Lex et Brexit — The Law and Brexit

Davis Polk

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Despite a weekend of Brexit brainstorming by the Cabinet at the Prime Minister's country retreat, we are still no closer to understanding the Government's preferred trading model for Brexit Britain.

Meanwhile, many Brexiteers in the Parliament and the Press have pointed to some positive economic data as proof that fears about the economic impact of Brexit were grossly exaggerated. Others point out that uncertainty about the political and regulatory impact of Brexit will eventually take its toll on key sectors of the British economy, including financial services.

In the sixth edition of Lex et Brexit, we take a look at the key features of the "Swiss model" and, in particular, its implications for financial services post-Brexit. Unlike many other areas of the trading relationship, there is no specific bilateral agreement covering financial services between the EU and Switzerland; Switzerland relies almost entirely on the third-country access regimes in existing EU sectoral legislation. Nevertheless, the Swiss model serves to illustrate some of the key benefits and pitfalls of relying on third-country provisions in EU financial services legislation.

We then examine the impact of Brexit on the regulation of the derivatives market under the European Market Infrastructure Regulation ("**EMIR**"). The scope and complexity of this legislation, combined with the importance of London as a global hub for the trading of derivatives, means that it will be critical for the EU and the UK to negotiate appropriate transitional arrangements to allow UK market participants to continue to function under the EMIR framework until suitable "third-country" arrangements can be finalized.

Run for the hills…Swiss-style Brexit

"Norway"? "Swiss Plus"? Customs union? WTO-only? Bespoke? During talks with her Italian counterpart Matteo Renzi on July 27, 2016, the UK Prime Minister expressed the following view: "I think we should be developing the model that suits the United Kingdom and the European Union, not adopting necessarily a model that is on the shelf already". Many commentators have suggested that the Swiss model could form the starting point for negotiating such a bespoke solution. But what is the Swiss model? And how well does it work for financial services firms?

Here, we consider the key features of the Swiss model, the difficulties it has presented for the Swiss, and in particular Swiss financial services firms, and the suitability of a model based on Switzerland for the UK.

The Swiss model

Switzerland is unique: it is the only European Free Trade Association ("**EFTA**") state which is not also part of the European Economic Area ("**EEA**"). In 1992, the Swiss electorate voted against EEA membership. This meant that Switzerland had no direct right to access the Single Market and, as a result, it opted for a different approach. Over the last 24 years, it has painstakingly negotiated over 120 individual agreements with the EU, addressing market access in various sectors. However, these bilateral arrangements only provide Switzerland with partial access to the Single Market. Whilst it has significant access to trade in goods, it has limited access to trade in services.

The bilateral EU-Swiss agreements are static in nature; there is no mechanism for automatically updating the Swiss bilateral arrangements as EU law develops. As an EFTA state that is not part of the EEA, Switzerland does not have a direct obligation to ensure that its national laws comply with any EU legislation. Nevertheless, if it opts not to implement national legislation reflecting certain EU laws, the EU is empowered to impede Switzerland's access to the related areas of the Single Market. In practice, to ensure that its businesses continue to have access to EU markets, Switzerland has chosen to continually amend and adopt domestic legislation in line with EU law.

The Swiss model and financial services

The absence of a bilateral financial services arrangement between Switzerland and the EU has impacted, directly and indirectly, the conditions under which Swiss entities provide financial services in both the EU and Switzerland.

Most directly, Switzerland has no general access to the EU market in financial services. It is not part of the passporting system that minimises the legal, operational and regulatory barriers to the provision of financial services across the EEA. As a result, Swiss banks are required to establish an authorized subsidiary in an EU/EEA state in order to obtain financial services passporting rights. As we noted in the **first issue of Lex et Brexit**, the process of obtaining separate authorization in an EU/EEA member state can be time-consuming and costly. Costs can include moving people and infrastructure to a new site and legal and compliance expenses in setting up a subsidiary, as well as an increase in the amount of capital needed to support a group's operations within the EU.

In drafting domestic legislation on banking regulation, Switzerland looks to both EU and international standards. The Swiss government and the Swiss Financial Market Supervisory Authority FINMA ("**FINMA**") have paid close attention to the EU Capital Requirements Directive IV ("CRD IV") in addition to the standards provided by the Basel III international framework in formulating its domestic laws.

More generally, Switzerland systematically seeks to ensure that any proposed domestic financial services legislation will be compliant and consistent with EU law (although it sometimes adopts a less prescriptive and detailed approach to that adopted at the EU level) so as to ensure equivalency with the relevant EU regime. The Swiss have taken this approach in relation to three key pieces of EU financial services legislation: the Alternative Investment Fund Managers Directive (the "**AIFMD**"), EMIR and the Markets in Financial Instruments Directive II ("**MiFID II**")/the Markets in Financial Instruments Regulation ("**MiFIR**").

In relation to asset management firms, fund management firms and custodian banks, Switzerland has adapted its regulation in order to be compliant and equivalent to the AIFMD. On July 19, 2016, the European Securities and Markets Authority ("**ESMA**") published its advice to the European Commission, the European Parliament and the Council of the EU on the application of the AIFMD passport to non-EU alternative investment fund managers and alternative investment funds. After evaluating Swiss law against the criteria of investor protection, market disruption, competition and monitoring of systematic risk, ESMA concluded that there were no obstacles to the AIFMD third-country passport being extended to Switzerland. It remains unclear when the European Commission will "activate" Switzerland's AIFMD passport, but the important point to note for present purposes is that Switzerland has gone to great lengths to ensure that its domestic legislation remains in line with EU law.

Similarly, under EMIR (please see the analysis below for further details on EMIR), the European Commission may adopt implementing acts declaring that the legal, supervisory and enforcement arrangements of a non-EU state are equivalent to the requirements in EMIR. Such a decision is necessary for a trade repository or central counterparty ("**CCP**") established in a non-EU state to provide their services in the EU. Any European Commission equivalence decision will be based on EMSA's technical advice and an assessment of the outcomes of the third country's rules, including whether the rules mitigate any risks faced by market participants in the EU to the same extent that the EMIR rules are intended to do so. On November 13, 2015, the European Commission adopted Commission Implementing Decision 2015/2042, declaring equivalence between the legal and supervisory regimes of Switzerland and EMIR for the regulation and supervision of CCPs.

Further insight can be gleaned from the Swiss response to the upcoming MiFID II/MiFIR legislation. Set to take effect from January 3, 2018, the Swiss Parliament has introduced a piece of legislation which, in effect, seeks to implement MiFID II in Switzerland. As with the AIFMD, one of the key concerns of the Swiss Parliament is to ensure that this piece of legislation ensures equivalency of the Swiss asset management industry. For in the absence of an "equivalence determination" (a finding that Switzerland's prudential and conduct framework has equivalent effect to the requirements under MiFID II) by the European Commission, Swiss investment firms would be unable to access the EU market under the third-country passport regime envisaged by MiFIR (for more detail on the third-country passport under MiFIR, please see the **first issue of Lex et Brexit**).

So, what does this mean for the UK? As we noted in the **third issue of Lex et Brexit**, certain commentators have argued that, now that the UK has voted to leave the EU, it will have more scope to amend the regulation of variable pay in the UK (the so-called "bonus cap") and possibly other unpopular elements of the EU regulatory regime. However, without access to the Single Market, we have **suggested** that, in the context of the third-country passport under MiFIR, it is conceivable that the UK's regulatory regime would not be deemed equivalent if the UK government amended or repealed the bonus cap. More generally, it might be said that should the UK wish to continue accessing the relevant areas of the Single Market, a Swiss-style approach (one that closely tracks the EU regime) to domestic financial services legislation will be required.

Ongoing issues for Switzerland

Switzerland's complex relationship with the EU continues to present difficulties. Perhaps most acutely, the substance of the terms of the EU-Swiss relationship is the subject of dispute. In February 2014, the Swiss electorate voted in a referendum to introduce quotas for immigration in respect of EU Member State nationals to Switzerland. In response, the Council of the EU made its position abundantly clear: "the free movement of persons is a fundamental pillar of EU policy… the internal market and its four freedoms are indivisible". In the meantime, the EU has suspended negotiations over deeper access to the EU market and reduced Switzerland's research funding and access to educational programs. Under Swiss constitutional law, the government must pass the result of the referendum into law within three years – by February 2017. At this stage, the approach to be adopted by the Swiss Government remains unclear but, if it were to introduce migration quotas, the EU could remove Switzerland's access to the Single Market under the bilateral agreements.

In financial services, moreover, Switzerland is a rule taker, rather than a rule maker. It has no role in the EU's legislative processes and no representation in the EU's institutions. It has no right to be consulted on laws drafted by the European Commission. We also understand that the FINMA does not make formal submissions in response to consultations on draft legislation prepared by ESMA. In short, in financial services, Switzerland has opted for a solution requiring continuous monitoring of the evolution of EU law, without the ability to provide any input into the formulation of those laws.

A bespoke model for the UK?

The Swiss model was conceived in a unique context: it was intended to oil Switzerland's eventual transition into the EU. That transition has clearly not happened and, in 2010, the Council of the EU expressed the view that the model of EU-Swiss relations is "complex and unwieldy to manage", adding that it "has clearly reached its limits". But what about a bespoke UK solution based on the Swiss experience?

There are three good reasons why the UK should pause for thought before seeking to negotiate a Swiss or "Swiss Plus" relationship with the EU. First, the plethora of bilateral arrangements between the EU and Switzerland has taken 24 years to negotiate; there is no good reason to assume that any similar arrangements between the EU and the UK could be negotiated on an expedited basis. Second, if the UK were to find itself in a similar position to Switzerland, each time that EU law changed, the UK would need to enact new legislation and/or amend existing legislation to maintain access to the Single Market. With the passing of time, this could negatively impact the competiveness of the UK as the Government would exercise little control over the new laws impacting on UK commercial entities. Finally, the Swiss experience, and in particular the fallout from the February 2014 referendum on immigration, provides a salutary lesson on the difficulty of negotiating a bespoke solution and subsequently maintaining those complex arrangements in the face of ongoing domestic political pressures.

EMIR and Brexit

What is EMIR?

London is one of the most important centers in the world for the trading of all types of derivatives. As an EU member state, the UK is subject to EMIR, the EU initiative to meet a commitment made at the G20 summit in Pittsburgh to require the clearing of standardized OTC derivative contracts and the reporting of all derivative contracts to trade repositories. EMIR can be considered to be the EU counterpart of the regime regulating the swaps market in the US under the Dodd-Frank Act, although there are significant differences in the scope, detail and application of the rules.

EMIR provides for:

- The prudential regulation of central clearing counterparties ("**CCPs**"), including requirements for authorization, capital, margins, organizational rules and the establishment of a default fund.
- A reporting obligation in respect of all derivatives (not just OTC derivatives) entered into by all EU counterparties, including CCPs, to registered or recognized trade repositories. ESMA is responsible for the registration and supervision of these trade repositories.
- A clearing obligation applicable to categories of standardized derivatives which meet criteria set out in EU secondary legislation. This obligation applies to EU "financial counterparties" and EU "non-financial counterparties" whose trading exceeds a specified threshold. This obligation also applies to certain non-EU counterparties in specified circumstances.
- Risk mitigation obligations designed to reduce risk for OTC contracts which are not subject to the clearing obligation, including contractual requirements around portfolio reconciliation and dispute resolution, and a requirement for exchanges of collateral for certain categories of OTC derivatives.

Implementation of EMIR standards

Despite EMIR entering into force in August 2012, the implementation of EMIR over the last four years has been a drawn-out affair, with thousands of pages of consultation and draft legislation produced by

ESMA. Until the Brexit referendum result in June, UK policymakers and major financial institutions based in the UK invested heavily in negotiating and then implementing these proposals and detailed rules.

Clearing

ESMA and the European Commission decided to phase in the application of the clearing obligation depending on the EMIR categorization of counterparties[1] and the size of their trading activities. The clearing obligation for the most commonly used interest rate swaps ("**IRS**") denominated in each of the so-called G4 currencies (Euro, sterling, Yen and US dollar) began for "Category 1" firms on June 21, 2016, with a phased introduction for other types of counterparty until December 21, 2018. A similar approach has been adopted for certain Credit Derivative Swaps ("**CDS**"), with a phase-in period running from February 9, 2017 through to May 9, 2019.

The three major CCPs for the EU derivatives market are located in London: LCH Limited, CME Clearing Europe Limited and LME Clear Limited. These entities are supervised by the Bank of England.

Trade reporting

The reporting obligation has been in place since February 2014. In practice, counterparties have opted either to set up a direct relationship with a trade repository or establish delegated reporting arrangements with their counterparty or a third party provider. A trade repository must register with ESMA if it wishes to receive and process reports in accordance with EMIR. Once registered, the trade repository will be able to receive reports from counterparties across the EU. In the UK, there are currently four data repositories registered with ESMA:

- DTCC Derivatives Repository Ltd
- UnaVista Limited
- CME Trade Repository Limited
- ICE Trade Vault Europe Limited

Margin requirements

On March 9, 2016, final draft EU secondary legislation outlining the EU regime on margining of uncleared OTC derivatives was published. The draft legislation provides for an obligation on counterparties which are in scope (mostly financial counterparties and other counterparties that carry out substantial levels of derivatives trading) to exchange initial and variation margin when dealing with each other. It also sets out a list of eligible collateral for the exchange of collateral and the criteria to ensure that the collateral is sufficiently diversified. EMIR also requires operational procedures relating to margin to be put in place by such counterparties, such as legal assessments of the enforceability of the relevant arrangements for the exchange of collateral.

The draft legislation also provided for a phased implementation of these requirements, based on the method used for the introduction of the clearing obligation. In June 2016, the European Commission confirmed that the legislation would not be finalized in time for the proposed start date for implementation: September 1, 2016. This original start date was designed to dovetail with the implementation of the US margin rules under the Dodd-Frank Act. In the view of ISDA and others, this

[1] There are four categories of counterparties. Category 1 counterparties are counterparties that are clearing members of at least one CCP which is authorized to clear any of the class of OTC derivatives subject to the clearing obligation, and whose membership enables clearing of one or more of the relevant classes of derivatives. Category 2 counterparties are financial counterparties not included in Category 1 and other alternative investment funds that belong to a group that exceeds a threshold of EUR 8 billion aggregate month-end average outstanding gross notional amount of non-centrally cleared derivatives. Category 3 counterparties are financial counterparties and alternative investment funds not included in Categories 1 and 2 with a level of activity in non-centrally cleared derivatives below the above amount (i.e. EUR 8 billion). Category 4 counterparties are all non-financial counterparties above the clearing threshold not included in categories 1, 2 or 3.

delay has resulted in a fracturing of the international timetable agreed at the G20 level, i.e., a commitment to begin the phase in of initial margin requirements by September 1, 2016 and variation margin requirements by March 1, 2017.

EMIR third-country access and equivalence provisions

If, as increasingly seems likely, the UK will not retain EEA membership following Brexit, the UK CCPs and trade repositories referred to above will no longer be authorized under EMIR. In the absence of recognition (as described below), this would mean that these institutions would no longer be able to provide clearing and trade repository services to EU counterparties.

For market participants, EMIR contains a mechanism which is intended to avoid duplicative or conflicting rules on clearing, reporting and risk mitigation requirements. The mechanism involves the European Commission making an “equivalence decision” in respect of a non-EU (third-country) jurisdiction. This means that the European Commission is satisfied that:

- the rules on clearing, reporting, the clearing thresholds and risk mitigation in that third-country are equivalent to those in EMIR;
- the third country has equivalent provisions on professional secrecy; and
- the rules are effectively applied and enforced so as to ensure effective supervision and enforcement.

After the European Commission has decided that a third-country jurisdiction is equivalent, counterparties entering into transactions within the scope of EMIR shall be deemed to have complied with the provisions of EMIR if at least one of the counterparties is established in that third-country.

In addition, EMIR provides for third-country CCPs and trade repositories to provide services through an ESMA recognition process. Below, we set out the ESMA recognition regimes for third-country CCPs and third-country trade repositories.

	Third-Country CCPs	Third-Country Trade Repositories
Requirements for recognition by ESMA	▪ ESMA has consulted the various national regulators in the EU member states where the counterparties or trading venues planning to use the services of the CCP are based	▪ the European Commission has determined that the regime for the supervision of third-country CCPs is equivalent to EMIR, including in relation to the protection of business secrets
	▪ the European Commission has determined that the regime for the supervision of third-country CCPs is equivalent to EMIR, and that arrangements for AML and counter-terrorist financing are also equivalent	▪ the trade repository is authorized and subject to effective supervision and enforcement in the relevant third-country
	▪ the CCP is authorized and subject to effective supervision and enforcement in the relevant third-country	▪ the third-country has entered into an international agreement with the EU regarding mutual access and exchange of information on derivatives contracts held in trade repositories
	▪ co-operation agreements must be in place between the ESMA and the relevant third-country regulator	▪ the third-country has entered into cooperation agreements to ensure that EU authorities, including ESMA, have immediate and continuous access to all the necessary information held by trade repositories in that jurisdiction

Potential difficulties for derivative markets arising from Brexit

As with the MiFIR third-country access provisions discussed in the **first issue of Lex et Brexit**, the process of obtaining an equivalence determination from the European Commission may seem straightforward given that the UK is currently subject to EMIR and therefore has in place regulatory rules and requirements designed to meet and implement EMIR standards. That said, there are a number of potential pitfalls and challenges in relying on the ESMA recognition process to mitigate the impact of Brexit on derivatives markets in the UK:

- As with the MiFIR third-country access provisions, the European Commission may not be willing to run the equivalence decision process in parallel with the withdrawal negotiations. The European Commission could, indeed, delay starting its assessment process until the final regulatory structure in the UK is settled (i.e., after Brexit negotiations are concluded).
- Determinations of equivalence for other third countries in relation to CCPs have taken a number of years, for political and practical reasons. The ability of UK CCPs to clear euro-denominated derivatives post-Brexit (on which, please see the **second issue of Lex et Brexit**) may be interlinked with this determination. Equivalence may also be something of a moving target in the coming years because of the slow implementation of the clearing and margin requirements under EMIR. The UK regulator has historically taken a materially different view on the categorization of certain FX forwards for EMIR compared with ESMA, the European Commission and other EU national regulators. It is not inconceivable that ESMA and the European Commission could point to that long held interpretation as a sign that the UK does not maintain a regime that is equivalent to EMIR.
- Based on a strict reading of EMIR, ESMA has no power to grant recognition under the third-country regime to a CCP which is an existing authorized EU CCP. In the absence of appropriate transitional provisions, a UK CCP may have to wait until the date of Brexit (when it becomes a third-country CCP) before it could even apply for recognition.
- Even after an application for ESMA recognition by a trade repository or CCP, the relevant provisions in EMIR envisage a substantial time delay for a third-country institution to obtain recognition from ESMA. For both CCPs and trade repositories, following a 30-working day period for ESMA to confirm that an application is complete after it has been received, ESMA then has a further 180 working days (approximately nine months) to decide whether recognition should be granted.

It is clear then, that in absence of appropriate transitional arrangements agreed during Brexit negotiations, there is a real risk that UK CCPs and trade repositories would not be able to continue to provide their clearing and repository services to EU counterparties for a period of time following Brexit. In the case of CCPs, this could lead to major market disruption and the fragmentation of the EU derivatives market (especially if the European Central Bank simultaneously imposes a location rule requiring the clearing of euro-denominated securities in a eurozone member state). In the case of trade repositories, the UK regulatory authorities could lose access to a significant amount of trade data (if EU counterparties were no longer able to fulfill their EMIR reporting obligation through reporting to a UK trade repository). This fragmentation of trade reporting might also be damaging to regulators across the EU in understanding risk in the derivatives market.

The wide scope of EMIR means that there may be other material effects on the wider EU derivatives markets derived from Brexit, including:

- A counterparty re-classification exercise may have to be carried out to accommodate the new status of UK counterparties as third-country, rather than EU counterparties. While it is possible that this could be dealt with in a relatively straightforward way through amendments to standard form derivatives documentation, there may well be knock-on effects in relation to the trading policies and procedures of EU and third-country financial institutions.
- Although much of EMIR's regulatory architecture is now in place, significant secondary legislation around margin requirements remains to be finalized. Informal Q&A guidance produced by ESMA also plays a significant role in interpreting the provisions of EMIR. EMIR is also going through a review process (mandated by a provision in EMIR itself), with the European Commission expected to bring forward legislative proposals later this year. The UK, despite its position as a global hub for derivatives trading, has already lost much, if not all, of its ability to influence these standards and guidance since the result of the Brexit referendum was announced – this loss of influence will be formalized at the time of Brexit.

- The UK could pursue its own interpretation of the scope of derivatives regulation. Currently the UK Financial Conduct Authority does not regard FX forwards entered into for commercial purposes to be derivative contracts for the purposes of EMIR, even though other EU regulators and ESMA consider that they are derivatives. As mentioned above, however, maintaining this view could endanger the chances of equivalence being granted.
- EMIR and MiFID II/MiFIR are heavily interrelated pieces of legislation in the derivatives field. If there are not adequate transitional arrangements, the implementation of MiFID II/MIFIR standards (e.g., the trading obligation for certain classes of derivative or the requirement for trading firms to use data reporting service providers) could be thrown into doubt, at least at the UK level. If the MiFIR third-country passport is delayed or unavailable to major UK financial participants in the derivatives markets, this could also cause significant disruption to the markets.

Conclusion

Given the global importance of London as a center for derivatives trading, it seems to us that reaching sensible transitional arrangements for derivatives trading should be of critical importance to both the UK and the EU during Brexit negotiations. Such arrangements should involve, at least, UK CCPs and trade repositories maintaining the right to provide services to EU counterparties until recognition by ESMA or the expiry of the transitional period.

Over the longer term, the complications around determinations of equivalence and the possible requirement to clear euro-denominated securities in the eurozone may well result in a fragmentation of the derivatives markets in the EU. This fragmentation will be accelerated if it proves impossible to negotiate suitable transitional arrangements for UK market participants, CCPs and trade repositories post-Brexit. We also consider that uncertainty and confusion around the position of London as a derivatives trading hub will have the indirect global effect of making harmonized implementation of the G20 standards agreed at Pittsburgh in 2009 more difficult.

Davis Polk

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Thomas J. Reid	**+1 212 450 4233**	tom.reid@davispolk.com
John D. Amorosi	**+1 212 450 4010**	john.amorosi@davispolk.com
John Banes	**+44 20 7418 1317**	john.banes@davispolk.com
Leo Borchardt	**+44 20 7418 1334**	leo.borchardt@davispolk.com
Kirtee Kapoor	**+1 650 752 2025**	kirtee.kapoor@davispolk.com
Will Pearce	**+44 20 7418 1448**	will.pearce@davispolk.com
Simon Witty	**+44 20 7418 1015**	simon.witty@davispolk.com
Connie I. Milonakis	**+44 20 7418 1327**	connie.milonakis@davispolk.com
Michael Sholem	**+44 20 7418 1027**	michael.sholem@davispolk.com
Joanna A. Valentine	**+44 20 7418 1323**	joanna.valentine@davispolk.com

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