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Brexit – legal consequences for commercial parties

Derivatives – possible implications

April 2016

Issue in focus

The UK is important for the global derivatives markets:

- London is arguably the leading financial centre for OTC derivatives activity both in the EU and globally.
- Businesses established in the UK use EU financial services regulation to "passport" their derivatives services throughout the EEA.
- Businesses established outside the UK may use a UK "passport" (for example, by setting up a local branch or a subsidiary in the UK) as a way of accessing the UK and/or the broader EEA derivatives markets.
- A vast number of OTC derivatives contracts, whether or not involving UK entities, are governed by English law and include a submission to the jurisdiction of the English courts.
- Key elements of market infrastructure (for example, central counterparties (**CCPs**) for cleared OTC derivatives) may be established in the UK.
- Many derivatives contracts reference, or are settled in, Sterling or UK assets.
- Sterling and UK assets are routinely used as collateral in support of derivatives trading relationships.

This article aims to highlight some of the areas in which Brexit may impact the derivatives markets and discusses possible documentation, regulatory and legal implications. However, it is important to note that the particular terms of a Brexit and the post-exit model negotiated will be central to the ultimate legal analysis and the precise impact on derivatives market participants. Consequently, this article cannot be regarded as a comprehensive list of all potential issues and their impact.

This article is one of a series of specialist Allen & Overy papers on Brexit. To read these papers as they become available, please visit: www.allenovery.com/brexit.

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Key considerations and analysis

Financial and economic volatility

Market analysts have raised concerns that the UK economy may be negatively affected by the increased economic, political and legal uncertainty resulting from a vote in favour of Brexit or Brexit itself (collectively referred to in this article as **Brexit**) and that this may lead to financial and economic volatility in the UK.

If the analysts are right, there are a number of fairly obvious consequences which could play out in the derivatives markets:

(i) **Deterioration in counterparty creditworthiness**

Businesses with significant exposure to the UK economy could find that their credit rating, or their counterparties' view of their creditworthiness, is adversely impacted by Brexit.

At best, this would be likely make it more expensive for those businesses both to enter into new derivatives (the cost of credit would be higher) and to maintain existing positions (for example, decline in creditworthiness may lead to new or enhanced collateralisation obligations in bilateral OTC derivatives contracts).

At worst, the effect could be so significant as to trigger termination rights – whether ratings-related or arising out of a real default of the credit-impaired counterparty.

(ii) **Changes in exposures**

Fluctuations and volatility in relevant markets may create or increase mark-to-market exposures under existing derivatives contracts. This, in turn, would trigger obligations to post additional margin.

(iii) **The value of UK-linked collateral could decline**

Where margin calls are, or have been, met by posting assets that are linked to the UK (such as Sterling cash or UK gilts), particularly to cover exposures measured in currencies other than Sterling, a deterioration in the value of those assets will also result in obligations to post additional margin – effectively compounding the potential adverse effects noted above.

In respect of the possible impact on financial collateral arrangements, please see further below.

In respect of each of the above risks, whilst consideration could be given to the possibility and/or desirability of hedging against or otherwise mitigating any perceived risks, in reality, it will be difficult to assess the precise impact of a Brexit on counterparty credit risk and the value of Sterling and any UK assets ahead of time.

Impact on derivatives documentation

It is hard to predict (and plan for) the impact of a Brexit on the 1992 and 2002 ISDA Master Agreements as the precise impact can only be determined when the form and detail of any post-Brexit regime is known and the true impact on the relevant counterparties is more clearly understood.

We are not aware of specific Brexit-related termination or other provisions being routinely included in standard ISDA documentation either historically or currently. There could be some value in carrying out appropriate due diligence on ISDA documentation to ensure that counterparties are aware of any potentially problematic provisions (for example, any non-standard termination rights or any references to specific EU regulation, EU territory and similar terms which would not continue to have the intended effect following a Brexit). Given the current uncertainty, however, counterparties may be better advised to wait so that they can focus on assessing the documentation impact when (and if) there is more certainty as to the form any Brexit may take.

Equally, there would seem little benefit in amending existing documentation (assuming such documentation is standard) until further detail of any Brexit and its impact is known.

We have given some thought to whether Brexit would have a material impact on the operation of agreements based on the standard ISDA Master Agreements. While there may be certain technical amendments required as a result of Brexit (depending, of course, on what form Brexit takes) and subject to the general caveats regarding

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the uncertainty surrounding Brexit, we have not identified any major areas of concern.

- **Can standard ISDA representations and agreements continue to be made following a Brexit?** It seems unlikely (assuming that current EU and UK laws and regulation continue to apply in substantially the same form) that standard representations and agreements would be directly affected by a Brexit.
- **Are Brexit or the effects of Brexit likely to trigger an Event of Default or Termination Event?** We have already discussed the possibility that adverse effects on the UK economy could impair the creditworthiness of UK-exposed businesses. Although defaults or credit-related termination events might arise under ISDA Master Agreements, this is by no means an inevitable result of Brexit, nor is it something that would surprise users of industry standard trading agreements such as the ISDA Master Agreements.

  It is highly unlikely that the effect of Brexit will be to render performance under existing ISDA Master Agreements unlawful, impossible or impracticable so as to trigger illegality or force majeure termination events in standard ISDA Master 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 Brexit would permit a situation which resulted in the forced close-out of validly concluded derivatives and the consequent instability across financial markets.
- **Does Brexit impact the withholding tax treatment?** If there is a change in withholding tax treatment as a result of Brexit, it is possible that the tax provisions (for example, Tax Event Termination Event) may be triggered although, in practice, such a change in treatment would seem to be relatively unlikely to occur. For further consideration on tax issues, please refer to our specialist paper on this topic, linked here.
- **Is the choice of English law as governing law impacted by a Brexit?** As discussed above, English law is a popular governing law choice in respect of the ISDA Master Agreement. 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 UK's relationship with the EU. We consider that it is highly unlikely that Brexit would substantively impact the enforceability of English governing law clauses. Consequently, we see no reason why English law would not continue to be an attractive choice for commercial parties regardless of any Brexit (both in respect of contractual and non-contractual obligations). Note that this analysis applies generally and is not limited to the ISDA Master Agreement. For further consideration of the choice of governing law, please refer to our specialist paper on this topic, linked here.
- **Is the choice of English jurisdiction impacted by a Brexit?** Section 13(b) of the ISDA 2002 Master Agreement refers to the Brussels Convention and the Lugano Convention. Following publication of the ISDA Master Agreements, the Brussels Convention has subsequently been amended by the EU Brussels Regulation (now set out in the Recast Brussels Regulation EU 1215/2015 (the **Recast Brussels Regulation**)). Consideration will need to be given as to the effect of Section 13(b) to the extent that the Recast Brussels Regulation no longer has effect following a Brexit. In practice, however, it may be unlikely that this is not addressed by mutual agreement as part of the negotiation of the post-Brexit regime. For further consideration of jurisdiction clauses, please refer to our specialist paper on this topic, linked here.

Impact on EU law and regulation applicable to the derivatives and collateral markets

There are a multitude of EU laws and regulations that assist the smooth functioning of the derivatives and collateral 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**) introduces certain central counterparty clearing,

reporting and risk mitigation – including margin - requirements).

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.

Consideration should, therefore, be given to the effect of existing EU Directives and Regulations in the UK following a Brexit.

Of course, there will only be certainty in respect of precisely how existing EU law and regulation will be dealt with following negotiation of the post-Brexit regime (which could take several years). However, currently we would expect that an agreement will be reached in respect of how existing law will be treated following a Brexit before such existing law ceases to have effect in the UK (although the possibility that an agreement is not reached or that there are any gaps or omissions in such agreement cannot be fully discounted). This is largely the result of, in a derivatives context, the UK being at the forefront of a number of these regulatory developments both at a global and an EU level. Consequently, it seems extremely unlikely that the UK would not wish for these requirements to continue to apply following a Brexit, particularly given the size and importance of the UK derivatives and collateral markets.

Notwithstanding this, in the event of a Brexit, it would be imperative to ensure that the protections and requirements essential to the successful operation of the UK derivatives markets continue in effect and that cross-border trading is not adversely affected. Key areas for negotiation as part of the post-Brexit regime from a derivatives perspective would, therefore, 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 UK would be keen to ensure that the passporting system was unaffected by Brexit.

- **Ensuring no adverse impact on financial collateral, netting and set-off arrangements** – The UK 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 UK 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.

  For further consideration of insolvency issues, please refer to our specialist paper on this topic, linked here.

- **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, UK 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 UK 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 UK regime is likely to be substantially similar to the EU regime). In any event, notwithstanding the

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outcome of such negotiations, UK 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 UK 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 UK from within to outside the EU would be whether or how the UK 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, UK CCPs and TRs might be forced to apply for recognition as equivalent CCPs and TRs under EMIR and the UK might need to recognise EU CCPs and TRs as equivalent for UK purposes in order for such CCPs and TRs to be able to carry on business within the UK and the EU. In addition, the UK 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.

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 UK 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 UK would crucially no longer be able to exert as much (if any) influence on the content of any relevant EU financial services regulation which could potentially leave UK entities at a competitive disadvantage. It remains to be seen how strong the UK's bargaining position will be post-Brexit.

For further consideration of the impact on financial services regulation generally, please refer to our specialist paper on this topic, linked here.

What does this mean for you?

The precise impact of a potential Brexit on the derivatives and collateral markets remains an unknown.

There is currently too much uncertainty in respect of whether and how a Brexit would occur to recommend that market participants routinely include any specific clauses addressing a Brexit scenario in new derivatives and collateral arrangements or amend existing derivatives and collateral arrangements. Indeed, we are not aware of market participants routinely including specific Brexit termination or other clauses in ISDA documentation. Such clauses would likely be difficult to draft and negotiate and would have limited benefit.

However, to the extent that counterparties are concerned that some of their existing contracts may include such clauses (or any other non-standard termination or other rights which may be triggered in a Brexit scenario), they could consider carrying out a due diligence exercise to ensure they are aware of these.

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.

The bottom line is, however, that unless and until the UK referendum indicates that a Brexit will occur and until we have further clarity of the specific terms of any such exit, a detailed analysis of the contractual impact will be next to impossible.

In terms of whether existing UK and EU regulation will continue to apply to derivatives and collateral arrangements post-Brexit, the position is unclear and will remain unclear until any details of a post-Brexit regime have been negotiated and are available. Notwithstanding this, if there is a vote for Brexit, the strong likelihood is that the UK government and those active and advising in the derivatives markets 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.

We encourage interested clients to get in touch with any questions and comments. We also encourage clients focussing on Brexit-related issues to refer to the other specialist papers in this series available at www.allenovery.com/brexit.

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