BREXIT

What now for the cleared derivatives markets?

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Important note: *This memorandum focuses on the key areas in which a Brexit is likely to impact the cleared derivatives markets. It is based on the assumption that following the referendum vote (which is technically advisory), the United Kingdom (U.K.) Government will press on with the process of negotiating its withdrawal from the European Union (EU) (as opposed to using the outcome of the referendum vote to seek to re-negotiate more preferential terms or, for example, doing nothing). Thus, the scope of this memorandum is limited solely to the U.K.'s options when considering its on-going relationship with the EU as part of a withdrawal from EU membership. It should be regarded as general guidance only and should not be relied upon as definitive advice. In particular, we note that the precise terms of a Brexit and the post-exit model negotiated will impact the ultimate legal analysis. [This memorandum examines the legal consequences of a Brexit. It does so in a neutral way without promoting an outcome in the vote one way or another.]*

[This memorandum has been prepared for FIA by Allen & Overy. For further analysis of the issues, Allen & Overy has published a series of specialist papers on the potential impact of a Brexit which can be accessed via: www.allenovery.com/brexit.]

The UK voted “Leave”: What now for the cleared derivatives markets?

IN BRIEF

- There will be a protracted period of uncertainty during which the terms of the U.K.’s exit from the EU will be negotiated and the framework for its future relationship with the EU and other non-EU states will be established.
- There is no precedent for withdrawal from the EU so any time frames are highly speculative. The EU Treaties specify a negotiating period of up to two years; however this period may be extended (by unanimous agreement by Member States).
- There is likely to be an immediate impact on financial and economic volatility in the U.K. which will affect the cleared derivatives markets.
- Other than in respect of provisions impacted by financial and economic volatility, in most cases cleared derivatives documentation is unlikely to be immediately affected but should be assessed longer term when more detail of the post-Brexit regime is known.

For additional resources from FIA on this topic, visit: www.fia.org/UK-EU-Relations.

1. THE EXIT PROCESS: WHAT WILL HAPPEN NOW?

1.1 What is the legal procedure to exit the EU?

Pursuant to Article 50(2) of the Treaty on the European Union (the TEU), the U.K. Government must give the European Council (the Council) notice of its intention to exit the EU (an Article 50 Notice). Neither the relevant Treaties nor the U.K. legislation governing the referendum specify the timing for the delivery of this notice. This is a political decision. The TEU provides at Article 50(1) that Member States may withdraw from the EU in accordance with their own constitutional requirements. The U.K. does not have a written constitution and there are no formal constitutional requirements that a U.K. Government would have to adhere to before serving the notice.

Article 50 of the TEU provides the legal framework for a Member State to exit from the EU as follows:

- Within two years of a Member State notifying the Council of its intention to withdraw from the EU, the EU "must negotiate and conclude an agreement with that Member State, setting out the arrangements for its withdrawal and taking account of the framework for its future relationship with the EU."
- That withdrawal agreement is to be signed by the Council, acting by a qualified majority, and after obtaining the consent of the European Parliament, acting on a majority vote basis.
- The relevant Treaties would cease to apply to the withdrawing Member State from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification of the Member State's intention to leave unless the Council, in agreement with the withdrawing Member State, unanimously decides to extend this period.

1.2 Can an Article 50 Notice be withdrawn?

There is no provision in the Treaties for the withdrawal of an Article 50 Notice. However, that is not to say that an agreement will not be reached amongst Member States which might allow such a notice to be withdrawn or set aside if there was political will to do so. Presumably if no such agreement was reached then the U.K. could reapply for membership of the EU at some later date. Article 49 of the TEU sets out the processes which all acceding states have to follow. In such a scenario the U.K. would also have to establish its eligibility criteria.

1.3 Can the two year time frame be extended?

Yes, but any agreement to extend the negotiating period beyond two years requires the unanimous agreement of the Council of Ministers (excluding the U.K.) in accordance with Article 50(3) of the TEU.

1.4 Are there any alternatives available to the U.K. other than the Article 50 route?

The U.K. could conceivably withdraw from the EU in breach of the TEU, perhaps citing the supremacy of Parliament. This would be a highly controversial move.

1.5 When will we know what the U.K.'s proposed post-Brexit model is (and what the EU's proposal is)?

This is unclear. However, some commentators have suggested scoping negotiations will begin immediately.

Significantly, the Treaties provide very little guidance about the legal consequences of withdrawing from the EU or what the post-exit world would look like for the departing Member State (and remaining Member States). Existing models for the EU's relations with non-Member States suggest that there are a range of arrangements that could be agreed if the U.K. decided to leave the EU, from the "EU-lite" precedent set by Norway, with its European Free Trade Association (EFTA) and European Economic Area (EEA) membership, through various levels of economic integration and cooperation with the EU, to the U.K. "going it alone" at the other end of the spectrum. There are a number of general points to note in relation to what the existing models might be able to tell us about the likely shape of the U.K.'s post-Brexit relationship with the EU. In particular, these models show a clear correlation between the level of access that non-Member States have to the EU's single market and the extent to which they are required to comply with EU law, agree to free movement (of people, goods, capital and services) and contribute financially to the EU budget.

The principal options are:

1. **EEA: The Norwegian model** - Assuming the necessary agreement/approvals could be obtained (and the U.K. becomes an EFTA member as required under the EEA Agreement), the U.K. could leave the EU but join the EEA as a non-EU Member State member, like Norway. This option would be closest to the U.K.'s current relationship with the other EU Member States and would retain the U.K.'s place within the single market. Therefore, it would minimise the practical consequences of a Brexit to the greatest extent. However, it may be the least politically appealing option as it would not allow the U.K. to disengage itself from some aspects of the EU legal regime that are unpopular among many in the Brexit camp (e.g. it would require the U.K. to permit free movement of people). It would also require a significant financial contribution from the U.K. If this approach was followed, the U.K. would be bound to apply a significant volume of EU law in a range of fields including in relation to financial services, employment and certain consumer protections. While remaining bound by EU law, however, the U.K. would not have a formal seat at the table when EU law is drawn up. There would be some EU legislation that the U.K. would no longer be required to apply if it followed this model, which may mean that the U.K. would have to enact domestic legislation in its place. Notably, as an EEA member, the U.K. could set its own rules in areas such as agriculture and fisheries, transport and energy.

2. **The Swiss model -** If it exited the EU, the U.K. might seek to adopt a model along the lines of the current Swiss model (albeit that this model was initially intended as a transition to full EU membership), with its many bilateral agreements with the Member States and limited access to the single market in specifically defined areas. The U.K. may also seek to become an EFTA member, like Switzerland. This model would require more detailed negotiation than the Norwegian model as bespoke terms for access to the single market would have to be agreed. It may well also require the U.K. to accept at least some of the EU's rules on freedom of movement and to comply with EU rules when trading within the market, again without a formal seat at the table when those laws are drafted. Also, if the Swiss model was adopted literally, freedom of movement of services would be limited. This model would also require a financial contribution from the U.K. It is understood that the Swiss arrangement is not a popular model in Brussels due to its complexity and so there may be limited enthusiasm for agreeing to a similar arrangement for the U.K.

3. **Customs union: The Turkish model** - If the U.K. leaves the EU, it may have little appetite for joining any new "club" along the lines described above. However, it is unlikely that the U.K. would not try to retain at least some form of arrangement with the EU. One such arrangement currently in existence is the customs union between the EU and Turkey. Under this model, which applies only to trade in goods and not services, no internal tariffs are applied to trade between Turkey and the EU and there are common external tariffs for trade with third states. If the U.K. adopted this model for trading with the EU, it would not have to make a financial contribution to the EU budget and would not be bound by the majority of EU law and would therefore have to legislate to fill the significant gaps in its national legislation that would be left upon exit. Nor would it have access to the market in services via such an arrangement. However, a formal customs union would not, in practice, be likely to achieve a total break from the EU legal regime. The EU and the U.K. would have to agree rules on trade which would in reality be highly likely to require the U.K. to adopt the relevant EU rules (e.g. on the standards applicable to goods entering the single market) without any ability to influence the setting of those rules or their interpretation by the EU courts.

4. **Deep free trade agreement: The Canadian model** - Alternatively, the U.K. may seek to negotiate an extensive free trade agreement and may look to the EU/Canadian free trade agreement, which has been agreed but is not yet in force. The Canadian deal (which took over seven years to negotiate) allows tariff free trade in goods (subject to complex country of origin rules) and provides for the removal of certain non-tariff barriers in relation to both goods and services, including financial services. Under such a model the U.K. would retain control over tariff arrangements with other (non-EU) countries.

5. **World Trade Organisation membership: U.K. alone** - This model, which would simply lead to: (i) the application of caps on tariffs applicable to goods traded between the U.K. and the EU; and (ii) limits on certain non-tariff barriers in relation to goods and services, would represent the greatest change from the status quo. It would not apply to services and may well require substantial amounts of new legislation to replicate EU legislation that would fall

away on a Brexit. The U.K. would not be required to make any financial contribution to the EU, however, nor would it be bound by EU laws.

There appears to be no uniformity amongst the Brexit camp as to their preferred model. Further, any post-Brexit model will depend on negotiation strength or perceived negotiation strength and the fact that EU will not want to set a precedent. In short, the potential models reveal there is a complex trade-off between market access and sharing of sovereignty.

There is no precedent for a Member State leaving the European Union, so estimating time frames for the relevant proposals would be highly speculative. Under Article 50(3) of the TEU, the EU Treaties will cease to apply to the withdrawing state after the two year negotiating period has elapsed if no agreement is reached within that timeframe. It seems likely discussions will commence in tandem with other third country (non-EU) states for new free trade agreements.

1.6 Will a Brexit have any impact on the U.K.'s relationship with non-EU states?

Yes, the EU has signed up to certain free trade deals with third country (non-EU) states on behalf of Member States. South Korea is an example of a free trade agreement entered into by the EU on behalf of Member States. It is thought that (unless there is specific agreement on this issue as part of withdrawal discussions) the U.K. will no longer be bound by these treaty arrangements and will need to renegotiate trade deals with these states. There is a view that given the difference in bargaining power between the EU and the U.K. that the terms the U.K. might reach with these third country states (assuming a deal can be reached) will be less favourable. They may also take some time to negotiate. On the other hand, Brexit campaigners have suggested that the U.K. will have more flexibility to enter into free trade deals with third country states (for example, with Commonwealth and former Commonwealth states) outside the EU as they will not be constrained by the need to obtain agreement of other Member States.

2. FINANCIAL AND ECONOMIC VOLATILITY WILL LIKELY HAVE AN IMMEDIATE IMPACT ON THE CLEARED DERIVATIVES MARKETS

Immediately following the vote to leave, there is likely to be considerable financial and economic volatility in the U.K. as a result of the increased economic, political and legal uncertainty negatively affecting the U.K. economy. Consequences for the cleared derivatives markets may include:

2.1 The creditworthiness of some counterparties may decline

Many derivatives contracts are entered into by U.K. entities (or entities with significant U.K. exposures) who could find that their credit rating, or others' opinion of their creditworthiness, is negatively affected.

Consequently, it may be more expensive for affected parties to enter into new derivatives transactions and to manage existing positions (for example, collateralisation requirements may increase).

Porting or termination rights may also be triggered to the extent that certain counterparties are particularly adversely affected.

2.2 Exposures under existing derivatives contracts may fluctuate

Many derivatives contracts reference, or are settled in, Sterling or U.K. assets. Volatility in financial markets may create or increase exposures under existing derivatives contracts triggering collateralisation obligations.

2.3 The value of U.K.-linked collateral may deteriorate

Sterling and U.K. assets are routinely used as collateral in support of derivatives trading relationships. Where margin calls are, or have been, met by posting assets that are linked to the U.K. (such as Sterling cash or U.K. gilts), particularly to cover exposures measured in currencies other than Sterling, a deterioration in the value of those assets will also result in increased collateralisation obligations.

3. CLEARED DERIVATIVES DOCUMENTATION IS UNLIKELY TO BE IMMEDIATELY IMPACTED BUT SHOULD BE ASSESSED LONGER TERM

3.1 Will the Brexit affect my existing derivatives contracts? Will there be an immediate impact on documentation?

Other than in respect of financial market volatility discussed above, there is unlikely to be any immediate impact on either new or existing derivatives clearing documentation as the form and detail of the post-Brexit regime must be determined before legal analysis can be meaningfully undertaken.

Due to the significant uncertainty to date, we are not aware of specific Brexit-related adjustment, termination or other provisions having been routinely included in standard documentation and, given the continuation of this uncertainty, documentation impact and any amendments or new provisions required are likely to be more usefully assessed when further details of the post-Brexit regime are known (which could be a number of years). That said, there may be some instances where potentially problematic provisions have been included (for example, non-standard termination rights). In such cases, due diligence of existing contracts may be helpful so that affected counterparties can consider their options together with their legal advisers. It may also be helpful to determine which counterparties and contracts are most likely to be affected and whether it is possible to mitigate any perceived risks.

3.2 Should I provide for the Brexit in my derivatives documentation?

As discussed above, whether specific Brexit-related provisions in new contacts are required may be more usefully assessed when further details of the post-Brexit regime are known. To the extent provisions are considered, careful drafting will be required to minimise scope for disputes and unintended consequences.

An important risk for parties to bear in mind is that legislation regulating a Brexit may override contractual provisions or, worse still, that contractual provisions may inadvertently override otherwise helpful legislation regulating the Brexit.

3.3 Should I carry out due diligence on my existing derivatives contracts?

When the detail of the post-Brexit regime becomes clearer, market participants may wish to assess contracts to determine whether any amendments are required and/or any existing provisions are affected. Areas for consideration may include:

- **Whether existing representations, warranties and covenants can continue to be made and whether any new representations, warranties and covenants are required** - it seems unlikely (assuming that current EU and U.K. laws and regulation continue to apply in substantially the same form) that standard representations, warranties and covenants would be directly affected by a Brexit.

- **Whether porting, events of default or other termination events are likely to be triggered** – as discussed above, it is possible that porting, defaults or credit-related termination events may arise (although this will be fact specific), however, it seems unlikely that performance under existing contracts will become impossible or illegal so as to trigger related termination provisions under standard cleared derivatives agreements. Although it is conceivable that withdrawal of a passporting privilege could affect the legality of executing transactions and, possibly, continuing to perform under existing transactions, it is hard to imagine that the inter-governmental agreements surrounding the Brexit would permit a situation which resulted in the forced close-out of validly concluded derivatives and the consequent instability across financial markets.

- **Whether there are any tax implications** - if there is a change in withholding tax treatment as a result of the Brexit, it is possible that the tax provisions may be triggered although, in practice, such a change in treatment would seem to be relatively unlikely to occur.

- **Whether there are any territorial terms (for example, references to the "European Union") or any references to pre-existing legislation that may need to be amended.**

3.4 Do I need to change my English governing law and jurisdiction clauses?

English law is a popular governing law choice in respect of derivatives contracts. The reasons for this relate to, amongst other things, the certainty, stability and predictability of English law as well as the commerciality and expertise of the English courts: reasons that are unconnected to the U.K.'s relationship with the EU. It is unlikely that a Brexit would substantively impact the enforceability of English governing law clauses and that English law would not continue to be an attractive choice for derivatives market participants.

In the majority of cases, market participants will not need to revise their English jurisdiction clauses. Consideration may need to be given to clauses in some OTC derivatives contracts which reference EU regulation, however, it would seem likely that concerns will be addressed by mutual agreement as part of the negotiation of the post-Brexit regime.

4. THE FULL IMPACT ON EU LAW AND REGULATION APPLICABLE TO THE CLEARED DERIVATIVES MARKETS WILL NOT BE KNOWN UNTIL THERE IS CLARITY ON THE POST-BREXIT REGIME

There are numerous EU laws and regulations that assist the smooth functioning of the derivatives markets. In addition, recent changes to EU financial services regulation have had a significant impact on how these markets operate (for example, the European Market Infrastructure Regulation **(EMIR)** imposes requirements on central counterparties **(CCPs)** and clearing members as well as reporting requirements in respect of exchange-traded derivatives).

Due to the global nature of the derivatives markets, much of this regulation relies on cross-border recognition, both within the EU and (increasingly) globally. The efficient functioning of key financial market infrastructure (such as CCPs and trade repositories **(TRs))** also relies on such EU and global recognition agreements.

Until the post-Brexit regime has been agreed and is implemented, existing U.K. and EU regulation will continue in place (albeit subject to uncertainty in respect of whether current regulation will ultimately be amended until the details of a post-Brexit regime have been negotiated and are available). However, due to the global nature of the derivatives markets and the key role of the U.K. in developing such regulation, existing regulation is ultimately expected to remain in place (at least in the short term). One long-term effect of a Brexit is likely to be that, notwithstanding global initiatives to which it is likely to remain a party, the U.K. regulatory rules impacting derivatives counterparties start to diverge from the equivalent EU rules. This would effectively leave those counterparties with cross-border operations with a dual compliance burden (to the extent that they were still required to comply with EU regulation in order to continue to trade with the EU – for example, as is very likely to be the case under EMIR).

In addition, without EU membership, the U.K. would crucially no longer be able to exert as much (if any) influence on the content of any relevant EU financial services regulation. It remains to be seen how strong the U.K.'s bargaining position will be post-Brexit.

Nonetheless, given the importance of the U.K. derivatives markets, the strong likelihood is that the U.K. government will be focussed on ensuring that current protections for derivatives and collateral arrangements continue in effect and that cross-border trading is not adversely affected.

Key regulatory areas for negotiation as part of the post-Brexit regime from a derivatives perspective include (without limitation):

- **Ensuring the continuation of Markets in Financial Instruments Directive (MiFID) "passports"** – In respect of those entities with cross-border operations, the potential withdrawal of the MiFID "passport" allowing entities to carry on business throughout the EEA (via a branch, a subsidiary or on a cross-border basis) would be a severe blow to an entity's own derivatives business and/or that of its derivatives counterparties. The U.K. would be keen to ensure that the passporting system was unaffected by a Brexit.

- **Ensuring no adverse impact on financial collateral, netting and set-off arrangements** – The U.K. would want to ensure that financial collateral, netting and set-off arrangements were not adversely impacted as a result of a Brexit. For example, it would be important to ensure that the U.K. Financial Collateral Arrangements (No 2) Regulations 2003 continue in effect so that the enforceability of financial collateral arrangements is not affected and that the relevant implementing measures relating to safeguards for such arrangements under the Bank Recovery and Resolution Directive and the Credit Institutions Winding Up Directive continue in effect.

- **Ensuring no adverse impact regarding the benefit of cross-border recognition provisions under EMIR** – Under EMIR, the European Commission (EC) can declare the legal, supervisory and enforcement arrangements of a third country relating to clearing, reporting and risk mitigation techniques "equivalent" to the EU framework under EMIR. If an equivalence decision is made, counterparties shall be deemed to have complied with such obligations under EMIR where at least one counterparty is established in a third country. No such declarations of equivalence have been made to date. However, following a Brexit, U.K. counterparties may no longer be able to benefit from any such recognition and, equally, may no longer be able to benefit from the EU regime being recognised as "equivalent" by third country regimes.

  The U.K. would need to negotiate as to whether it could continue to benefit under the existing EU regime or whether it would need to embark upon its own equivalence discussions with the EU, the US and other third country jurisdictions. Such discussions could be lengthy and complex (as well as duplicative as the U.K. regime is likely to be substantially similar to the EU regime). In any event, notwithstanding the outcome of such negotiations, U.K. entities would effectively need to continue to comply with EMIR requirements in order to trade with counterparties in the rest of the EU.

- **Ensuring no adverse impact regarding access to financial market infrastructure** – The U.K. would want to ensure that it can still take advantage of the regulatory structure under the Markets in Financial Instruments Directive II (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR) which provide for cross-border access to trading venues, clearing and settlement systems (although note that MiFID II and MiFIR do not yet apply in practice).

  In addition, under EMIR, the mandatory clearing obligation can only be satisfied if relevant derivatives contracts are cleared through an authorised or recognised CCP. EU CCPs must apply for authorisation and non-EU CCPs must apply to be recognised so that they can provide services throughout the EU. A non-EU CCP can only be recognised if, amongst other things, the EC has determined that the legal and supervisory arrangements of a third country ensure that CCPs subject to supervision in such country are "equivalent" to those set out in EMIR. To date, there have been a number of such equivalence decisions (for example, relating to the US, Canada, Singapore and Hong Kong).

Equally, the reporting obligation under EMIR can only be satisfied if the relevant TR has been registered (in the case of an EU TR) or recognised (in the case of a non-EU TR) in which case it can provide its services throughout the EU. A non-EU TR can only be recognised if, amongst other things, the EC has determined that the legal and supervisory arrangements of a third country ensure that TRs subject to supervision in such country are "equivalent" to those set out in EMIR.

Significant negotiations have taken place to agree the equivalence decisions made to date with each jurisdiction. In particular, negotiations with the US have been challenging. An important issue in relation to the transition of the U.K. from within to outside the EU would be whether or how the U.K. would continue to benefit under the existing EU regime (including from the negotiated position with third countries to date).

In the worst case, and absent agreement to the contrary, U.K. CCPs and TRs might be forced to apply for recognition as equivalent CCPs and TRs under EMIR and the U.K. might need to recognise EU CCPs and TRs as equivalent for U.K. purposes in order for such CCPs and TRs to be able to carry on business within the U.K. and the EU. In addition, the U.K. may no longer be included in the EU-US regulatory co-operation discussions and may be in the unenviable position of starting these from scratch.

If a CCP can no longer benefit from authorisation or recognition under EMIR, there may also be knock-on consequences for regulated entities from a regulatory capital perspective.

- **Ensuring the continuation of the agreement reached between the European Central Bank (ECB) and the Bank of England (BoE) relating to the clearing of euro-denominated derivatives.** If a Brexit occurs, there is a risk that the ECB may seek to renegotiate its settlement with the BoE resulting from the General Court of the EU judgment on the ECB's location policy for CCPs. The judgment annulled the Eurosystem Oversight Policy Framework published by the ECB in so far as it set a requirement for CCPs involved in the clearing of securities to be located within the Eurozone. Prior to the judgment, the ECB's policy was that CCPs clearing Euro must be located within the Eurozone. In the worst case, and absent agreement to the contrary, this could mean that non-eurozone CCPs may no longer be able to clear EU-denominated derivatives or derivatives that can settle using euro-denominated financial instruments.

For additional resources from FIA on this topic, visit: [www.fia.org/UK-EU-Relations.](www.fia.org/UK-EU-Relations)

ABOUT FIA:

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