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BREXIT: OVERVIEW OF POTENTIAL IMPACT ON DERIVATIVES

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The process of Brexit will take many years, and the implications for our clients' businesses will unfold over time. Our MoFo Brexit Task Force is coordinating Brexit-related legal analysis across all of our offices, and working with clients on key concerns and issues, now and in the coming weeks and months. We will also continue to provide MoFo Brexit Briefings on a range of key issues. We are here to support you in any and every way that we can.

There are several relationship models that could be implemented between the UK and the EU following Brexit, including the free trade agreement, WTO arrangement, customs union, EFTA membership or EEA membership. Whilst EEA membership is the only relationship model alternative to the EU membership currently allowing full access to the EU single market for goods and services, this model may not be acceptable to the UK from a political perspective, as it requires the UK to accept free movement of people from the EU and make contributions to the EU budget, issues which were central to the debate in the lead-up to the Brexit referendum. For the purposes of this briefing, we consider the legal implications that Brexit could have if the UK does not join the EEA, nor negotiates a bespoke arrangement with the EU, such that it no longer has access to the EU single market in services via the EEA membership.

1. Access to the EU single market for investment services

One of the advantages of the UK being part of the EU is that a UK firm is entitled to provide financial services (including entering into derivative transactions) to a client based in another EU Member State on a cross-border basis, subject to compliance with the requirements of the single market directives. In particular, the Capital Requirements Directive ("**CRD**") and Markets in Financial Instruments Directive ("**MiFID**") (and MiFID II and Markets in Financial Instruments Regulation ("**MiFIR**") which will be effective from 2018) allow banks and investment firms incorporated and authorised in one EU Member State to conduct cross-border business with counterparties based in other EU Member States without any additional authorisation in those countries. The CRD passport covers deposit-taking and other banking business (including securities and derivatives) and MiFID passport covers securities and derivatives business. Unless the UK joins the EEA or negotiates a bespoke deal with the EU, it may lose its automatic access to the EU single market after Brexit. In order to maintain access to the EU single market in such a scenario, a financial institution based in the UK would have to establish a subsidiary in one of the EU Member

States, which would need to be licensed, regulated and capitalised under the laws of the host Member State and applicable EU legislation. This will certainly increase compliance and capital costs for financial institutions in the UK providing investment services to EU clients.

Whilst the UK would not be able to rely on single market directives following Brexit, there are potentially other alternative arrangements for UK-headquartered financial institutions to access the EU single market without needing to establish presence in another EU member state. The EU legislation, in particular MiFID II, provides for a so-called “third country regime” that is designed to allow a non-EU entity to access the EU single market in order to provide investment services to non-retail clients if such entity is incorporated and authorised in a country which has a regulatory regime that is declared to be equivalent to the EU regulatory regime and where such country provides reciprocal rights for EU firms to access its market. The UK would only be able to rely on this option if a positive decision about the equivalency of the UK regulatory regime were adopted by the European Commission.

Such third country regime could mitigate the consequences of Brexit as UK financial institutions would be able to continue providing certain financial services (including selling derivative products) to non-retail EU clients on a cross border basis. To benefit from this arrangement, the UK would need to adopt new legislation to ensure that its regulatory regime is perceived to be “equivalent” to the EU regulatory regime. Given the sophistication of the UK financial services markets, it is expected that the UK will be able to implement the required legislation for such purposes. However, as the third country regime under MiFID is yet untested, it is not clear what political considerations in the EU will play in a decision to grant equivalent status. Another issue is that, even if such equivalency status were given to the UK regulatory regime, theoretically it could be withdrawn at a later stage.

The “third country regime” under MiFID II only allows non-EU firms to provide investment services to professional clients and eligible counterparties, and it does not cover services to retail clients. Under MiFID II, a non-EU firm will only be able to conduct regulated investment business with an EU retail client if such firm has established a branch in the relevant EU Member State.[1] Any such branch established by a UK firm will be subject to local capital requirements and conduct of business rules which would add an additional layer of compliance requirements to firms established in the UK.

The regulatory regime in the UK, compared to other EU Member States, is favourable to non-EU firms providing investment services in the UK to professional clients. Non-EU firms can provide certain investment services to professional clients in the UK (including entering into derivative contracts with UK counterparties) without obtaining any licence in the UK due to an “overseas persons” exemption.[2]

Unless the UK joins the EEA, negotiates a bespoke arrangement or benefits from the “third country regime” under MiFIR, following Brexit, UK firms may not be able to enter into new derivative transactions with counterparties based in the EU unless there are exemptions under the local law of the host Member State. Whilst it is not entirely clear at this stage, it is likely that the UK and the EU will negotiate some grandfathering provisions where the existing derivative contracts between a UK firm and an EU firm remain in force, in which case these contracts would not be affected by Brexit.

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[1] This will be possible if Article 39 of MiFID II is implemented in the relevant host Member State.
[2] Article 72 of the Financial Services and Markets Act (Regulated Activities) Order 2001.

2. Regulation of CCPs and TRs

The EU regulation on OTC derivatives and central counterparties ("**EMIR**") imposes requirements on counterparties to derivative contracts, central counterparties ("**CCPs**") and trade repositories ("**TRs**"). One of the main requirements under EMIR is to clear certain OTC derivative contracts through a CCP. EMIR sets out requirements for authorisation and prudential and conduct of business regulation over CCPs. Similar to MiFID in respect of investment services, EMIR provides passporting rights for a CCP incorporated in one EU Member State to provide clearing services to any counterparty in the EU without the need to obtain further local authorisations.

There are several CCPs which are incorporated in the UK and which provide clearing services in respect of derivatives on an EU-wide basis. Following Brexit, such UK CCPs might not have the automatic right to continue providing clearing services to EU clearing members, trading venues or EU entities that are subject to clearing obligations under EMIR. Similar to MiFID II, a non-EU CCP may apply to ESMA for recognition in order to provide clearing services in the EU, provided that the European Commission has granted 'equivalent' status to the non-EU country where such CCP is incorporated. As the European Commission has granted the status of equivalent CCP regulatory regime to various countries,[3] it is reasonable to expect that the UK would get such status as well. Once such 'equivalent' status were granted, the relevant CCP incorporated in the UK would need to make an application to ESMA to be added to the list of recognised third-country CCPs to gain access to the EU market for clearing derivatives. The same analysis will also apply to any UK-incorporated TRs, as they would not be able to receive reports from EU entities subject to reporting obligations under EMIR, unless they were recognised by ESMA on the basis that the UK has an equivalent regime to the EU for EMIR purposes.

The European Central Bank ("**ECB**"), in its Eurosystem Oversight Policy Framework[4] published in 2011 suggested that clearing houses based in non-Eurozone countries would have to move inside the Eurozone to continue to do clearing business in Euros. The UK challenged this decision in the European Court of Justice ("**ECJ**")[5] by arguing that implementation of such policy would be a discrimination against the UK as an EU Member State and could lead to a fragmentation of clearing across different currencies. Despite the ECB's argument that its regulatory oversight requires day-to-day monitoring, which it cannot guarantee outside the euro area, the ECJ in its decision in 2015 annulled the ECB Policy. The ECJ did not scrutinise the legal arguments put forward by the UK as it concluded that the ECB did not have the power to make a decision in the first place. If, following Brexit, the ECB decides to re-introduce such policy (following a change in its statute expanding its powers to cover clearing) and other EU Member States do not challenge this decision, the UK would not have the right to challenge such policy in the ECJ.

3. EU resolution regime

The EU Bank Recovery and Resolution Directive ("**BRRD**") sets out a framework for the recovery and resolution of EU banks and investment firms. BRRD requires each member state to recognise

[3] As of July 2016 the European Commission has determined that the following countries have equivalent regulatory regimes for CCPs as the EU: Australia, Singapore, Japan, Hong Kong, Canada, Mexico, South Africa, Switzerland, USA and Republic of Korea.
[4] http://www.ecb.europa.eu/pub/pdf/other/eurosystemoversightpolicyframework2011en.pdf
[5] United Kingdom v European Central Bank, Case T-496/11: http://curia.europa.eu/jcms/upload/docs/application/pdf/2015-03/cp150029en.pdf

and give effect to resolution actions taken by the home state resolution authority in relation to an EU bank or investment firm. If, following Brexit, there is a failing UK entity which is currently subject to the BRRD (a bank or an investment firm), such entity could be subject to local insolvency proceedings, as the EU Directive on the reorganisation and winding up of credit institutions would no longer apply to such UK financial institution. As the host EU Member State would no longer be required to recognise the UK's resolution action in relation to such failing entity, if a failing UK entity had assets in another EU Member State, the UK resolution authority may not be able to deal with those assets in an efficient manner.

BRRD empowers the resolution authorities to write down and convert the liabilities of an institution under resolution to ensure that shareholders and creditors bear an appropriate part of the costs arising from the failure of a credit institution (the so-called "bail-in"). The scope of these bail-in powers extends to liabilities arising from derivative contracts. In this context, resolution authorities can determine the value of derivative liabilities as part of the general valuation of assets and liabilities carried out under BRRD and in accordance with methodologies and principles adopted by the European Commission.[6] Under BRRD any decision by the UK resolution authority, including bailing-in in respect of derivatives entered into by a UK firm and valuation of its derivatives book, shall be recognised by other EU Member States. Following Brexit, there is no guarantee of recognition in EU Member States of resolution measures taken by the UK, including the valuation of derivatives governed by non-English law. This could diminish the effectiveness of any action taken by the Bank of England as the resolution authority of a UK entity. This might also lead to a requirement for all banks based in the UK to include a contractual recognition clause in EU-law governed contracts to preserve the powers of the UK resolution authority.

4. EMIR margining rules

EMIR applies to EU undertakings that qualify as "financial counterparties" or "non-financial counterparties." Following Brexit, UK entities would become third-country entities ("**TCEs**") for EMIR purposes. TCEs are still subject to EMIR, as some of its provisions have extraterritorial effect, including in relation to mandatory margining of uncleared trades and mandatory clearing. Some of the EMIR provisions would not apply to UK firms post Brexit, such as trade reporting. However, it is reasonable to expect that the UK will introduce similar reporting requirements given the importance of the UK derivatives market and the fact that the implementation of EMIR has been driven by G20 intergovernmental commitments agreed in 2009. Any TCE would be required to determine whether it would be a financial counterparty or a non-financial counterparty if it were established in the EU. It would also be necessary to determine if any UK non-financial counterparty has entered into derivatives with a notional value exceeding the relevant thresholds set out in EMIR (and is therefore equivalent to an "NFC+") to determine if EMIR margining rules are applicable to trades between that counterparty and an EU counterparty. It is expected that UK firms which are currently subject to the EMIR clearing and margin requirements will continue to be subject to such requirements when entering into derivatives transactions with EU firms after Brexit, due to the extraterritorial effect of EMIR.

[6] Commission Delegated Regulation of 23.5.2016 on supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising from derivatives.

If, following Brexit, a UK counterparty deals with another non-EU counterparty where each or either of them would be a financial counterparty or NFC+ were they established in the EU, such trade should not be subject to EMIR requirements (including margining) unless the contract has a "direct, substantial and foreseeable effect" within the EU or otherwise where necessary or appropriate to prevent the evasion of EMIR. Whilst this may give more flexibility to UK firms to deal with non-EU counterparties post Brexit, it is expected that non-EU countries where counterparties are based may have similar regimes to EMIR, which will effectively mean that the UK firms would still have to post margin and arrange trade reporting for their uncleared OTC trades. It is also expected that, to secure access for UK banks, investment firms, CCPs and TRs in the EU single market, the UK will adopt local regulations to reflect the regime established by EMIR to make sure it has an equivalent regime to the EU. In this case, the practical effect of Brexit on EMIR margining rules for the UK firms may not be material.

5. Recognition of judgements and choice of law provisions

Jurisdiction

Most OTC derivative transactions are governed by the standard Master Agreement prepared by ISDA. The jurisdiction clause in the 2002 ISDA Master Agreement provides that the English courts will have (i) non-exclusive jurisdiction if the proceedings do not involve a Convention Court and (ii) exclusive jurisdiction if the proceedings involve a Convention Court. "Convention Court" is defined as the court bound by the Recast Brussels Regulation (applicable to the courts based in the EU) or the 2007 Lugano Convention (applicable to the courts based in the EU, Iceland, Switzerland and Norway). This effectively means that English courts have exclusive jurisdiction in respect of English-law governed ISDA 2002 Master Agreements entered into between EU-based counterparties. Following Brexit, this analysis may be different, as the UK courts will no longer be bound by the Recast Brussels Regulation or the 2007 Lugano Convention, so they will not constitute a Convention Court.

Under the Recast Brussels Regulation, where a contract contains an exclusive jurisdiction clause in favour of an EU Member State, it is for that court to determine whether it has jurisdiction to hear a dispute arising out of the contract. Any proceedings issued in other EU Member States must be stayed until the question of jurisdiction is determined by the court chosen by the parties, if proceedings have also been commenced in that court. The purpose of this is to uphold parties' choice of exclusive jurisdiction and avoid parallel proceedings being commenced in another EU Member State for tactical reasons. Following Brexit, the EU courts will not be prevented from considering disputes under the standard Master Agreement, even though the UK courts have exclusive jurisdiction.

The UK may choose to adopt the Hague Convention, which contains rules regarding the validity and effect of jurisdiction agreements and subsequent recognition and enforcement of judgments by designated courts. Hague Convention Contracting States' courts will give effect to exclusive jurisdiction agreements in favour of the courts of another Hague Convention Contracting State. Following Brexit, the UK would need to join the Hague Convention as a separate country (rather than being part of the EU). This means that any exclusive English court jurisdiction clause in a contract entered into *before* the Hague Convention becomes effective in respect of the UK (which would only occur after the UK joins the Hague Convention) will not be covered by the Hague Convention. This will limit the effectiveness of the Hague Convention for contracts with exclusive jurisdiction of English courts entered into before that date. Another drawback of the Hague Convention is that interim protective measures (such as interim injunctions or freezing orders) cannot be enforced under the Hague Convention, in contrast to the existing position under the Recast Brussels Regulation.

The Hague Convention only covers exclusive jurisdiction clauses and would not address the issues relating to non-exclusive jurisdiction clauses common in financial agreements, including under the ISDA Master Agreements. Therefore, it is likely that the UK would try to join the Lugano Convention to secure the current position of UK courts within the EU.

Choice of law

The governing law applicable to contractual and non-contractual/tortious obligations is currently governed by the Rome I and Rome II Regulations respectively, both of which provide that the courts will uphold the parties' choice of law. Post Brexit, Rome I and Rome II will cease to apply in the UK. The EU courts will, however, continue to apply Rome I and Rome II rules, so the courts of EU Member States will still respect the parties' choice of law (even if it is a law of a country which is outside the EU). The UK and the EU may agree to retain rules equivalent to those in Rome I and Rome II. If not, the English courts will likely apply the rules equivalent to Rome I and Rome II as follows:

(a) Contractual obligations: The previous regime, the Rome Convention (enacted in the UK by the Contracts (Applicable Law) Act 1990), contains similar terms to those in Rome I, particularly with respect to recognition of the parties' choice of law. It is therefore unlikely that Brexit will impact parties' choice of governing law in relation to contractual claims.

(b) Non-contractual/tortious obligations: The old rules on non-contractual obligations are contained in the Private International Law (Miscellaneous Provisions) Act 1995. A crucial difference with the existing regime under Rome II is that this Act does not give the parties an express right to choose the law applicable to non-contractual obligations. It instead provides that the applicable law will be based upon the law of the country in which the tort occurred, or the country in which the most significant event occurred.

Service out

Brexit is also likely to impact the ease with which parties in EU Member States can be served with proceedings. Under the Recast Brussels Regulation, permission to serve English proceedings in another EU Member State is generally not required. A similar exemption applies under the Lugano Convention. However, if the UK decides not to adopt the Lugano Convention (or an equivalent international treaty), parties will most likely have to apply to the English court for permission to serve proceedings in EU Member States under English law civil procedure rules (as is presently the case with respect to service in other countries outside the EU). This would create an additional (albeit generally easily surmountable) hurdle to bringing proceedings against parties in EU Member States, with associated time and cost implications.

6. Tax

The EU has not developed any EU tax legislation which would be directly relevant in the context of derivatives, subject to imposition of a financial transaction tax as discussed below. The most relevant tax for derivatives is withholding tax, which can be imposed locally by the country where the payor is incorporated. Derivative transactions are structured on a presumption that no withholding tax will be applicable to any payment and in practice the local tax legislation typically provides for specific exemptions for derivatives. There are provisions in the 1992/2002 ISDA Master Agreements providing protection to the payee, requiring the payor to gross up any payments subject to withholding tax.

Under the UK tax legislation, almost all types of derivatives (except for certain derivatives relating to equities, the rights of a unit holder under a unit trust scheme or intellectual property) are exempt from withholding tax.[7] It is unlikely that the UK position towards withholding tax in respect of derivatives would change post Brexit.

The Economic and Financial Affairs Council on 8 December 2015 discussed the possibility of introducing a financial transaction tax ("**FTT**") in 11 member states[8] through enhanced co-operation. If FTT were introduced, it would also have an effect on derivatives transactions. The UK, as well as some other EU Member States, rejected this idea, so if the FTT were introduced, the expectation is that it would be not be payable by UK entities regardless of the UK negotiation position in respect of Brexit.

7. AIFMD

The EU Directive on alternative investment funds ("**AIFMD**") introduced a harmonised regulatory framework across the EU for managers ("**AIFMs**") of alternative investment funds ("**AIFs**"). EU-incorporated and authorised AIFMs can market EU AIFs to professional investors across the EU without additional approvals and also provide cross-border services and act as manager of AIFs in other EU Member States as well as provide investment management and related services.

Post-Brexit, AIFMs based in the UK would lose the marketing passport rights under AIFMD when marketing to EU investors any EU or UK AIFs managed by such AIFMs. To continue such marketing activities, UK AIFMs would have to rely on the national private placement regime ("**NPPR**") in each relevant EU Member State. The NPPR allows (in theory, at least) AIFMs to market AIFs that otherwise cannot be marketed under the AIFMD domestic marketing or passporting regimes. The NPPR principally relates to the marketing of non-EU AIFs and any AIFs (including EU and non-EU) managed by non-EU AIFMs. Some EU Member States have not implemented NPPR, and some have implemented very restrictive placement regimes.

If NPPR were not available in the relevant EU Member State into which the AIFM wished to market, UK AIFMs would not be able to market AIFs in such jurisdiction post-Brexit. The UK NPPR regime is fairly relaxed under the FCA rules. A non-EU AIFM can make a notification to the FCA that it will market an AIF, and it can commence such marketing as soon as the notification is submitted. Both

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[7] See Income Tax 2007, s.980 and Corporation Tax Act 2009, s.589.
[8] France, Germany, Austria, Belgium, Spain, Estonia, Greece, Italy, Portugal, Slovakia and Slovenia.

professional and retail investors in the UK are within the scope of the NPPR (although marketing to retail investors is caught by additional UK financial promotion rules).

It is expected that all national private placement regimes in the EU will be abolished in 2018. AIFMD contemplates that non-EU AIFMs will have EU marketing passport rights prior to the termination of the NPPR in the EU. ESMA announced in 2015 that it would conduct an assessment of 22 non-EU jurisdictions for the purposes of determining whether it should recommend access to the "marketing passport" for AIFMs established in those jurisdictions. ESMA completed such assessment of regulatory framework in the United States, Canada, Hong Kong, Singapore, Japan, Isle of Man, Australia, the Cayman Islands and Bermuda and published its advice on 18 July 2016.[9] ESMA concluded that there are no significant obstacles impeding the extension of the AIFMD passport to Canada, Guernsey, Japan, Jersey and Switzerland. ESMA also provided detailed feedback on the remaining seven jurisdictions. ESMA's advice will be considered by the EU to assess whether to extend the AIFMD passport to any AIFMs or AIFs registered outside the EU. Whilst ESMA provided positive feedback on a number of jurisdictions, it is not clear if the EU will extend the AIFMD passport to any non-EU country in the immediate future. Given the level of development of the fund industry in the UK, it is possible that ESMA would recommend giving the UK the passporting rights for AIFMs established in the UK, which would significantly mitigate consequences of Brexit for the UK fund industry.

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[9] https://www.esma.europa.eu/sites/default/files/library/2016-1140_aifmd_passport_1.pdf