MAPLES GROUP

UPDATE

Luxembourg Securitisation Bill and Amended Draft Law: A Bright Future for CLOs

For the past two decades, the law of 22 March 2004 on securitisation, as amended (the "Law") has made Luxembourg one of the primary global jurisdictions for the setting up of securitisation transactions, with (as of end of March 2021) 1,370 active vehicles representing around 9,000 segregated compartments[1].

Luxembourg's flexible and stable regime has offered an ideal framework for a broad range of structured finance transactions, whether falling within or outside the scope of the EU Regulation on securitisation[2] since its entry into force on 23 September 2020. While very flexible, the Law contains a certain number of restrictions that constituted an impediment to particular types of arrangements and structures.

Implementation of Regulations

According to the Law as typically construed - in particular and putting aside the loan origination activity that is authorised under a number of conditions - the essence of a securitisation undertaking (as such term is defined in the Law, an "SV") is that the risks that are securitised must strictly result from the third parties' assets or activities themselves, either acquired or assumed by the SV and subsequently securitised.

In other words, no additional management risks should be introduced by the SV itself or by its own activity. Any form of 'active management' or entrepreneurial approach is therefore excluded, and the SV should restrict itself to a 'passive' and 'prudent man' management of the securitised risks, i.e. administering the financial flows generated by the securitised risks themselves. The Law itself does not expressly specify the prohibited activities or how the aforementioned concepts should be construed.

The *Commission de Surveillance du Secteur Financier* (the "CSSF") provided clarification on these concepts by issuing useful guidance in the form of an FAQ. According to the CSSF's interpretation, any form of active management of the portfolio, such as an opportunistic driven ongoing activity of claim acquisition and assignment to take advantage of short term fluctuations of market values, would fall under such prohibition, regardless of whether such activities would be directly

[1] Compartments are one of the most advantageous features of the Law, which allows separate compartments to be created by a single securitisation vehicle with the assets and liabilities from each compartment being segregated from the others. It is therefore possible to structure several securitisation transactions through one securitisation undertaking (be it a corporation or a securitisation fund).

[2] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

exercised by it or have been delegated to a third party.

According to Article 61(1) of the Law, any assignment or transfer, or any re-employment (by the SV's counterparty) of the securitised assets (to the exclusion of opportunistic short term speculation) must be expressly authorised under the SV's constitutional documents (e.g. articles of association if formed as a commercial company, or management regulations, if formed as a securitisation fund) and / or the issue documents, i.e. prospectus. The terms of any such assignment or rehypothecation that may be implemented must be precisely and expressly laid down, i.e. the party responsible for such decisions and according to which method. More generally and from a regulatory perspective, it should also be noted that any asset management activities implemented by an SV must avoid falling within the scope of the regulations governing the operation and management of undertakings for collective investment in transferable securities and alternative investment funds.

As an exception, in the context of the securitisation of a portfolio of financial assets where and to the extent active management activities may be deemed as essential to the very nature of such securitisation schemes (e.g. concluding transactions on financial instruments, forward transactions with a view to hedging risks or effectively managing the portfolio through repurchase agreements and securities lending activities to improve the return), such activities must be limited under the constitutional documents to a 'strict minimum'.

As an illustration, an SV may acquire and own shares or units to the extent it will limit itself to the receipt of distributions (i.e. dividends) as a professional investor, and may not intervene in the management or supervision of the entities whose shares or units are held, as a holding company would typically do.

The foregoing has been seen as preventing the implementation of repackaged debt, and notably collateralised loan obligations transactions ("CLOs") and collateralised debt obligations transactions, out of Luxembourg. These transactions, which consist of the issuance of tranched securities that are secured or collateralised by a portfolio of leveraged corporate senior secured loans or bonds, unsecured senior or mezzanine obligations, mortgages or bonds (as applicable), imply an active management of the securitised assets, are typically selected by an asset manager during the ongoing life of the transaction from various sources, thereby requiring the form of active management prohibited under the current version of the Law. While the vast majority of CLOs are issued in the US (around 80%), the European market has been active and dynamic in these fields with 66 new issuance deals priced to date in 2021, representing an aggregate amount of €26.99 billion. While Dutch and Irish SPVs were used extensively in the past, as of Q4 2020, Ireland has become the issuers' European jurisdiction of choice following the migration of all pre-existing Dutch CLOs due to the Netherlands effectively shutting these transactions out.

Amendments to the Securitisation Law

On 21 May 2021, a long-awaited draft law[3] 7825 amending the Law (the "Draft Law") was lodged at the Luxembourg Parliament.

Among the many amendments contained in the draft, generally aimed at enhancing legal certainty or strengthening the flexibility of the Luxembourg securitisation regime, the Draft Law alleviates the restrictions on active risk management of securitised assets (either directly or through appointed portfolio

[3] 7825 amending the Securitisation Law

managers), including in consideration of short term market variations, subject to the following conditions being met:

(a) the securities are issued under private placement (no offering to the public); and
(b) the securitised assets consist of repackaged debt (debt instruments, financial instruments and claims) (Art.14 of the Draft Law, amending Art. 61(1) of the Law).

The Draft Law is still at an early stage and many changes may be made before the final amendments are implemented into law. Nevertheless, the elimination of the passive management limitation means that Luxembourg will now offer an efficient legal framework for actively managed CLOs, making Luxembourg an alternative jurisdiction of choice for the establishment of such transactions in Europe.

Aside from the above, there are other contemplated changes that may attract some of the transactions that were previously structured through other European jurisdictions or issued in the US but structured through offshore jurisdictions. One of the main contemplated changes applies to the limitation relating to the granting of security interests and guarantees.

According to Article 61(3) of the Law, the granting of security by SVs over their assets is allowed only if in favour of its investors or for the purpose of securing the obligations subscribed in connection with the securitisation of those same assets (e.g. for the purpose of financing the acquisition and subsequent securitisation of the securitised assets). This typically goes against the expectations and conditions set out by third-party creditors. Any guarantee or security interests granted in breach of the foregoing are deemed void by operation of the applicable legal provisions. The Draft Law authorises SVs to grant security interests to a wider scope of beneficiaries, i.e. any creditor - direct or indirect - to the securitisation transaction, and any reference to the current sanctions, applicable when granting a security interest in breach of the rules currently set forth in the Law, will be removed.

Another main change is the removal of the conditions that SVs must finance their operations primarily through the issuance of securities (in practice, through the issuance to their investors of notes, preferential shares or units, but also derivative instruments). Additionally, they may also seek complementary leverage by way of loans that do not qualify as securities:

(a) on a transitional basis (for warehousing and bridging purposes between the acquisition of the assets and the issuance of securities – prudent market practice suggests that a securitisation transaction may be entirely loan-financed at the beginning of the transaction for a period of time not exceeding 18 months); and / or
(b) on the basis that any lasting loan financing would not account for more than one third of the total financing.

The Draft Law removes these restrictions and authorises SVs to be entirely financed through borrowings.

Future Amendments

A few other amendments and changes are contemplated, such as expressly authorising the use of Luxembourg SVs for aircraft or vessel sale and lease back transactions (provided that the operational risk remains with the lessee) or enlarging the panel of options for legal forms available to SVs, and in particular, the inclusion of partnerships (e.g. general corporate partnerships (*sociétés en nom collectif*), simple limited partnerships (*sociétés en commandite simple*), simplified joint stock companies (*sociétés par actions simplifiées*) and special limited partnerships

(*sociétés en commandite spécial*)), clarifications on the legal subordination by including express rules in the law, refining the definition of issuance of securities to the public as per the CSSF recommendations or clarifying the treatment and distribution of profits and losses of equity-financed compartments or reducing ambiguity of omissions regarding the registration of securitisation funds.

The contemplated amendments are expected to significantly increase the attractiveness of Luxembourg as a European hub for securitisations generally and in particular, for CLOs.

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