend payment or a return of any kind paid by the EDP to the SLC in respect of the SLC shares

CORPORATE LAW IMPLICATIONS OF EDTs

Own stock requirements

A SLC may only acquire its own shares within the limits and on the conditions set out below (Article 146 Capital Companies Act (*Ley de Sociedades de Capital* – LSC)):

(a) That the acquisition has been authorised by the company in a General Shareholders' Meeting by means of a resolution establishing the manner of acquisition, the maximum number of shares to be acquired, the minimum and maximum acquisition price and the duration of the authorisation

(b) Shares acquired in the context of a stock option plan must be specifically authorised for such purpose

(c) That the nominal value of the shares acquired, added to that of the shares already held by the acquiring company and its subsidiaries and, if applicable, the controlling company and its subsidiaries, does not exceed 10% of share capital (or 20% in a non-listed company)

(d) That the acquisition enables the acquiring company and, if applicable, the controlling company, to make the appropriate reserves without a capital reduction or amortisation or reduction of reserves which, by law or under the article of association, may not be distributed

(e) That the shares acquired are fully paid up

The directors are expected to exercise control over the fulfilment of their own share acquisition requirements described above.

Even for permitted acquisitions in accordance with the conditions laid out above, treasury stock is subject to the following regime, *inter alia:*

(a) Voting rights over the shares are suspended and therefore shares cannot be voted

(b) The management report of the issuer company must account for and report on the terms and conditions of the acquisition

Breach of the above requirements and limitations carries with it penalties under the Securities Act.

Therefore on the basis that the subject of the EDT is stock of a SLC, consideration needs to be given as to whether the EDT (and in particular any potential feature of it) in any way breaches (directly or indirectly) treasury stock requirements (and limitations) identified above by the parties to it.

FINANCIAL ASSISTANCE RESTRICTIONS

Financial assistance is regulated in article 150 of the LSC on the following terms *"the company may not advance funds, grant loans, grant security or otherwise contribute any type of financial assistance for the acquisition by a third party of the company's shares or the shares of the company's controlling entity".*

The background of the original regulation on financial assistance is not meant to capture EDTs, however the wording of the Spanish law provision is wide enough to potentially capture certain types of EDTs. This is the case since, contrary to terms under which the Directive was implemented in most EU jurisdictions, the Spanish LSC provides that the prohibition is breached where the company does any of the following:

(a) advance funds

(b) grant loans

(c) grant security

(d) provide any type of financial assistance for the acquisition of its own shares.

It is this latter mention in paragraph (d) to *"any type of financial assistance"* that acts as a "catch all" provision and which forces us to consider whether any transaction in which an element of support by the company in the acquisition of its shares falls under the prohibition.

The following undertakings under any EDT would need to be considered for the purpose of determining if financial assistance is or is not an issue: (i) any premium payment by the SLC to the EDP under any "legs" of the deal and (ii) payment of the settlement price by the SLC to the EDP under the equity derivative structure.

Given that the wording of Article 150 of the LSC is general in nature, a variety of transactions relating to the acquisition of stock in Spanish S.A.s may fall under the prohibition. As a result, it will be necessary to identify, in the context of transactions involving own shares, the objectives of the prohibition. In this respect it has been contended by scholars that Article 150 of LSC (previously Article 81.1 of the Stock Companies Law *(Ley de Sociedades Anonimas)*) is designed to regulate transactions involving acquisitions of shares issued by a company but not transactions involving disposals of own shares held by the company. The argument in this respect runs to the effect that the financial assistance restriction imposed by the law is meant to restrict the acquisition of the company's shares (i.e. the shares issued by the company) but not the shares which are the property of the company. A proposition in this respect would be that, if one is to balance the restriction on the acquisition of own shares as opposed to the obligation to dispose of own shares, the later would outweigh the former. Clearly this may not be the structure of the transaction subject to specific review but it is an argument to identify the reasoning behind the rule in case it features such elements.

Typically, and given the uncertainty that generally surrounds this area, one will seek to obtain (as a mitigant) a representation from the SLC to the extent that the entering into of the EDT is not in breach of Article 150 of the LSC[2]. Such representation will help limiting the argument that the EDP had knowledge of a potential breach and agreed to enter into the transaction consenting to it. Requesting such representation will also require the SLC to consider, in any given transaction, whether the issue of financial assistance arises.

SECURITIES LAWS IMPLICATIONS OF EDTs

Securities laws will govern dealings in shares of listed companies. As such, anyone entering into an EDT needs to consider the following areas/issues:

Prohibitions on trafficking/speculative trading by a company of its own shares

Market manipulation rules are applicable in Spain pursuant to the securities market law. Pursuant to such rules, artificial creation of prices for quoted stock is deemed to be a breach of law.

The Securities Market Act, which regulates conduct, includes within the list of "very serious breaches": the performance of activities aimed at the manipulation of the free creation of prices within the securities market, where the conduct or activities create a significant alteration in quotations.

[1] It should be noted that in recent years the alleged breach of financial assistance has been used by minorities in listed and non-listed companies to file claims before the Spanish courts. The type of transactions in which such claims have been put forward are typically leveraged buy-outs, hostile or not.

[2] This representation could be drafted in the following terms: *"The entering into the Transaction does not constitute any* breach by [the SLC] of financial assistance restrictions set out under Spanish law and particularly, of those set out under *Article 150 of the Spanish Companies Act".*

Reporting duties

(a) Significant shareholdings disclosure

The Spanish transparency rules are set out in the Spanish Securities Market Act *(Ley 24/1988, del Mercado de Valores),* Royal Decree 1362/2007 (the RD) and Spanish Securities Market Commission (CNMV) Circulars 2/2007 and 1/2008. These regulations deal with control over or access to voting rights attached to issued shares. It is a broad regime covering direct shareholdings, indirect interests (i.e. access to voting rights) and certain financial instruments which give the holder an entitlement to acquire shares with voting rights attached.

Disclosure applies when a person's holding of voting rights reaches, exceeds or falls below the following thresholds 3%, 5%, 10%, 15%, 20%, 25%, 30%, 35%, 40%, 45%, 50%, 60%, 70%, 75%, 80% and 90% of the total voting rights in an issuer.

For shareholders who are resident in tax haven countries, disclosure is required when the shareholding reaches 1% of the total voting rights in an issuer and for every subsequent increase or decrease of 1% of the total voting rights in an issuer.

These disclosure requirements apply to shareholdings in issuers who have Spain as their home member state, the shares of which are listed on a regulated market in Spain, or in any other regulated market within the European Union.

The disclosure regime contains three main components: (1) disclosure of acquisitions or disposals of voting rights; (2) disclosure of indirect holdings of voting rights; and (3) disclosure of entitlements to acquire voting rights under financial instruments.

The disclosure obligation can be triggered by: (a) acquisitions or disposals of shares to which voting rights are attached and indirect holdings; (b) a change in the shareholding by virtue of a change in the issuer's share capital; or (c) acquisitions, disposals or maturity of financial instruments.

For the purposes of calculating a person's holding of voting rights, (a) direct shareholdings (Article 23 of the RD) and (b) indirect interests (Article 24 of the RD) are aggregated, but (c) financial instruments (Article 28 of the RD) are not aggregated to (a) and (b).

The term for the above-mentioned notification is four Stock Exchange Business Days *(dias habiles bursatiles)* from the following day to such day in which the obligated person was aware or should have been aware of the acquisition or transfer. Knowledge of the transaction is assumed within the two Stock Exchange Business Days following the relevant transaction.

(b) Own share transactions

Any listed company acquiring (by means of one transaction or successive transactions) it's own shares (or shares of the controlling company) representing more than 1% of its own share capital shall inform the CNMV.

In case of acquisitions by means of several successive transactions, the obligation to inform starts when the acquisition or transaction which, added to the previous transactions taking place after the last communicated transaction, determines that the percentage of 1% of share capital is exceeded.

Communications shall be effected *prima facie* by the relevant listed company who shall inform of both acquisitions made by itself or through intermediaries and acquisitions of its listed shares carried out by their controlling companies (whether the latter are listed or not). For the purposes of calculating the percentage of 1%, all these acquisitions shall be added.

For the avoidance of doubt, the obligation to notify applies even when the voting rights of shares are suspended.

The term for the above-mentioned notification is four days from the acquisition of the relevant shares.

The CNMV (on a non-name basis) has in the past confirmed their position in relation to certain EDTs for the purposes of the notifications above and its unofficial non-binding interpretation is that the execution of such a derivative transaction: (i) does not fall under the scope of the significant participations notification obligations; and (ii) cannot, generally speaking, be regarded as an acquisition of own shares by an issuer and therefore, does not fall under the scope of the own share acquisition transactions notification.

(c) Significant information

Article 82 of the Securities Market Law establishes the obligation of issuers to make public and immediately disclose to the market and to the CNMV all significant information, which is understood to mean *"all information whose knowledge may reasonably encourage an investor to acquire or transfer securities and which, therefore, may have a significant influence on the security's price in a secondary market".*

Article 82 has been further developed by Rule EHA/142/2009 (the Rule) which complements the market abuse regime in general in relation to the disclosure of significant information.

> The Rule will be applicable to significant information that has to be disclosed by security issuers in accordance with article 82 of the Securities Market Law. The disclosure of *"information regarding future acts or decisions that may become significant and that in any way (i) may give rise to, (ii) are a consequence or continuation of (iii) mean a change in, or (iv) complete, alter or end the significant information that was initially communicated/disclosed"* is also included.

RECHARACTERISATION RISK UNDER SPANISH LAW

In order to analyse the possibility that an EDT is re-characterised by Spanish courts as a disguised treasury stock acquisition, the first assumption that needs to be made is that the EDT is not being entered into with the purpose of avoiding the application of mandatory provisions of Spanish law (i.e. for fraudulent purposes).

Given the assumptions we have made in paragraph 2 above, this article disregards this move and considers alternative grounds. Such grounds relate to *simulacion negocial* (simulated contracting) under which a Spanish court could disregard the name *(nomen iuris)* which the parties have attributed to an agreement where such agreement is intended to conceal their true agreement.

Simulacion negocial is understood by Spanish courts as the abnormal contractual situation which is produced when under the appearance of a normal legal transaction, the purpose is hidden by the parties, either contrary to the existence of a contractual relationship between them (absolute simulation) or coincident with another form of legal transaction (relative simulation). Simulation entails a divergence or contradiction between the declaration of the parties under the apparent transaction and the will of the parties to simulate *(cosilium simulationis).* The divergence between the declared will and the real will of the parties has to be proved by the party (which includes in case of insolvency its insolvency administrators) alleging such simulation.

In the case of relative simulation, the hidden purpose would arise and the true underlying legal transaction would be valid between the parties if and to the extent that the formalities and requisites required to validly contract such transaction have been observed by the parties when contracting the simulated legal transaction.

Therefore, it is very important to understand the reason why both the EDP and the SLC have entered into the EDT as the re-characterisation risk will be higher if the purpose of the EDT is to allow/facilitate EDT to acquire treasury stock.

The above, together with the legal benefits achieved by entering into the EDT may be used by the authority/party that wants to bring an action for the re-characterisation of the EDT into a pure treasury stock acquisition on the basis of a *simulacion negocial.*

There is no case law from the Spanish Supreme Court regarding re-characterisation of equity derivative transactions. The position therefore, will need to be considered upon the terms of the specific transaction.

FINAL CONSIDERATIONS

EDTs are complex legal intensive transactions. They cut across a number of different legal disciplines; corporate law, securities law, tax, and insolvency.

EDTs will also need to be considered from a conflicts of law point of view as they are typically documented under ISDA Master Agreements governed by New York law or English law. As such they require international and local legal expertise and analysis.

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COMMISSION DELEGATED REGULATION ON LIQUIDITY COVERAGE – BETTER FOR EUROPEAN SECURITISATION

The range of high quality liquid assets eligible for Basel Liquidity Coverage Ratio as finally adopted by European Commission in Delegated Legislation in October 2014 includes certain classes of securitisation – beyond simple residential mortgage backed securities – a better result.

BASEL LIQUIDITY COVERAGE RATIO – A SHAKY START

In December 2010, the Group of Governors and Heads of Supervision of the Basel Committee on Banking Supervision (the Basel Committee) announced the introduction of the liquidity coverage ratio (the Basel Liquidity Coverage Ratio). The purpose of the Basel Liquidity Coverage Ratio was to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high quality liquid assets (HQLA) to survive a significant stress scenario lasting for one month[1]. From a securitisation perspective, the initial drafting of the Basel Liquidity Coverage Ratio caused major concerns as it failed, amongst other things, to recognise securitisation exposures in the definition of HQLA, an omission which would have discouraged banks from holding securitisation exposures and negatively impacted the securitisation industry. Following substantial lobbying by banks and the securitisation industry, the Basel Committee released an updated Basel Liquidity Coverage Ratio in January 2013, which contained, amongst other things, substantive revisions to the definition of HQLA, the main one from a securitisation perspective being the inclusion of certain residential mortgaged-backed securities rated AA or higher subject to a haircut of 25 per cent. It also provided that full implementation of the Basel Liquidity Coverage Ratio would be deferred so that the minimum requirement would begin at 60 per cent on 1 January 2015 and rise in equal steps to 100 per cent by 1 January 2019 so that the Basel Liquidity Coverage Ratio could be "introduced without material disruption to the orderly strengthening of banking systems or the on-going financing of economic activity"[2].

LIQUIDITY COVERAGE REQUIREMENT – EUROPE'S OPPORTUNITY TO DIVERGE

In June 2011, between the first and second iterations of the Basel Liquidity Coverage Ratio, the European Commission made provisions in the then new Capital Requirements Regulation (CRR) to apply the Basel Liquidity Coverage Ratio in the European Union. In June 2013, the CRR was adopted and provided that all institutions have to maintain a general liquidity coverage requirement (Liquidity Coverage Requirement) and to report regularly on the composition of the liquid assets in their liquidity coverage buffer. The power to specify the detail of the Liquidity Coverage Requirement was delegated to the European Commission under Article 460 of the CRR and required the European Commission to take European "specificities" and "international standards" into account when adopting such a delegated act (this delegated act eventually took the form of a delegate regulation (the Delegated Regulation)). The general liquidity requirement became applicable as from 1 January 2014, whereas the detail in respect of the Liquidity Coverage Requirement for credit institutions shall first become applicable on an unspecified date in 2015. With a progressive rate of application rising from 60% of the ratio to 100% in 2018, one year prior to the Basel Liquidity Coverage Ratio.

[1] European Banking Authority Discussion Paper on Defining Liquid Assets in the LCR under the draft CRR dated 21 February 2013

[2] Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools – January 2013

AN OPPORTUNITY MISSED?

In February 2013, the European Banking Authority (EBA) produced a discussion paper on *Defining Liquid Assets in the Liquidity Coverage Requirement* under the then draft CRR, in which it set out the methodology and steps it intended to take in the analysis in relation to high and extremely high liquidity and credit quality of transferable assets and appropriate haircuts for the purposes of the Liquidity Coverage Requirement. On 20 December 2013, the EBA produced a report based on the analysis it had carried out pursuant to the discussion paper. The report did not suggest the inclusion of any further classes of securitisation and largely backed the Basel Liquidity Coverage Ratio. In March 2014, the European Commission held a public hearing to discuss, amongst other things, some of the outcomes from the discussion paper, including the EBA's view that the Basel Liquidity Coverage Ratio was generally appropriate and that there were no European Union "specificities" which should justify significant deviations from the Basel Liquidity Coverage Ratio and further that the definition of HQLA for the purposes of the Delegated Regulation would generally follow that used for the Basel Liquidity Coverage Ratio. During the summer of 2014 an unofficial draft of the Delegated Regulation was circulated to a select few and was followed by the European Commission's final version of the Delegated Regulation on 1 October 2014. On 10 October 2014, the European Commission adopted the Delegated Regulation.

HQLA EXPANDED – A BETTER RESULT

Fortunately in the Delegated Regulation, it was recognised that the Basel Liquidity Coverage Ratio had been developed with a view to its application to large, internationally active banks and did not fully take account of the extent to which certain other assets may be more liquid in some of the signatory jurisdictions. The European Commission concluded that these assets warranted more appropriate inclusion in the Liquidity Coverage Requirement than strictly foreseen under the Basel Liquidity Coverage Ratio as they had displayed superior or comparable liquidity/credit performance to those admitted to the Basel Liquidity Coverage Ratio.

The Delegated Regulation accepted a range of securitised assets wider than only residential mortgage-backed securities. Within the 15% limit of the liquidity buffer envisaged for level 2B assets, the Delegated Regulation includes some other types of securitised assets such as auto-loan asset-backed securities. In addition, the Delegated Regulation includes some smaller securitisation asset classes which have also demonstrated a good liquidity and credit track-record and which are important as a method for financing lending to SMEs and consumers, namely SME loan and consumer credit asset-backed securities.

CONCLUSION

Additional calls to include revolving securitisations and credit card asset-backed securities as HQLA and additional requests for further clarity in the Delegated Regulation were not addressed in the final Delegated Regulation, which resulted in disappointment in some quarters, but given the disconcerting beginning in 2010, the Liquidity Coverage Requirement, as set out in the Delegated Regulation, does now support certain areas of the securitisation market at least, and in this regard can be seen as a positive result for the securitisation industry.

Authored by: Ronan Mellon

INTERCREDITOR ARRANGEMENTS IN RESPECT OF WHOLE LOAN TRANSACTIONS

In 2012, the Commercial Real Estate Finance Council (Europe) (CREFC) published the draft guidelines for intercreditor agreements in UK commercial real estate finance transactions (the 2012 Draft Guidelines). The purpose of the 2012 Draft Guidelines was to encourage principals, service providers and advisers in the European commercial real estate industry to promote greater consistency in and understanding of intercreditor issues which arise in the context of commercial real estate (CRE) finance transactions.

Earlier this year the Loan Market Association (LMA) published its own intercreditor agreement (the LMA ICA) which was, in many respects, based on the principles set out in the 2012 Draft Guidelines. While subject to some ongoing discussion as to certain commercial terms, the LMA ICA and the 2012 Draft Guidelines have provided the market with a fairly fixed set of parameters in which participants in the CRE market are able to negotiate and agree intercreditor issues.

Both the 2012 Draft Guidelines and the LMA ICA contemplate a transaction structure whereby two loans are advanced to finance CRE assets: a senior loan to the property owning entities and a mezzanine loan to a mezzanine borrower (who is the sole shareholder of the parent of the propcos).[1] The effect of this structure is to structurally subordinate the mezzanine loan to the senior loan. The transaction structure contemplated by the 2012 Draft Guidelines and the LMA ICA is therefore referred to as the Structural Subordination Model.

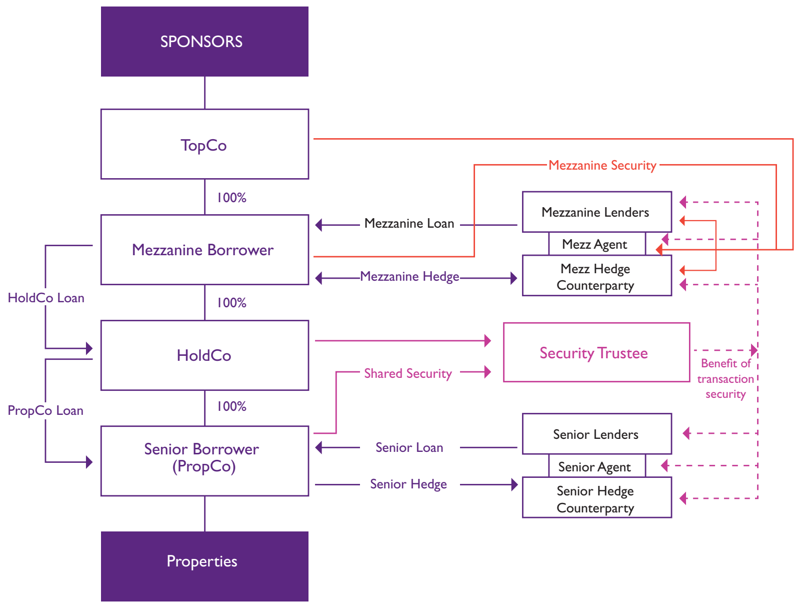
Neither the 2012 Draft Guidelines nor the LMA ICA contemplate alternative models for structuring debt finance packages such as whole loan structures whereby a single loan is made to the propcos and, at some point at or following origination, is then tranched into senior and junior interests (A Notes and B Notes respectively), without any involvement of the equity sponsor. Such whole loan structures are referred to as the Whole Loan Model.

In the past six or so months, it has become apparent that certain lenders and borrowers, when constructing debt finance packages, have a preference to adopt the Whole Loan Model as opposed to following the Structural Subordination Model. However, certain structural issues need to be considered by lenders looking to follow the Whole Loan Model to ensure that a number of legal and economic outcomes match what was anticipated.

As CREFC has taken a leading role in developing general intercreditor principles for some time now, it is seen as a natural progression for this group to supplement its existing intercreditor working group with an additional initiative that deals specifically with the structural issues arising from the Whole Loan Model. CREFC has started this process by initiating a kick off meeting for this supplemental working group at its most recent autumn conference on 7 November 2014.

DIFFERENCES

Structural Subordination Model

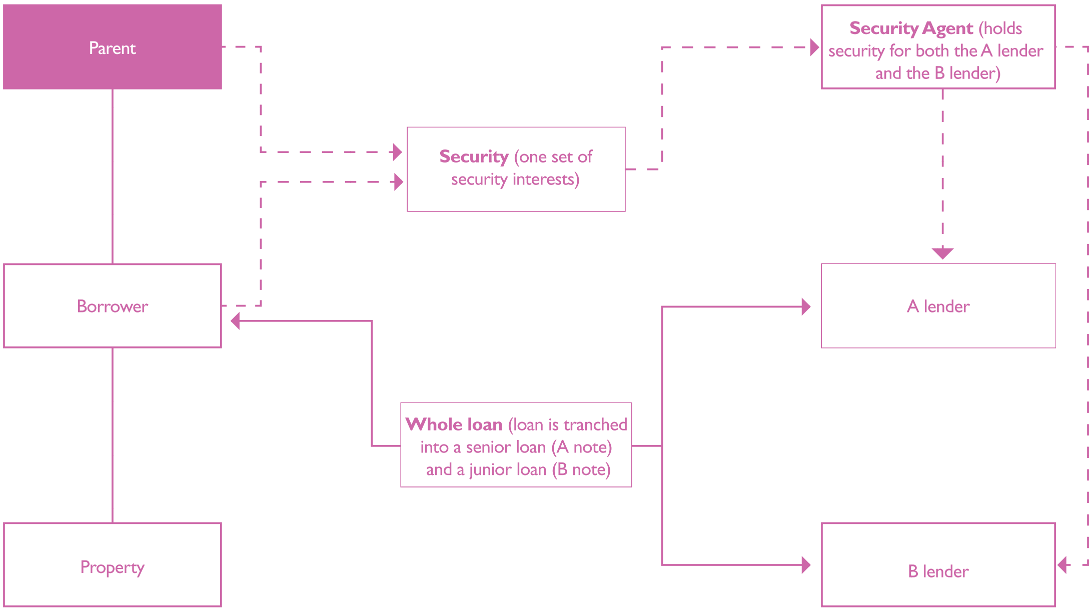


[1] *The LMA ICA is slightly different to the 2012 Draft Guidelines as it envisages an additional midco in the structure.*

Where the Structural Subordination Model is followed (by way of very brief summary and as illustrated by the chart set out at figure 1):

- two loans are advanced by two lenders at two levels of the capital stack: the senior borrower level and the mezzanine borrower level
- the senior obligors grant common security which is for the benefit of both the senior finance parties and the mezzanine finance parties. This common security is regulated by an intercreditor agreement that is entered into by senior and mezzanine obligors and finance parties. In addition, the mezzanine obligors grant security in favour of the mezzanine finance parties only. The purpose of the mezzanine only security over the assets of the mezzanine obligor is to allow the mezzanine finance parties to control the equity interests in the borrowing group without necessarily impacting on the senior loan package

Whole Loan Model



The Whole Loan Model has a number of differences to the Structural Subordination Model:

- one loan is advanced to one borrower with that loan being tranched into an A Note (which will be the senior tranche of the loan) and a B Note (which will be the junior tranche of the loan) with the arrangements between the two lenders being regulated "behind the scenes" in a bilateral intercreditor agreement entered into by the lenders but not the borrower; and
- the obligors of a whole loan grant one set of security interests to one security agent and these security interests are, again, regulated by the intercreditor agreement.

These basic structural differences lead to differences in outcomes for lenders following one model against another model. It is worth highlighting a couple of these different outcomes below (although it should be noted that there are numerous others that also need to be considered).

Cashflows

Where a Structural Subordination Model is followed, two loans are advanced at two levels of the capital stack which means that (usually) two cash waterfalls are implemented. The senior cash waterfall applies amounts from the senior borrowers' rent accounts to service and pay senior debt with the second cash waterfall at the mezzanine loan level applying surpluses to service and pay the mezzanine debt, before any additional amounts are applied to be distributed to equity.

On the occurrence of a material default of the senior loan, it is usual that payments to the mezzanine finance parties are stopped until the default has been cured or repaid. Unless the senior loan has been accelerated, amounts that would have been available to the mezzanine finance parties (but for the stop on payments) are escrowed until the loan is accelerated, (at which point the amounts are applied to repay the senior loan) cured or waived (at which point the amounts are applied to service and pay the outstanding amounts of the mezzanine loan).

In addition, where payment to the mezzanine finance parties have been stopped, interest charged at the default rate will accrue on all unpaid amounts.

The position is different when a Whole Loan Model is followed because only one loan is advanced to one borrower. This means that only one waterfall is run at the loan level and arrangements as to how amounts paid to the lenders are applied as between themselves are regulated in the intercreditor agreement (which is not seen by the borrower).

On the occurrence of a material default of the whole loan, it is usual that payments to the junior lender are stopped (as with the Structural Subordination Model). Amounts that would have been paid to the junior lender are either held back in an escrow arrangement or applied to pay down the senior tranche of the whole loan. The fact that such amounts are held back from the junior lender even when the borrower is performing all of its payment obligations under the whole loan agreement (assuming the material default is not a payment default) creates mismatches as to how much is payable by the borrower to the lenders as against each lender's principal and interest ledgers. Moreover, the junior lender is unable to charge default interest on its tranche of the whole loan even though it is unable to receive payments of principle or interest.

So, where a mezzanine lender in a Structural Subordination Model is able to ensure that there is always available recourse from the mezzanine borrower to pay all amounts owed (including default interest) a junior lender in a Whole Loan Model structure does not have such certainty.

Control of equity security interests

Both the Structural Subordination Model and a number of Whole Loan Model arrangements attempt to grant the mezzanine or junior lender control of the security interests over the ultimate equity interest in the borrowing group.

The reason for this is that mezzanine/junior lenders are now used to the ability to equitise their interest in the debt arrangement and take over the borrowing group to influence the performance of the asset with a view either to stabilisation or as an exit strategy.

Control of the mezzanine obligors' equity interests is not difficult to obtain in the Structural Subordination Model as the separation of loans to different levels in the capital stack mean that the mezzanine loan can be accelerated without adversely impacting on the senior loan or the senior obligors.

The position is more challenging when following the Whole Loan Model because both the senior and the junior interests are advanced in one loan to one borrower. Without considerable engineering (and dependant on the insolvency analysis of the relevant jurisdiction of the borrower), it is difficult to crystallise one element of the whole loan to allow the junior lender to effect a full enforcement of the equity security interest. This means that any attempt of the junior lender to control an equitisation of its position is likely only to be effective with the consent of the senior lenders.

Next steps

The structural issues set out above are just two examples of the challenges facing participants in the CRE market when looking to address Whole Loan Model arrangements. These challenges are not insurmountable but will require some thought as to how they can best be addressed in a way which will be acceptable to both the senior and the junior lender community. It is hoped that the CREFC supplemental work stream will be able to achieve this. Certainly, judging by the level of interest at its initial meeting there is an appetite to make progress.

Authored by: Paul Gray

PRINCIPAL WITH PRINCIPLES

AN OVERVIEW OF "GREEN" BONDS

Abengoa Greenfield, S.A. issued the first-ever European high yield "green" bond on 30 September, 2014, which makes this an opportune time to give readers a brief introduction to green bonds.

Investors with a desire to put money to work in environmentally sustainable or beneficial ways may have very particular criteria for identifying "green" instruments, but they have been finding the capital markets to be a friendlier place since the International Capital Markets Association, ICMA, promulgated its ***Green Bond Principles*** in early 2014.[1]

One important thing to know about a green bond is to know what it is <u>not</u> required to be: it does not have to fit any particularly defined "green" category. Although the ***Green Bond Principles*** do not have strict criteria for what constitutes green projects, they do recognise broad categories of green projects, ranging from renewable energy to sustainable land use and clean water projects but they make clear that the categories are not exclusive. Instead of getting bogged down in voluminous (and often subjective or contested) descriptions of eligible activities to be funded, the Green Bond Principles are a set of voluntary process guidelines designed to provide environmentally focussed investors the information to make their own green investment decisions.

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[1] ICMA's Green Bond Principles may be found at www.icmagroup.org/greenbonds.

By choosing to follow the ***Green Bond Principles***, issuers and underwriters are following a road map relating to disclosure and transparency covering four key areas, summarised below:

- **Use of Proceeds:** clearly describe (and, if possible, quantify) the environmental benefits that will come from the application of proceeds from the green bond.
- **Process for Evaluation and Selection:** outline for investors the process through which the issuer will work to identify the environmental profile and impact (including, if relevant, social impact) of an investment made with green bond proceeds.
- **Management of Proceeds:** establish a formal internal process to ensure that the proceeds of the green bond are tracked and appropriately applied throughout the life of the green bond. This principle includes a suggestion that an external auditor or other third party verifies the internal tracking process, a method that Abengoa Greenfield, S.A. is following with their green high yield bond.
- **Reporting:** the principle of regular reporting underpins the three principles listed above by encouraging issuers to report, where and how feasible, on the environmental impact of green projects.

The ***Green Bond Principles*** currently recognise four types of green bonds, in each case requiring exclusive application of proceeds to green projects: Green Use of Proceeds Bonds, Green Use of Proceeds Revenue Bonds, Green Project Bonds and Green Securitized Bonds. The description of the two types related to use of proceeds include suggested procedures to ensure tracking and proper application of the bond proceeds, while the project and securitized bonds are expected to be directly applied to specific projects. The ***Green Bond Principles*** make clear that additional types of green bonds may be recognised in the future as the market develops.

Another development that may arise in the future is the potential for third party certification or verification of green bonds. The ***Green Bond Principles*** welcome the idea, and indicate that this is an area for further development. In the meantime, experts and consultants currently make themselves available as "second party consultants" to be commissioned by issuers to provide independent opinions on the sustainable credentials of a given green bond.

The green bond market is growing rapidly, helped by the broad adoption of the ***Green Bond Principles***. The old adage that "***a man is usually more careful of his money than he is of his principles***"[2] might now be restated to "an investor may be as careful of their money as they are with their principles".

[2] Uncertain attribution: either Ralph Waldo Emerson or Oliver Wendell Holmes.

Authored by: Tony Lopez

CONNECTING TO ASIA'S BOND MARKETS

Asia's bond markets are seeing increased interest, with bond issues totalling US$143.8 billion in 2013. Coordinated developments within the region, including a new linked exchange between Shanghai and Hong Kong, pave the way for greater investment.

Local currency bond markets in Asia are experiencing a steady increase. Bond issues in Asia accounted for 24.2 per cent of Asia's GDP in 2012, rising from 16.7 per cent in 2008.[1] Local currency issues remain the larger proportion however, foreign currency issues are increasing. The ratio of public to private placements varies throughout the region. China, Korea, Malaysia and the Philippines are amongst the regions/countries with the greatest proportion of public placements. Lower country ratings have limited the investor base, however, ratings are improving. Currently Singapore and Hong Kong are AAA rated, Taiwan and China are rated AA- and Fitch upgraded Indonesia's sovereign credit rating to investment grade (BB+) in December 2013. China Citic Bank raised US$300 million in its issue of Asia's first U.S. dollar-denominated tier-1 capital securities compliant with Basel III bank-capital rules in April, an issue that was largely oversubscribed. Semiconductor manufacturer Advanced Semiconductor Engineering also raised US$300 million in Asia's first corporate green bond in July, with orders of around US$2 billion. Such large issues are likely to increase levels of interest from a broader range of investors.

Currency gains, yield and the opportunity to diversify investments has made investment in Asian bonds attractive. Many jurisdictions, including Japan, have made internal changes in a bid to attract investors. Japan's Tokyo Pro-Bond Market for professional investors offers investors, issuers and other market participants a mechanism for flexible and timely issuance of bonds. The disclosure documents have been simplified and accounting standards are flexible, with the option to use Japanese, international or US accounting standards. The Japanese Bond Income Exemption Scheme provides foreign residents with tax exemption on interest arising on Japanese revenue bonds, in addition to the existing exemption on government issued bonds. Tax exemptions are also available to *sukuks* and Hong Kong has made proposals to amend its tax legislation to provide special tax treatment to such bonds.

Many Asian jurisdictions have demonstrated a combined commitment to the development of the market, implementing key reforms in an aim to reduce impediments to investment and the lack of consistency throughout the region. The Asian Bond Markets Initiative (ABMI) was developed in 2002 by the ten members of the Association of Southeast Asian Nations (ASEAN), in a bid to develop the local currency bond market. To promote bond market development, two Asian bond funds were launched providing pooled funds totalling US$1 billion and US$2 billion in 2003 and 2005 respectively, from central banks and monetary authorities, to be invested in local currency bonds issued by sovereign and quasi sovereign borrowers. Subsequently ASEAN and China, Japan and Korea (ASEAN +3) set up an ABMI Roadmap in 2008 and Bond Market Forum in 2010 to address issues and foster greater harmonisation in the market. An online system, Asian Bonds Online, has been developed to provide information on bond markets in the region, addressing concerns of a lack of information generally available to investors.

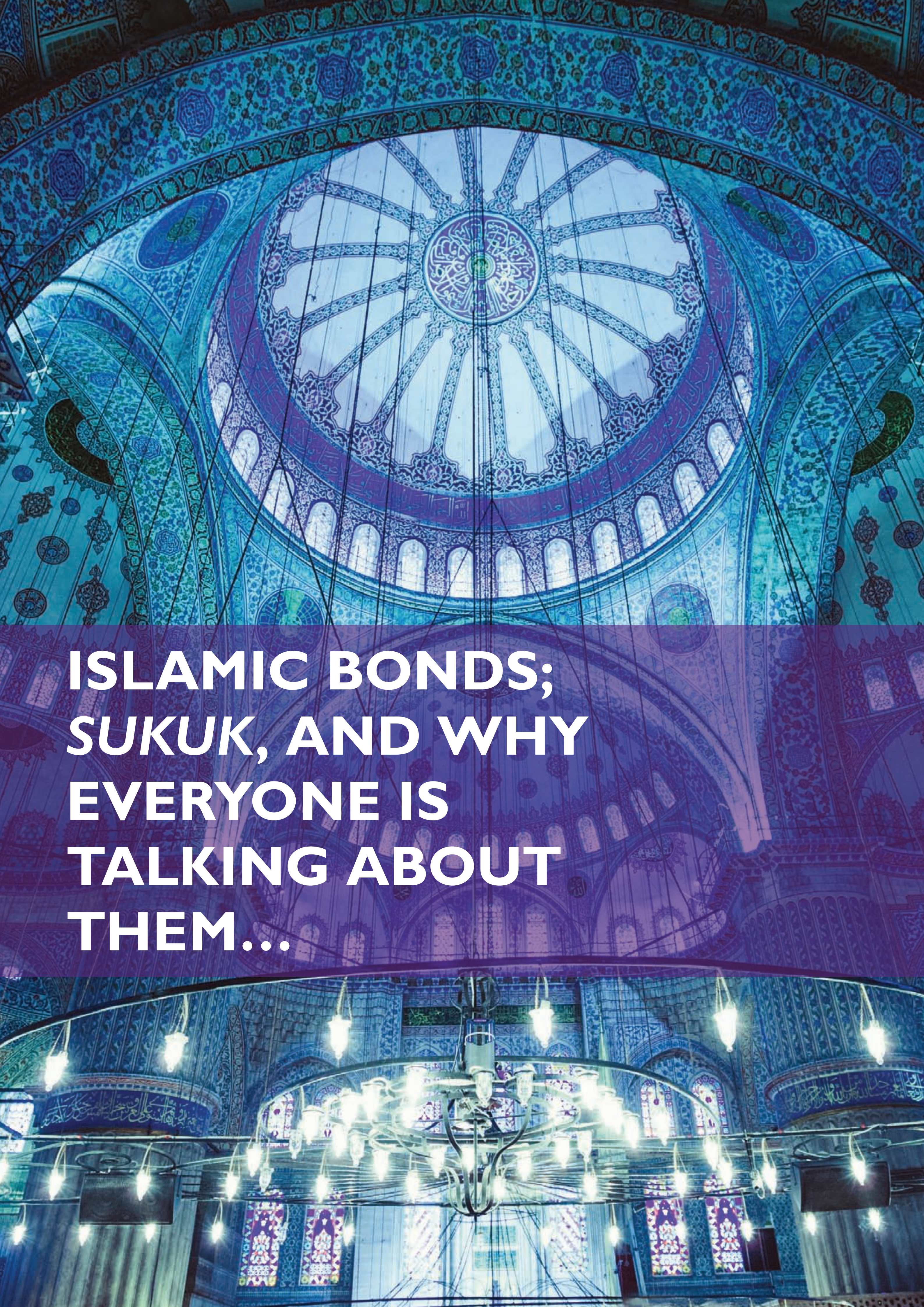
[1] Deutsche Bank Research 2014

The Hong Kong Monetary Authority (HKMA), Euroclear and some central banks and central securities depositories (CSDs) in the region formed a Pan-Asian CSD Alliance, to facilitate the further development of the bond market. In a white paper published in June 2010, the Alliance proposed a Common Platform Model in Asia to enable Asian CSDs to adopt harmonised procedures and shared technology in processing debt securities. The ABMI established a Credit Guarantee and Investment Facility (CGIF) in November 2010, with a view to boosting investment and promoting financial stability within the ASEAN +3 countries, to be achieved through the provision of guarantees on local currency denominated bonds issued by domestic corporates. It is hoped that such guarantees will aid the securing of long-term finance, whilst reducing the dependency on short term foreign currency borrowing. Although the emphasis appears to be on strengthening local currency bond markets, foreign currency issues have not been ignored. Since 1994 the Asian Development Bank (ADB) issues at least once in the US global bond market each year and as at the end of July had over US$28 billion outstanding in US dollar-denominated public offerings. In August, Moody's reported that Indian foreign currency bond issues are to reach a record high this year. The wave of initiatives have created momentum in the market which should assist the development of more foreign currency bond issues.

In April the China Securities Regulatory Commission (CSRC) and the Securities and Futures Commission of Hong Kong (SFC) announced the linking of exchanges in Shanghai and Hong Kong, enabling investors to invest in each other's securities. In the pilot programme, the Shanghai-Hong Kong Stock Connect (Stock Connect) will facilitate secondary market trading, consisting of a Northbound link whereby investors can trade almost all securities on the Shanghai Stock Exchange and a Southbound link, where investors can trade securities on the Hong Kong Stock Exchange. This is anticipated to greatly increase the volume of trades. Trades will only be permissible when both markets are open for trading and banking services are available in both markets on the corresponding settlement day. Clearing and settlement will be carried out by China Securities Depository and Clearing Corporation Limited and the Hong Kong Securities Clearing Company Limited. Although investors will still be subject to the regulatory framework in the jurisdiction in which they are investing, the CSRC and SFC are working together to create information sharing and enforcement mechanisms. The Stock Connect was expected to launch in October, however, it will be launched once regulatory approval has been obtained and market participants have had time to accommodate the new changes internally. The success of the pilot could set the path for further coordination of exchanges throughout the region.

The members of ASEAN aimed to develop a single economic market by 2015. The ADB also proposed standardising bond issues in the ASEAN + 3 countries. Although a single economic market, if implemented effectively, could contribute to the success of a single bond market in Asia, is a unified bond market really possible? Further developments are still required to address investor's concerns on issues such as price volatility and liquidity within Asian bond markets. Bridging the gap between jurisdictions with differing trading procedures and regulations will not be a simple task. It may prove less problematic for a new system or platform to be implemented, similar to the proposed Stock Connect, consistently linking all markets concerned whilst reducing legal and institutional impediments. Regulation and enforcement will also need to be addressed, along with greater clarity to all participants so risk can be accurately assessed. Such changes are likely to lead to greater investment from a wider investor base, generating more liquidity in the market providing opportunity for domestic and international investors. Despite the difficulties of coordinated development, the market is progressing and additional coordinated initiatives and regulatory reforms are welcomed.

Authored by: Annabel Akintomide



ISLAMIC BONDS; *SUKUK*, AND WHY EVERYONE IS TALKING ABOUT THEM...

In June 2014, the UK Government issued £200 million of sovereign *sukuk* (also known as Islamic bonds). The size may be quite modest, but the order book was much larger. High demand saw the issue almost 12 times oversubscribed. This was a landmark achievement for the UK, and the culmination of many years of hard work.

The UK's issuance of *sukuk* is important for a number of reasons. First and foremost, it was one of the first sovereign *sukuk* to be issued outside of the Islamic world – with Hong Kong, Luxembourg and South Africa (among others) all issuing in the months that have followed.[1] It has also been regarded as the clearest indication yet of the UK government's commitment to become a 'hub' for Islamic finance, as the industry continues to grow into new geographies beyond its traditional hubs in the Middle East and Southeast Asia. The government has also established an Islamic Finance Task Force in order to further strengthen London's position as the 'Western' centre for Islamic finance.

The deal was also a high-level test of the UK's fiscal and regulatory framework for Islamic finance: although the starting point for the various changes which have brought about that particular framework can be traced back to the last Labour government, the turmoil of the 2008 global financial crisis and the eurozone crisis had combined to put on-hold any tangible plans at around the same time (including the earlier plans for a UK sovereign *sukuk*). With a number of dedicated Islamic banks established in London and across the UK, the hope is that the government's moves will provide a benchmark and the confidence that is needed to stimulate more Islamic finance activity in the UK's private sector.

WHAT IS ISLAMIC FINANCE ALL ABOUT? A QUICK REFRESHER ON ISLAMIC PRINCIPLES IS SET OUT BELOW

The key difference between Islamic and conventional finance is in the approach, and not necessarily on the financial impact. Islamic financing is best described as asset-based, not currency-based (as a conventional loan would be). The rate of return in Islamic financing is based on an underlying asset or investment, as opposed to earning interest on money loaned (which is *riba* and therefore prohibited, as discussed later in this article). The rationale underpinning all of this is that money is only a means of exchange, and should not have its own intrinsic time cost or value.

Islamic principles do not prohibit a financier in an Islamic finance transaction from making a p*rofit, rental* or other *return* on its asset or investment. To that end, a number of contemporary structuring techniques (or Islamic contracts) have developed which allow bankers to structure transactions and products in a way that comply with Islamic principles whilst also replicating the economics of conventional loans and products. *Sukuk* (plural of *sak*) are based upon these structuring techniques, and the public nature of the debt capital markets deals has led to a number of notable issuers and some headline-grabbing deals.

In their basic form, *sukuk* are a type of certificate or note which represent a proportionate interest (also described as a participatory interest) in an underlying asset or investment. They are generally considered to be debt securities (akin to bonds) which, depending on the underlying asset or transaction, can be traded in the secondary market. The *sukuk* certificates are often 'layered' on top of other underlying Islamic financing techniques which themselves are intended to derive a return from an underlying asset or investment: for example, *ijara* (leasing), *mudaraba* (investment partnership) or *wakala* (investment agency) are commonly used to generate the periodic distributions (i.e. amounts comparable to the 'coupon' on a bond) which are payable to the investors.

However, for modern day purposes, the vast majority of *sukuk* structures are best described as being 'asset-based' because the primary credit risk remains that of the issuer/obligor who is obliged to pay the *sukuk* holder irrespective of the performance of the underlying asset or investment. This is to be distinguished from less prevalent 'asset-backed' *sukuk* (i.e. securitization) where recourse to, and revenues from, the underlying asset or investment play a more critical role.

[1] We note that many commentators consider the 2004 issue by the German state of Saxony-Anhalt to have been the first sovereign *sukuk* outside the Islamic world.)

The Islamic finance industry has developed on the basis of the following strict Islamic principles (also known as *Shari'a*):

- ***No interest*** – under *Shari'a*, money is regarded as having no intrinsic value and also no time value. The payment and receipt of interest (*riba*) is prohibited under Islamic law and any obligation to pay interest is considered to be void. This rule also prevents a financier from charging penalties and/or default interest.
- ***No uncertainty*** – uncertainty (*gharrar*), particularly any uncertainty as to one of the fundamental terms of an Islamic contract (such as subject matter, price or delivery), is considered to be void under *Shari'a*. This principle is fairly broad as it requires certainty on all fundamental terms of a contractual arrangement.
- ***No speculation*** – contracts which involve any speculation are not permissible (*haram*) and are considered to be void. This does not, however, prevent a degree of commercial speculation which is evident in a lot of commercial transactions. The prohibition applies to forms of speculation which are regarded as gambling. The general test is whether something has been gained by chance.
- ***Unjust enrichment/exploitation*** – a contract where one party is regarded as having unjustly gained (at the expense of another) is also void. The principle also extends to the enrichment of one party who exercises undue influence or duress over the other party.
- ***Investments*** – the proceeds in Islamic finance should not be used for the purposes of purchasing or investing in products or activities that are prohibited. These prohibited items and activities include the manufacture and/or the sale or distribution of alcohol, tobacco, pork products, music or pornographic productions, the operation of gambling casinos or manufacturers of gambling machines – but also extend to conventional banking and insurance activities, as well as defense and weaponry.

Islamic financiers or investors work closely with *Shari'a* scholars – these are Muslim scholars who specialise in providing guidance on the application of *Shari'a* principles to commercial activities – to make sure that structures and products remain compliant with the rules and principles outlined above. In effect, these scholars have a controlling say in whether or not a particular structure, product or document should be approved.

To put all of this into context, it is expected that the Islamic finance industry will exceed £1.3 trillion in assets by the end of this year. Growing demand across a number of different industries and sectors, rational pricing and innovative products are trends that are shaping the future of Islamic finance. To fuel this growth, the search for alternative sources of liquidity in established markets has presented a unique opportunity for Islamic finance to expand beyond its traditional hubs in the Middle East and Southeast Asia.

What is also clear from all of this is that the strategic importance of becoming an Islamic finance hub is not being overlooked. It is clear that the UK government sees Islamic finance as having a significant role to play as London looks to strengthen its position as one of the World's leading financial centres. This will further broaden the investor base and provide increased opportunities for issuers to look to products structured to appeal to followers of *Shari'a* principles.

Authored by: Paul McViety

U.S. CREDIT RISK RETENTION RULES:

Will CLOs Survive?

On 21 October and 22 October 2014, the Agencies[1] adopted a final rule (the Final Rule) implementing the Risk Retention Requirement.[2] The Final Rule retains the basic risk retention framework of the Re-Proposed Rule[3], with certain changes designed to address comments from market participants and to provide further clarity on certain points. Unfortunately, the Agencies rejected most of the comments submitted by market participants seeking relief for CLOs through structural exemptions and third-party options. In rejecting these comments, the Agencies concluded that risk retention is appropriately applied to CLO managers, and any structural exemption or third-party option would likely undermine the consistent application of the Final Rule. The Agencies noted that the recent increase in the level of activity in the leveraged loan market (comprising the primary assets purchased by most CLOs) has coincided with widespread loosening of underwriting standards, which could expose the financial system to risks. As such, the Agencies concluded that it is appropriate to apply the Risk Retention Requirement to open market CLOs as well as balance sheet CLOs with limited relief.

The Final Rule will become effective one year after the date of publication in the Federal Register with respect to residential mortgage-backed securities and two years from the date of publication in the Federal Register with respect to all other asset-backed securities (ABS).

OVERVIEW OF RISK RETENTION REQUIREMENT

The Final Rule permits a sponsor to satisfy the Risk Retention Requirement by retaining (i) an eligible vertical interest, (ii) an eligible horizontal residual interest or (iii) any combination thereof (an L-shaped interest); *provided* that in the event that a sponsor elects to satisfy the Risk Retention Requirement by retaining an L-shaped interest, the Risk Retention Requirement must be calculated proportionally based on the applicable percentage of eligible vertical interest and eligible horizontal residual interest comprising such L-shaped interest. The determination regarding the sponsor's satisfaction of the Risk Retention Requirement must be made as of the closing date of the securitisation transaction.

The Final Rule permits a sponsor to transfer its obligation to satisfy the Risk Retention Requirement to a "majority-owned affiliate" of the sponsor[4].

- *Eligible Vertical Interest*. The Final Rule permits a sponsor to satisfy the Risk Retention Requirement under the vertical option by retaining (i) at least 5% of the face value of each tranche of the ABS interests issued as part of the securitisation transaction or (ii) a single vertical security which represents an interest in each tranche of the ABS

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[1] In April 2011, the Federal Deposit Insurance Corporation (the FDIC), the Federal Housing Finance Agency (the FHFA), the Office of the Comptroller of the Currency (the OCC), the Federal Reserve Board (the FRB), the Securities and Exchange Commission (the SEC) and the Department of Housing and Urban Development (the HUD and, together with the FDIC, the FHFA, the OCC, the FRB and the SEC, the Agencies) proposed a rule (the Proposed Rule) designed to implement the credit risk retention requirements (the Risk Retention Requirement) of Section 15G of the Securities Exchange Act of 1934 (15. U.S.C. 78o-11) (the Exchange Act), as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

[2] See footnote 1 above.

[3] In August 2013, the Agencies issued a re-proposed rule (the Re-Proposed Rule) that amended the Proposed Rule in response to comments received from various market participants.)

[4] A majority-owned affiliate is defined as an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, the sponsor. For purposes of this definition, majority control means ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP.

interests issued in the securitisation equal to at least 5% of the cash flows paid on each class of ABS interests in the issuing entity (other than such single vertical security).

- *Eligible Horizontal Residual Interest*. The Final Rule permits a sponsor to satisfy the Risk Retention Requirement under the horizontal option by retaining a first loss eligible horizontal residual interest in the issuing entity in an amount equal to no less than 5% of the fair value of all ABS interests in the issuing entity that are issued as part of the securitisation transaction, determined using a fair value measurement framework under General Accepted Accounting Principles (GAAP).
  - The eligible horizontal residual interest may consist of either a single class or multiple classes in the issuing entity; *provided* that each interest qualifies, individually or in the aggregate, as an eligible horizontal residual interest.
  - Eligible Horizontal Cash Reserve Account. In lieu of holding all or part of its risk retention in the form of an eligible horizontal residual interest, the Final Rule permits a sponsor to cause to be established and funded, at closing of the securitization transaction, in cash, an eligible horizontal cash reserve account in an amount equal to the fair value of such eligible horizontal residual interest or part thereof, *provided* that the account meets all of the following conditions:
    - the account is held by the trustee (or person performing similar functions) in the name and for the benefit of the issuing entity;
    - amounts in the account are invested only in cash and cash equivalents; and
    - until all ABS interests in the issuing entity are paid in full, or the issuing entity is dissolved, amounts in the account are released only to (i) satisfy payments on ABS interests in the issuing entity on any payment date on which the issuing entity has insufficient funds from any source to satisfy an amount due on any ABS interest or (ii) pay critical expenses of the trust unrelated to credit risk on any payment date on which the issuing entity has insufficient funds from any source to pay such expenses; *provided* that (a) such expenses, in the absence of available funds in the eligible horizontal cash reserve account, would be paid prior to any payments to holders of ABS interests and (b) such payments are made to parties that are not affiliated with the sponsor.

RISK RETENTION DISCLOSURE REQUIREMENTS

Eligible Horizontal Residual Interest

With respect to any eligible horizontal residual interest held under the Final Rule, a sponsor must disclose:

- within a reasonable period of time *prior to* the sale of an ABS –
  - the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest that the sponsor expects to retain;
    - if the specific prices, sizes, or rates of interest of each tranche of the securitisation are not available, the sponsor must disclose (i) a range of fair values (expressed as a percentage of the fair value of all

of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest that the sponsor expects to retain based on a range of bona fide estimates or specified prices, sizes, or rates of interest of each tranche of the securitisation and (ii) the method by which the sponsor determined any range of prices, tranche sizes, or rates of interest;

- a description of the material terms of the eligible horizontal residual interest to be retained by the sponsor;
- a description of the valuation methodology used to calculate the fair values or range of fair values of all classes of ABS interests, including any portion of the eligible horizontal residual interest retained by the sponsor;
- all key inputs and assumptions or a comprehensive description of such key inputs and assumptions that were used in measuring the estimated total fair value or range of fair values of all classes of ABS interests, including the eligible horizontal residual interest to be retained by the sponsor;
- quantitative information about discount rates, loss given default (recovery), prepayment rates, default rates, lag time between default and recovery and the basis of forward interest rates used;
- descriptions of all inputs and assumptions that either could have a material impact on the fair value calculation or would be material to a prospective investor's ability to evaluate the sponsor's fair value calculations; and
- a summary description of the reference data set or other historical information used to develop the key inputs and assumptions referenced in the disclosure, including loss given default and default rates.

- Within a reasonable time *after* the closing of the securitisation transaction –
  - the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest the sponsor retained at the closing of the securitisation transaction, based on actual sale prices and finalised tranche sizes;
  - the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest that the sponsor is required to retain; and
  - to the extent the valuation methodology or any of the key inputs and assumptions that were used in calculating the fair value or range of fair values disclosed prior to sale materially differs from the methodology or key inputs and assumptions used to calculate the fair value at the time of closing, descriptions of those material differences.
- If the sponsor retains risk through the funding of an eligible horizontal cash reserve account –
  - the amount to be placed (or that is placed) by the sponsor in the eligible horizontal cash reserve account at closing, and the fair value (expressed as a percentage of the fair value of all of the ABS interests issued in the securitisation transaction and dollar amount) of the eligible horizontal residual interest that the sponsor is required to fund through the eligible horizontal cash reserve account in order for such account, together with other retained interests, to satisfy the Risk Retention Requirement;
  - a description of the material terms of the eligible horizontal cash reserve account; and
  - each of the disclosures required above with respect to the eligible horizontal residual interest held by the sponsor.

Eligible Vertical Interest

With respect to any eligible vertical interest held under the Final Rule, a sponsor must disclose:

- within a reasonable period of time *prior to* the sale of an ABS –
  - the form of the eligible vertical interest;
  - the percentage that the sponsor is required to retain as a vertical interest; and
  - a description of the material terms of the vertical interest and the amount that the sponsor expects to retain.

- Within a reasonable time *after* the closing of the securitisation transaction –
  - the amount of the vertical interest the sponsor retained at closing, if that amount is materially different from the amount disclosed above.

RECORD MAINTENANCE

A sponsor must retain the certifications and disclosures required in the Final Rule with respect to (i) the Risk Retention Requirement and (ii) the disclosure requirements set forth above in its records and must provide the disclosure upon request to the SEC and its appropriate Federal banking agency, if any, until three years after all ABS interests are no longer outstanding.

HEDGING, TRANSFER AND FINANCING RESTRICTIONS

Hedging and Transfers. The Final Rule prohibits a sponsor or any affiliate from hedging the credit risk the sponsor is required to retain under the Final Rule or from purchasing or selling a security or other financial instrument, or entering into an agreement (including an insurance contract), derivative or other position, with any other person (other than a majority-owned affiliate of the sponsor) if: (i) payments on the security or other financial instrument or under the agreement, derivative or position are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor is required to retain, or one or more of the particular securitised assets that collateralise the ABS and (ii) the security, instrument, agreement, derivative, or position in any way reduces or limits the financial exposure of the sponsor to the credit risk of one or more of the particular ABS interests or one or more of the particular securitised assets that collateralise the ABS.

Financings. The Final Rule also prohibits a sponsor or any of its affiliates from pledging as collateral for any obligation (including a loan, repurchase agreement, or other financing transaction) any ABS interest that the sponsor is required to retain with respect to a securitisation transaction pursuant to the Final Rule *unless* such obligation is with full recourse to the sponsor or its affiliate, respectively.

Sunset on Hedging and Transfer Restrictions

For all ABS interests (other than RMBS, which are subject to different sunset provisions), the transfer and hedging restrictions under the Final Rule will expire on or after the date that is the latest of –

- the date on which the total unpaid principal balance of the securitised assets that collateralise the securitisation is reduced to 33% of the original unpaid principal balance as of the date of the closing of the securitisation;
- the date on which the total unpaid principal obligations under the ABS interests issued in the securitisation is reduced to 33% of the original unpaid principal obligations at the closing of the securitisation transaction; or
- two years after the date of the closing of the securitisation transaction.

CLO MANAGERS ARE DEEMED TO BE "SPONSORS" SUBJECT TO THE RISK RETENTION REQUIREMENT

Section 15G of the Exchange Act generally requires the securitiser of ABS to retain not less than 5% of the credit risk of the assets collateralising any ABS issuance. A "securitiser" under Section 15G includes either (i) an issuer of an ABS

or (ii) a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate or issuer. The sponsor of a securitization transaction fits within clause (ii) of the definition of securitiser.

Numerous market participants submitted comments to the Agencies asserting that CLO managers are not securitisers subject to the Risk Retention Requirement because (among other things) they cannot sell or transfer the assets securitised through the CLO, as they do not own, possess, or control the CLO assets. The Agencies rejected this premise and made it clear in the Final Rule that CLO managers are indeed sponsors subject to the Risk Retention Requirement. The Agencies' reasoning for this determination is as follows:

- a CLO manager organises and initiates a securities transaction because it typically negotiates the primary deal terms of the transaction and the primary rights of the issuing entity, and it directs the issuing entity to acquire the loans that comprise its collateral pool;
- a CLO manager indirectly transfers the assets to the issuing entity because it has sole authority to select the loans to be purchased by the issuing entity for inclusion in the collateral pool, directs the issuing entity to purchase such assets in accordance with investment guidelines, and manages the securitised assets once deposited in the CLO structure; and
- an asset is not transferred to the CLO issuing entity unless the CLO manager has selected the asset for inclusion in the collateral pool and instructed the issuing entity to acquire it.

As a result of this determination, CLO managers are sponsors under the Final Rule and must therefore comply with the Risk Retention Requirement unless they can avail themselves of the Arranger Option set forth below.

ARRANGER OPTION

The Final Rule provides for a lead arranger option (the Arranger Option) for open market CLOs, under which an open market CLO could satisfy the Risk Retention Requirement if, among other requirements:

- the CLO does not hold or acquire any assets other than CLO-eligible loan tranches and servicing assets;
  - To qualify as a CLO-eligible loan tranche, a term loan of a syndicated credit facility to a commercial borrower must have the following features:
    - a minimum of 5% of the face amount of the CLO-eligible loan tranche must be retained by the lead arranger from the time of origination of the syndicated loan until the earliest of the repayment, maturity, involuntary and unscheduled acceleration, payment

default or bankruptcy default of such CLO-eligible loan tranche; *provided* that such lead arranger must also comply with the limitations on hedging, transferring and pledging set forth in the Final Rule with respect to the interest retained by the lead arranger;

- lender voting rights within the credit agreement and any inter-creditor or other applicable agreements governing such CLO-eligible loan tranche must be defined so as to give holders of the CLO-eligible loan tranche consent rights with respect to, at minimum, any material waivers and amendments of such applicable documents, including but not limited to, adverse changes to the calculation or payments of amounts due to the holders of the CLO-eligible tranche, alterations to pro rata provisions, changes to voting provisions, and waivers of conditions precedent; and
- the pro rata provisions, voting provisions, and similar provisions applicable to the security associated with such CLO-eligible loan tranches under the CLO credit agreement and any inter-creditor or other applicable agreements governing such CLO-eligible loan tranches cannot be materially less advantageous to the holder(s) of such a CLO-eligible tranche than the terms of other tranches of comparable seniority in the broader syndicated credit facility.

- the lead arranger takes on an initial allocation of at least 20% of the face amount of the broader syndicated loan or credit facility, with no other member of the syndicate assuming a larger allocation or commitment;
- the open market CLO does not invest in ABS interests or in credit derivatives other than hedging transactions that are servicing assets to hedge risks of the open market CLO;
- all purchases of CLO-eligible loan tranches and other assets by the open market CLO issuing entity or through a warehouse facility used to accumulate the loans prior to the issuance of the CLO's ABS interests are made in open market transactions on an arms-length basis;
- the CLO manager of the open market CLO is not entitled to receive any management fee or gain on sale at the time the open market CLO issues its ABS interests;
- the CLO manager discloses a complete list of every asset held by an open market CLO (or before the CLO's closing, in a warehouse facility in anticipation of transfer into the CLO at closing) containing the following information:
  - the full legal name, Standard Industrial Classification (SIC)[5] category code and legal entity identifier (LEI)[6] issued by a utility endorsed or otherwise governed by the Global LEI Regulatory Oversight Committee or the Global LEI Foundation (if an LEI has been obtained by the obligor) of the obligor of the loan or asset;
  - the full name of the specific CLO-eligible loan tranche held by the CLO;
  - the face amount of the CLO-eligible loan tranche held by the CLO;
  - the price at which the CLO-eligible loan tranche was acquired by the CLO;
  - for each loan tranche, the full legal name of the lead arranger subject to the sales and hedging restrictions; and
  - the full legal name and form of organisation of the CLO manager.

[5] The Standard Industrial Classification (SIC) is a system used by government agencies (e.g., the SEC) for classifying industries by a four-digit code.

[6] The legal entity identifier (LEI) is a 20-digit, alpha-numeric code that connects to key reference information that enables clear and unique identification of companies participating in global financial markets.

- The CLO manager is required to provide this disclosure list within a reasonable period of time prior to the sale of the ABS in the securitisation transaction (and at least annually with respect to information regarding the assets held by the CLO) and, upon request, to the SEC and the sponsor's appropriate Federal banking agency, if any.
- The CLO manager is also required to certify or represent as to the adequacy of the collateral and certain attributes of the borrowers of the senior, secured syndicated loans acquired by the CLO and certain other matters.

To date, market participants have been doubtful about the feasibility of the Arranger Option. It remains to be seen whether the CLO market will ultimately adopt the Arranger Option with respect to future CLO issuances.

ORIGINATOR OPTION

The Final Rule permits a sponsor to allocate a portion of the Risk Retention Requirement to any originator of the underlying assets if –

- such originator originated at least 20% of the underlying assets in the pool;
- the amount of the retention interest held by such originator allocated credit risk is at least 20%, but is not in excess of the percentage of the securitised assets it originates;
- the originator holds its allocated share of the Risk Retention Requirement in the same manner as is required of the sponsor (i.e., in the form of an eligible vertical interest, eligible horizontal residual interest or L-Shaped interest);
- the originator is subject to the same restrictions on transferring, hedging and financing as the sponsor;
- the sponsor provides, or causes to be provided, to potential investors (and the appropriate regulators upon request) the name and form of organisation of any such originator that will acquire and retain (or has acquired and retained) an interest in the transaction, including a description of the form, amount, and nature of the interest (e.g., senior or subordinated), as well as the method of payment for such interest;
- the sponsor agrees to be responsible for any failure of an originator to abide by the transfer, hedging and financing restrictions set forth in the Final Rule.

By limiting this option to originators that originate at least 20% of the asset pool, the Agencies sought to ensure that the originator retains risk in an amount significant enough to function as an actual incentive for the originator to monitor the quality of all the securitised assets (and to which it would retain some credit risk exposure).

15 U.S.C. 78o-11(a)(4) defines the term originator as a person who, through the extension of credit or otherwise, *creates* a financial asset that collateralises an asset-backed security; and who sells an asset directly or indirectly to a securitiser (i.e., a sponsor or depositor). The Final Rule incorporates this definition without modification, and expressly excludes any person that *acquires* loans and transfers them to a sponsor, as such person would not be the *creator* of such asset.

There is a consensus among market participants that the Originator Option is not applicable to CLOs backed by broadly syndicated loans. However, the Originator Option may be a feasible alternative in the middle market space.

QUALIFYING COMMERCIAL LOAN EXEMPTION

The Final Rule includes stringent underwriting standards for qualifying commercial loans (QCLs) that, when securitised, would be exempt from the Risk Retention Requirement. The underwriting standards impose limitations on debt service coverage ratios, leverage ratios, liability ratios, amortisation periods and other loan terms. In addition, (i) a QCL must base loan payments on a straight-line amortisation schedule over no more than a 5-year term (rather than a bullet amortisation typical in most CLOs), (ii) all QCLs must be funded prior to the securitisation, (iii) the securitisation cannot allow for any reinvestment

periods and (iv) if a loan is subsequently found not to have met the QCL criteria, the sponsor is required to effect a cure or buyback of the loan.

Clearly, most loans acquired by CLOs would not meet the stringent QCL criteria. Therefore, the Qualifying Commercial Loan Exemption is not a plausible option for CLOs.

ELIMINATION OF RESTRICTION ON PROJECTED CASH FLOWS TO ELIGIBLE HORIZONTAL RESIDUAL INTEREST

One of the few positive changes included in the Final Rule that actually benefits CLOs is the Agencies' decision to eliminate the proposed cash flow restriction set forth in the Re-Proposed Rule, which would have restricted the amount and timing of projected cash flows to be paid to the eligible horizontal residual interest. Under the proposed cash flow restriction, the sponsor would have been prohibited from receiving any cash flows at a faster rate than the rate at which principal was projected to be paid to investors on all ABS interests in the securitisation. The proposed cash flow restriction would have been problematic for CLOs and other structures that use principal proceeds to reinvest in additional assets, but continue to pay interest, for significant reinvestment periods. In addition, the calculations, disclosures, and certifications required by the proposed cash flow restriction would have created a costly administrative burden for CLO participants.

REFINANCINGS, RE-PRICINGS AND AMENDMENTS: ARE LEGACY CLOS REALLY GRANDFATHERED?

CLO managers will become subject to the Final Rule in connection with any new CLO issuance occurring on or after the effective date of the Final Rule in late 2016. CLOs issued prior to the effective date of the Final Rule are exempt from the Final Rule. However, to the extent that any legacy CLOs otherwise grandfathered under the Final Rule issue new securities on or after such effective date in connection with a refinancing, a re-pricing or another additional securities issuance, it appears that such legacy CLOs would be subject to the Final Rule by virtue of such new securities issuance. Moreover, it is unclear whether the Agencies would take the view that certain other amendments to legacy CLOs not involving the issuance of new securities could also potentially trigger the Risk Retention Requirement. These and other issues will be the subject of further discussion and analysis by market participants.

Market participants may want to consider seeking further clarity on these points and other issues that will emerge as the market adjusts to the Final Rule. Although the Agencies are comprised of six different regulators, the SEC has primary jurisdiction over the CLO industry. Therefore, market participants may want to seek certain relief and further clarification on specific points from the SEC through the issuance of no-action letters or interpretive letters. With respect to grandfathered CLOs that permit refinancings, re-pricings and other types of additional issuances, it may be worth exploring whether the SEC would be sympathetic to the view that such transactions should not be subject to the Final Rule because there is no real sponsor or "transfer of assets" in connection with such new issuances.

OTHER ISSUES FOR CLO MARKET PARTICIPANTS TO CONSIDER

The Final Rule is silent with respect to the termination or resignation of a CLO manager subject to the Risk Retention Requirement. Presumably the successor CLO manager will be required to assume the predecessor CLO manager's risk retention obligations but the requirement is not clear under the Final Rule. Some market participants expect that CLO issuances will significantly decrease when the Final Rule becomes effective because smaller CLO managers will not have the ability to fund the Risk Retention Requirement and will therefore be subsumed by larger CLO managers with significant capital. If a CLO manager decides to finance the required retention amount with full recourse and such

CLO manager subsequently defaults on the loan, a lender's foreclosure during the retention period could result in non-compliance with the Final Rule. Therefore, CLO managers may attempt to negotiate financing terms with lenders that are willing to forebear the right to foreclose upon a default until the end of the retention period. However, such financing may be on less favorable terms than standard financing terms.

In addition, the Final Rule provides a safe harbor for foreign CLO issuances; *provided* that (among other things) with respect to a particular CLO issuance, US noteholders cannot represent more than 10% of all noteholders relating to such issuance. Although this 10% threshold excludes secondary sales, large volumes of contemporaneous secondary sales to US investors may be deemed to have exceeded the scope of this safe harbor. Assuming that a refinancing triggers the Final Rule, if less than all of the related notes are refinanced, it is unclear under the Final Rule whether the required retention amount would be 5% of the fair value of the entire CLO transaction, or only 5% of the face value of the refinanced notes (and if the latter, it is equally unclear what form of retention would be permissible under the Final Rule). CLO managers may want to consider the inclusion of new provisions in CLO Indentures that would grant the manager consent rights with respect to refinancings and other actions that could potentially trigger the manager's Retention Requirement under the Final Rule.

CONCLUSION

The Final Rule retains the basic risk retention framework of the Re-Proposed Rule, with very limited changes. CLO managers are deemed to be sponsors under the Final Rule. Therefore, CLO managers (or their majority-owned affiliates) must comply with the Risk Retention Requirement unless they can avail themselves of the Arranger Option or obtain subsequent relief from the Agencies. Although the Final Rule will not become effective for CLOs until late 2016, market participants currently involved in new issuances of CLOs otherwise grandfathered under the Final Rule must consider the impact that CLO structures with refinancings, re-pricings or the ability to effect other securities issuances will have on the CLO manager's obligation to meet the Retention Requirement when the Final Rule becomes effective in late 2016.

Authored by: Steven Lozner

HAS THE EUROPEAN HIGH YIELD MARKET COME OF AGE?

OUR OBSERVATIONS FROM AFME'S 9TH ANNUAL HIGH YIELD CONFERENCE

A number of high yield market participants from the sell-side and the buy-side, together with their legal advisors, gathered in the City of London at the beginning of October for the Association for Financial Markets in Europe (AFME) 9th Annual European High Yield Conference to reflect on the state of the European high yield market and its potential for the coming year.

The conference came during a difficult time for high yield – following record issuance volumes in the first half of the year (€51.4 billion was issued, some €12 billion more than in the first half of 2013, which itself was an all-time European record, according to Leveraged Commentary and Data (LCD) the third quarter witnessed a slowdown in primary issuance as unpredictable secondary market conditions prevailed.

As a result, non-seasoned issuers that came to market had to increase the coupon and adjust deal terms to get their deals away. During the road show, investors were steered towards pricing in the mid-6% region for Nyrstar's euro-denominated senior notes and low-8% for Keepmoat's sterling-denominated senior secured notes; Nystar's notes eventually priced to yield 9% and Keepmoat's senior secured notes priced at 9.75%. As both of these deals were the lowest rated of the post-summer supply, each rated B- by Standard & Poor's, the wider-than-whispered pricing shows that the market required large premiums for credits on the lower rungs of the ratings ladder.

Despite difficult market conditions, the mood among speakers at the conference was upbeat, as most felt that the market shut-down was just a blip in the overall picture, and that investors with cash to put to work will soon return to fuel further primary issuance. Representatives from the sell side reported that market fundamentals remain strong – the low interest rate environment combined with a low default rate and an improving global economy create ideal conditions for high yield – but technical elements, including outflows from funds and a volatile secondary market, are keeping a lid on primary issuance.

Speakers also agreed that the pendulum has swung firmly in favour of investors in high yield, illustrated by changes to covenants in response to market feedback and wider pricing for issuers that launched during the third quarter. By way of example, Keepmoat was forced to remove its portability provision[1], and Nyrstar gave up its ability to call the bonds prior to maturity (the "non-call") except at a pricey make-whole redemption premium, in order to get the deals over the line.[2]

More recently, Arrow Global launched an offering of floating rate notes (FRNs) with a non-call period of three years, (FRNs have typically been expected to have a non-call period of one or two years). This is one of only seven FRN deals with a non-call period of more than two years since LCD began tracking such terms for the European high yield market in 2006. In addition, the deal does not contain a portability provision, whereas the issuer's first, and only, other deal allows this flexibility, demonstrating that the sell-side is aware that the term has fallen out of favour with investors and that if deals are to get done in this challenging market they must be structured to be attractive to investors.

According to deal teams, other terms eliciting negative investor feedback recently include "soft-cap" restricted payment capacity (which allows high yield bond issuers to dividend cash to shareholders outside of the standard 50% of consolidated net income basket) and "EBITDA-growers", or baskets with capacity measured by reference to a per cent of EBITDA (rather than the more traditional total assets soft-cap metric). The latter elicits objections from investors due to the calculation flexibility embedded in most definitions of EBITDA, which allows CFOs to add back synergies, sponsor fees and other costs with wide discretion.

Interestingly, whilst these provisions appear primarily in sponsor-lead high yield deals, they are becoming more common in high yield deals from corporate issuers, showing that companies are benefitting from more flexibility in their high yield covenants due to the higher prevalence of these terms in the European high yield market and the resultant familiarity to investors.

While the pace of primary issuance has slowed, leaving most issuers waiting in the wings for conditions to improve, those desiring liquidity can still access the market – albeit at a higher cost – demonstrating that the European high yield market has reached a deeper level of maturity than ever before.

Authored by: Sabrina Fox

[1] This term allows an issuer to be sold with its bonds in place, rather than triggering a change of control, which would increase the overall cost of an acquisition by requiring the issuer to make an offer to noteholders repurchase the bonds at 101%.

[2] The non-call period is an important attribute of high yield covenants for investors, as it provides them with a locked in period in which they will receive interest payments. A shorter non-call period directly constrains an investor's potential returns on its investment in the bond.

THE EUROPEAN CENTRAL BANK'S **PURCHASE PROGRAMMES**

On 2 October 2014, the European Central Bank (ECB) set out technical details of its plans to purchase simple and transparent asset backed securities (ABS) and euro-denominated covered bonds, yet it did not commit to an overall size. Mario Draghi, the president of the ECB, stated that "the potential universe" that the two programmes could address is up to €1 trillion[1].

Since the announcement and following the publication of Decision (ECB/2014/40) on the implementation of the third covered bond purchase programme (CBPP3) on 15 October 2014 and Decision (ECB/2014/45) on the implementation of the ABS purchase programme (ABSPP) on 19 November 2014, the ECB began purchasing covered bonds and ABS.

The ECB has appointed four executing asset managers[2] to carry out its ABSPP. These asset managers will act on specific instructions of the Eurosystem, which will undertake price checks and due diligence prior to approving the transactions.

The ECB hopes that these measures, along with the introduction of the targeted long term refinancing operations (TLTROs) earlier this year, will encourage banks to lend to businesses, which will in turn stimulate economic growth in the Eurozone and bring inflation back up to a level close to, but below 2%.

This article summarises the eligibility criteria for the outright purchases of ABSPP and covered bonds.

THE PROGRAMMES

The ECB intends to make these programmes available to the whole of the euro zone and has therefore made an exception for ABS and covered bonds from countries that do not satisfy the minimum rating requirement of BBB-, namely Greece and Cyprus. Additional requirements have been put in place for these countries in order to mitigate risk. For more details of the requirements applicable to Greece and Cyprus, please refer to the ECB Decisions for ABSPP and CBPP3, as referred to above.

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1 http://www.ecb.europa.eu/press/pressconf/2014/html/is141002.en.html

2 Amundi and Amundi Intermediation, Deutsche Asset & Wealth Management International, ING Investment Management and State Street Global Advisors.

ABSPP

The modalities of the ABSPP include only senior and guaranteed mezzanine tranches of ABS being purchased in both the primary and secondary markets. The details of the eligibility criteria for guaranteed mezzanine tranches has not been revealed and the ECB has said such details will be communicated at a later stage. To qualify for purchases under the ABSPP, the senior tranches must:

- be eligible under the collateral framework for Eurosystem's credit operations;
- be denominated in Euro and have issuer residence within the euro area;
- be backed by obligors, no fewer than 90% of which must be private sector non-financial corporations or natural persons;
- be secured by claims against non-financial private sector entities in the euro area, of which a minimum share of 95% is Euro-denominated and of which a minimum share of 95% are resident in the euro area; and
- have a second-best credit assessment of at least CQS3, expressed in the form of at least two public credit ratings provided by any two External Credit Assessment Institutions (ECAIs), currently equal to an ECAI rating of BBB-/Baa3/BBBl.

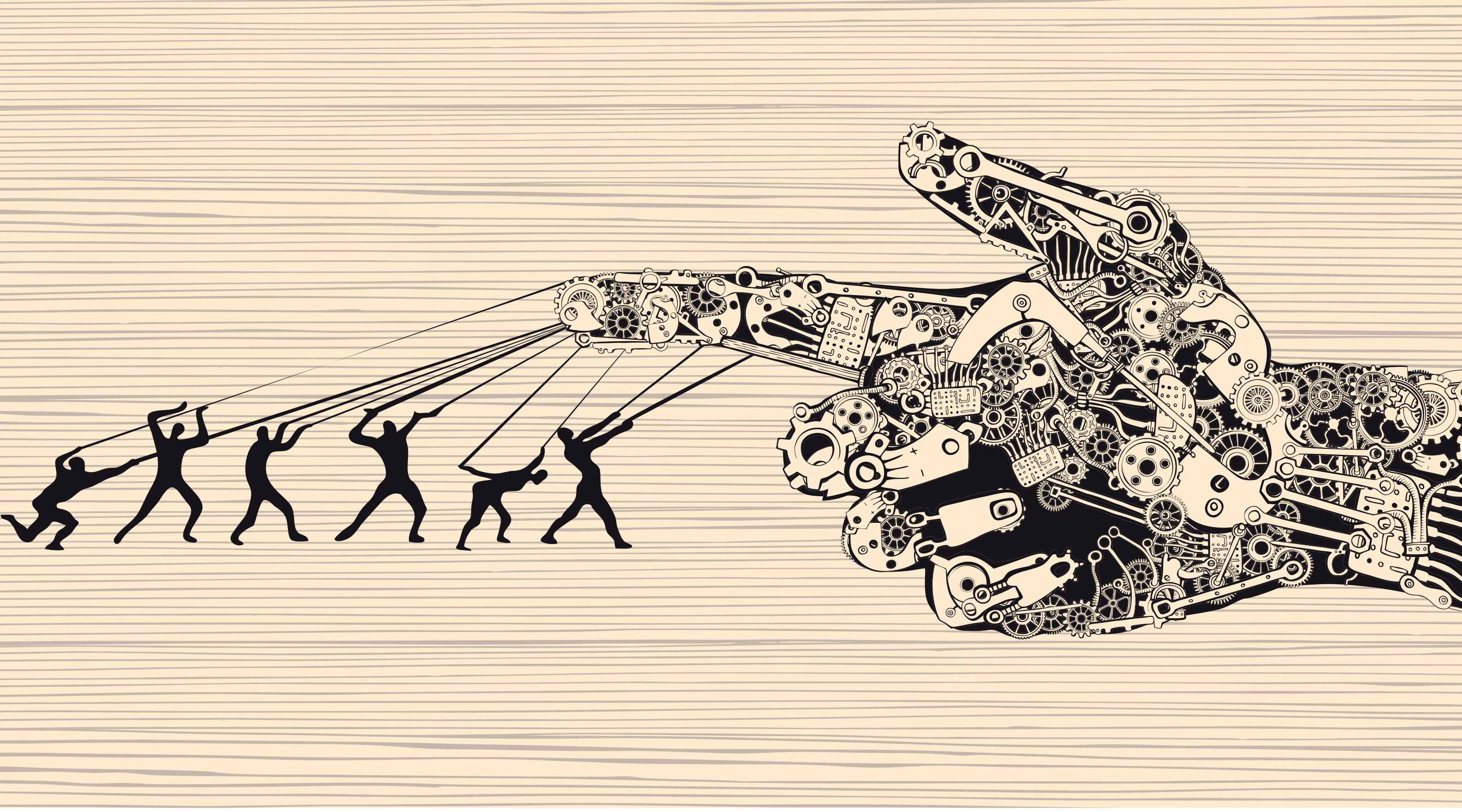
An issue share limit of 70% per ISIN will be applied, except in the case of Greece and Cyprus where it will apply an issue share limit of 30% per ISIN.

The Eurosystem will also consider purchasing fully retained securities, subject to some participation by other market investors.

CBPP3

This programme differs slightly from the previous two covered bond purchase programmes (CBPPI and CBPP2) in that a minimum volume of bonds to be issued has not been announced and a maximum residual maturity has not been applied. Instead the ECB has applied the same share limits of 70% per ISIN, as set out above for ABSPP. Also fully retained issues will be eligible for this programme, unlike the previous two.

The modalities for the CBPP3 include the purchase of Euro denominated covered bonds, issued by banks in the euro area, by the ECB and national central banks in both the primary and secondary markets.



To qualify for purchases under the CBPP3 programme, covered bonds must:

- be eligible for monetary policy operations as defined in Guideline ECB/2011/14 as amended and, in addition, fulfil the conditions for their acceptance as own-used collateral as laid out in Section 6.2.3.2.
- be issued by euro area credit institutions, or in the case of multi-cedulas by Special Purpose Vehicle's incorporated in the euro area
- be denominated in euros and held and settled in the euro area
- have underlying assets that include exposure to private and/or public entities
- have a minimum first best credit assessment of CQS3 (ECAI rating of BBB- or equivalent)

Counterparties eligible for the Eurosystem's monetary policy operations will also be eligible for the CBPP3, together with any of the counterparties that are used by the Eurosystem for the investment of its euro-denominated portfolios.

The CBPP3 portfolio will be available for lending. Such lending will be voluntary and conducted through security lending facilities offered by central securities depositories, or through matched repo transactions with the same set of eligible counterparties as for CBPP3 purchases.

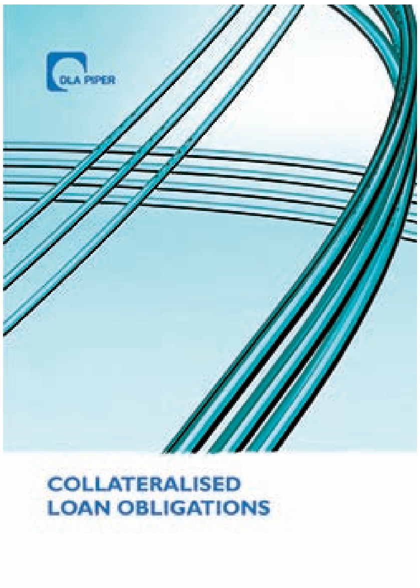
CONCLUSION

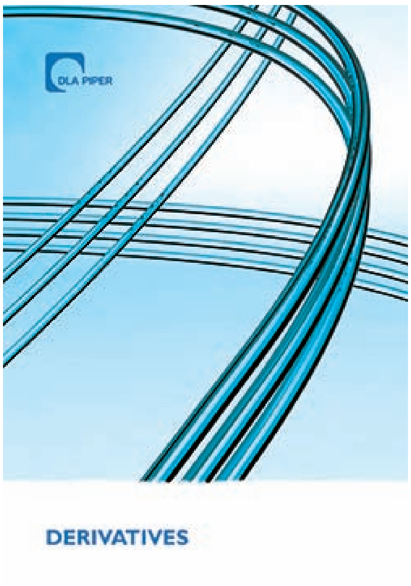
This year the ECB has cut its main interest rates to record lows of 0.05% to encourage borrowing and implemented negative rates on overnight bank deposits held at the ECB to incentivise banks to lend. However, even with such interest rate cuts, many are sceptical that these programmes, along with the second TLTRO to be announced in December, will expand the ECB's balance sheet by €1 trillion and prevent the Eurozone falling into deflation.

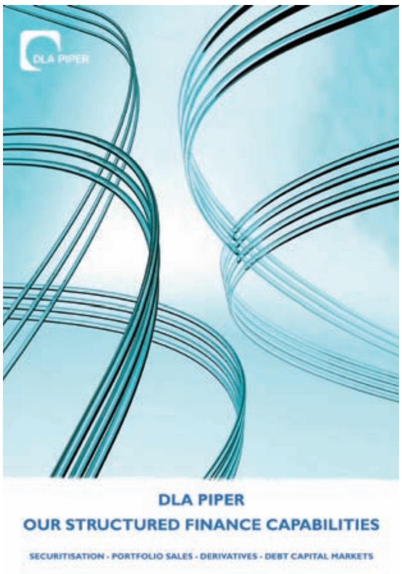
Whether the ABSPP and CBPP3 play a key role in financing the economy and have enough of an effect on the medium to long-term inflation expectations is yet to be seen. The ECB has so far refrained from entering into a full-fledged quantitative easing programme, however Mario Draghi has recently announced *"we will do what we must to raise inflation and inflation expectations as fast as possible"*[3] and this could include purchasing government bonds.

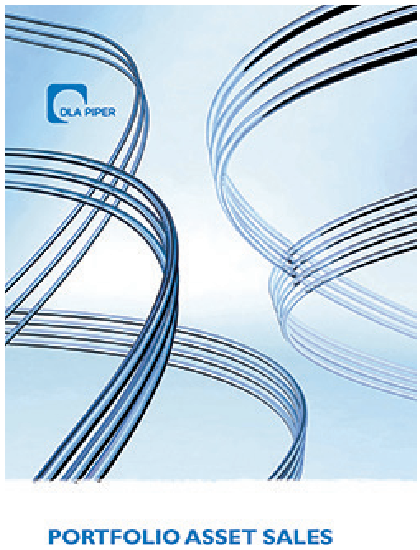
Authored by: Purdeep Sihota

[3] http://www.ecb.europa.eu/press/key/date/2014/html/sp141121.en.html









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