Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Last-Minute Brexit Preparations For EU Financial Firms

By **Gilles Kolifrath and Linda Sharkey** (December 18, 2018, 2:33 PM EST)

At 11 p.m. on March 29, 2019, the United Kingdom will leave the European Union. The repercussions of a vote to leave the EU may not have been well understood in June of 2016, but since the referendum a dizzying number of complications have come into focus, particularly where the financial services industry is concerned.

Gilles Kolifrath

EU membership provided the U.K. access to the single market, comprised of its respective member states, via passporting rights, which permit a financial services institution established in an EU member state to "passport" its license and operate in all other member states. The loss of passporting rights is a subject of concern for the city of London as well as the EU, and for good reason — in 2016, 8008 firms established in the Euro-zone made use of 23,535 passports to provide financial services, and 5476 firms in the UK made use of 336,421 passports.[1] Thus, the loss of passporting rights, combined with the prospect of what is commonly referred to as "hard Brexit" (leaving the EU single market and customs union without a new trade agreement in place), could lead to considerable market disruption.

Linda Sharkey

An overwhelming majority of EU financial markets transactions (and therefore a significant proportion of global financial markets transactions) are executed, booked, cleared and reported through London. Given the disproportionate significance of London (and therefore the U.K.) as an EU financial center, Brexit represents both a risk to financial markets and an opportunity for EU member states to spur economic growth by drawing the financial sector onto the continent.

In this article we will give a brief overview of the possible terms upon which the U.K. will leave the EU, before addressing their likely impact on transactions and contractual relationships between banks/financial institutions and end users, as well as various steps to mitigate business interruptions that might arise as a result of Brexit.

Brexit: Possible Outcomes

Following the referendum, the British government quickly quelled speculation that the U.K. might withdraw from the EU while maintaining access to the single market (as is the arrangement between the EU and Switzerland, for example). Intransigence on both sides has given rise to the (previously unfathomable) possibility that the U.K. will leave the EU without any sort of agreement in place.

Should an agreement be reached, the withdrawal agreement (as provided by the most recent draft dated March 19, 2018[2]) provides for a transition period through Dec. 31, 2020, pending which the status quo for passporting in financial services would be maintained. While a transition period would certainly alleviate the urgency attached to Brexit preparation, delaying the inevitable should not give false comfort to those overwhelmed by the complexities that will arise once the U.K. is no longer part of the EU.

What are some of those complexities? Without passporting rights, the U.K. will lose the ability to provide banking, financial and insurance services within the EU (absent separately negotiated agreements between the U.K. and each EU member state, which do not currently exist and may take years to negotiate). This could bring business between the U.K. and the EU to a virtual halt, with potentially catastrophic impact on both the U.K. and EU economies. Mindful of this risk, UK regulators have scrambled to ensure that, at least on the U.K. side, a transition period will be assured regardless of whether a withdrawal agreement is reached. The Bank of England and its regulatory arm, the Prudential Regulation Authority, along with the Financial Conduct Authority, have already proposed a temporary permissions regime to ensure it will be business as usual post-Brexit through December 2020[3].

While the U.K. has proven accommodating to industry concerns, the EU has taken a more strident tone in encouraging the relocation of business (including sales and trading desks and central counterparty clearinghouses ("CCPs")) to the continent. Rather than provide assurances on business continuity, the European Commission has published a series of notifications highlighting the impact the U.K.'s withdrawal from the EU will have on different financial services[4]. Moreover, the European Central Bank has indicated that U.K. groups that relocate resources and personnel to provide services within the EU will face scrutiny should they make use of "empty shells"[5] on the continent that function as a hub to route transactions through to the U.K.[6]

It is impossible to ignore the political dimension at play here, particularly as EU member states seek to opportunistically reap the benefits of financial firms relocating certain activities out of London. Moreover, despite warnings from the Bank of England[7] (particularly where derivatives are concerned), the European Central Bank's unwillingness to make concessions in the interests of protecting the market is perhaps a sign of the vastly diminished role the U.K. (and therefore its regulators) will play in the financial services industry in continental Europe moving forward. That being said, there is evidence that the EU may blink and grant a temporary reprieve, in spite of the European Central Bank's unwillingness to publicly back such contingency measures.[8]

Equivalence

Given both the stalemate surrounding the withdrawal agreement and the risk to financial markets, the European Parliament has shifted its attention towards what could represent a partial solution to the loss of passporting rights for U.K. financial firms. Many pieces of EU legislation provide for a third country equivalence regime pursuant to which a non-EU country's supervisory or regulatory regime is deemed equivalent to the corresponding EU regime. Where such third country's regime is deemed equivalent, EU legislation would effectively treat that country's regime and its respective actors as equivalent to EU member states, obviating the need for third country entities to establish a presence in each EU member state in order to do business[9].

The European Parliament recently published a study of EU equivalence regimes along with proposed changes,[10] and industry groups (including the futures industry association, or FIA, and international swaps and derivatives association, or ISDA) have urged that equivalence decisions be expedited and authorizations grandfathered to ensure operational and contractual continuity. However, since any third country's demand for an equivalence decision must await the U.K.'s exit from the EU (at which point it will actually be a third country), there will almost certainly be a period of time during which the U.K. will be out of the single market without an equivalence determination having been made; that is, unless some kind of stop-gap measure can be implemented by political agreement.

Although an equivalence scenario would mitigate the impact of a hard Brexit, it would not represent a viable long-term arrangement, for several reasons. First and foremost, no third country regime exists with respect to most core banking and financial activities (such as deposit taking, lending, payment services and investment services to retail clients). Furthermore, the commission has previously

taken the position that equivalence decisions are not intended to expand the single market, but are rather to be used as a tool for managing global market risk and fostering cooperation between EU and non-EU countries. Since the U.K. is a market actor of considerable consequence, it is possible that equivalence decisions would receive heightened scrutiny, and a favorable decision could not be assured. Finally, equivalence decisions may be withdrawn anytime at the sole discretion of the European Commission.

While it is evident that an equivalence determination would be a logical outcome for two markets that, despite any form of Brexit, will remain heavily intertwined for the foreseeable future, such a determination would be reliant on multiple political and economic interests electing to compromise. Although the U.K. has been heavily involved in driving EU financial regulatory reform post-financial crisis, it cannot be overlooked that it may seek to reinforce its current competitive advantage as a financial center with a more favorable regulatory framework at some point in the future. With the U.K. likely to be more agile post-Brexit in terms of passing legislation than the EU, any deviation from the EU regulations to take advantage of regulatory arbitrage would likely derail any equivalence determination process.

Notwithstanding the foregoing, an equivalence scenario would represent a soft(er) landing than a hard Brexit and it is worth taking a moment to understand how such a scenario could play out.

Concretely, the following sectors could benefit from equivalence decisions and allow UK actors access to the EU markets:

Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR)

- Allows for consolidated supervision of subsidiary credit institutions active in the EU, provided the third country parent is subject to supervision equivalent to that of the EU;
- Sets forth an equivalence regime for prudential regulation of exposures and calculation of risk weights for EU based market operators in respect of third country institutions.

European Market Infrastructure Regulation (EMIR)

- Third country regime for CCPs to provide clearing services to clearing members or trading venues established in the EU, subject to CCP recognition by the European Markets and Securities Authority ("ESMA") and equivalence decision.[11]

Markets in Financial Instruments Regulation and Directive (MiFIR, MiFID II)

- Includes an equivalence regime granting access to third country firms wishing to provide investment services or perform investment activities in respect of eligible counterparties (subject to registration with ESMA);
- Introduces a regime for member state authorization of third-country firms that have established a branch in an EU member state.

Assuming favorable equivalence decisions in respect of the U.K.'s regulatory regime, it seems likely that U.K. banks could continue to enter into derivatives transactions with EU counterparties and U.K. CCPs could continue to clear such transactions post-Brexit, subject to several caveats. First, equivalence decisions under MiFID II/MiFIR apply only with respect to eligible counterparties, which do not include retail clients.[12] Second, the European Committee on Economic Affairs has already voted to restrict equivalence decisions in respect of systemic firms, including by limiting the investment services they may provide.[13] Finally, insofar as clearing services are concerned, the European Parliament has backed a proposal by the commission to amend the process for recognition of third-country CCPs under EMIR.

The amendment introduces three categories of CCPs: Tier 1 (nonsystemic), Tier 2 (systemic, requiring increased supervision), and supersystemic CCPs that are of such consequence to the financial markets that they must be located within the EU.[14] Such a location policy would lead to market fragmentation, generating higher transaction costs and margin requirements for banks and end users. In addition, the EU regulators will have to make a decision to either grandfather existing trades to ensure minimal initial disruption or to apply the regulations retroactively to ensure liquidity in the market for post-Brexit trades executed, booked, cleared and reported in the EU.

Hard Brexit Without Equivalence: Brace For Impact

Under an optimal equivalence scenario, the U.K. could continue to provide investment services (albeit of a restricted range) and clearing services (albeit at a higher cost) to eligible counterparties within the EU, and those counterparties could continue to benefit from reduced risk weights and capital requirements to U.K. counterparty exposures under EMIR. However, there is a real possibility of the U.K. exiting the EU without a transition period and without equivalence decisions having been made. If this were to be the case, the immediate consequences would include the following:

- U.K. firms could no longer provide investment services (e.g. execution and clearing) to EU eligible counterparties, unless authorized by EU member states; and
- U.K. CCPs would no longer be able to provide clearing services to EU clients.

Clearly, losing access to the single market will compromise the ability of U.K. firms to provide financial services within the EU. Unwinding longstanding relationships and relocating activities to continental Europe will be costly, time consuming and disruptive. In addition, depending upon the extent to which financial firms must relocate activities, there may also be certain systemic limitations such as infrastructure, language and willingness of individuals to relocate.

With regard to existing transactions, as a general matter the loss of passporting rights should not trigger an authorization requirement within the EU, subject to certain exceptions. ISDA has published a Brexit FAQ[15] detailing the "lifecycle events" that give rise to what could be considered the entry into a new transaction, which are as follows: rolling an open position, material amendments to the terms of the transaction, novations, unwinds and portfolio compression.[16] Otherwise, the loss of passporting rights should not render illegal the performance of obligations under transactions entered into between U.K. and EU counterparties prior to Brexit.

From a contractual respective, however, the situation is slightly more complicated. Leaving aside the potentially problematic individual clauses of existing master agreements between EU and U.K. counterparties, there is the overarching question of whether the English-

law governed ISDA will be a viable option following Brexit. Choice of law and jurisdiction clauses in English law contracts between EU and non-U.K. counterparties may no longer be recognized on the basis of common law rules, and judgments could face enforceability hurdles. Moreover, EU legislation concerning, among other matters, insolvency proceedings and enforceability of netting and collateral arrangements will no longer apply as between U.K. and EU counterparties. EU counterparties could query the interest in concluding an English law governed contract between European counterparties, particularly if the enforcement of an English law judgment would then require an exequatur. In this respect, ISDA has published two new versions of the master agreement, under French and Irish law.

While it remains to be seen to what extent these new versions will be adopted, it is clear that the industry is already banking on the U.K.'s diminished role post-Brexit. For the moment, it is worth noting that English law's dominance with respect to derivatives documentation may yet survive, as neither the French nor the Irish legal system features certain advantages inherent to the U.K. judicial system that are responsible for its privileged position in the financial services industry. Although Ireland is a common law jurisdiction similar to the U.K., its courts and regulators are potentially disadvantaged by a historical lack of Irish law governed financial contracts; the prevalence of English law governed financial contracts allowed English courts and regulators to accumulate considerable experience in adjudicating matters arising from or related to such contracts, making English courts a forum of choice for market participants.

Regarding French law agreements, while institutional knowledge and capacity compares favorably to the U.K. courts and regulators on account of the existing French FBF master agreement, the market is less comfortable with the civil law system which is viewed as less adaptable to ever-changing markets requiring potentially pragmatic and evolving precedent. Recent proposed reforms, as well as the addition of English law trained magistrates, are intended to position France as a more attractive venue for litigation of financial contracts post-Brexit, and it will be interesting to see whether French courts successfully capture a greater share of financial markets litigation post-Brexit.

Post Brexit: A Way Forward

The next few months of negotiations will determine whether the U.K. leaves the EU on terms that allow for the safeguarding of financial markets. While it is proving difficult to reach an agreement that is politically palatable to the British, there is cause to hope that, given what is at stake, cooler heads will prevail. Based on the likely outcomes for Brexit, it would behoove market participants to evaluate the extent of their U.K.-based relationships and activities. While existing transactions should not normally face enforceability issues, clients may prefer to novate trades to an EU branch, and new contractual relationships within the EU may need to be negotiated. Some banks have already begun notifying clients of their options in order to continue trading post-Brexit, anticipating a possible rupture of services. Clients should also take into account ancillary matters such as the potential impact of the British pound weakening, and whether U.K. CCPs may continue to clear trades on behalf of EU clients. Whatever the outcome, it seems clear by now that there are no safe assumptions to be made and we should all prepare for a bumpy ride. All financial firms operating in the U.K. or EU should monitor the status of negotiations and be prepared to take swift actions as the deadline for a hard-Brexit gets ever closer.

Gilles Kolifrath is a partner and Linda Sharkey is a law clerk at Kramer Levin Naftalis & Frankel LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] European Parliament: Implications of Brexit on EU Financial Services, 2017 (http://www.europarl.europa.eu/RegData/etudes/STUD/2017/602058/IPOL_STU(2017)602058_EN.pdf).

[2] https://ec.europa.eu/commission/sites/beta-political/files/draft_agreement_coloured.pdf

[3] https://www.fca.org.uk/news/statements/fca-statement-eu-withdrawal-following-march-european-council

[4] https://ec.europa.eu/info/brexit/brexit-preparedness/preparedness-notices_en

[5] One question many financial firms continue to deal with is to what extent they may be required to relocate services and personnel from London to EU member states. The more significant the presence required by the EU and European Central Bank the more issues such as expertise, relationship continuity and middle/back office efficiency are a cause for concern.

[6]
https://www.bankingsupervision.europa.eu/banking/relocating/shared/pdf/ssm.supervisoryexpectationsbookingmodels_201808.en.pdf

[7] https://www.bankofengland.co.uk/-/media/boe/files/statement/fpc/2018/financial-policy-committee-statement-october-2018.pdf?la=en&hash=A10878A3FF65433E1296FD552C4406C9D28ACAC2

[8] https://www.reuters.com/article/uk-britain-eu-markets-exclusive/exclusive-uk-derivatives-clearers-may-get-no-brexit-deal-reprieve-eu-document-idUSKCN1MY2G5

[9] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/international-relations/recognition-non-eu-financial-frameworks-equivalence-decisions_en

[10] http://www.europarl.europa.eu/RegData/etudes/IDAN/2018/614495/IPOL_IDA(2018)614495_EN.pdf

[11] It is worth noting that all major CCPs are currently based in the U.K. If such CCPs are not recognized under EU regulations post-Brexit clearing will be forced to migrate onto the continent. Any migration of CCPs would provide yet more pressure to execute and/or book trades where they will be cleared, thereby incentivizing CCPs to establish new functions in other EU member states may be used as a tool to drive trading out of London.

[12] Post-MiFID II, the universe of "retail clients" was significantly expanded beyond what would typically be considered as definitively retail.

[13] http://www.europarl.europa.eu/news/en/press-room/20180919IPR13813/econ-meps-backed-tailor-made-regime-for-investment-firms

[14] http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/625193/EPRS_BRI(2018)625193_EN.pdf

[15] https://www.isda.org/2018/04/10/brexit-faq-members-only/

[16] We note that the Haut Comite de la place financiere de Paris has taken the view that unwinds and portfolio compression do not entail the offering of a new service and therefore authorization should not be required

---

All Content © 2003-2019, Portfolio Media, Inc.