

The Latest Brexit Chaos: What Does it Mean for Derivatives Markets?

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Futures and Derivatives; Commodity Futures Trading Commission (CFTC)

The past few weeks have been chaotic for both Brexit negotiations and UK politics overall. On January 15, 2019, British Prime Minister Theresa May's Brexit plan succumbed to historic defeat in Parliament. Brexit watchers expected a defeat but the record margin of 432 votes against, and 202 votes for, was still shocking. On January 16, 2019, the Prime Minister narrowly survived a vote of no-confidence in her government. On Monday, she submitted to Parliament a Plan B for Brexit with a vote on such plan scheduled for tomorrow, January 29th. Against this backdrop of upheaval and uncertainty, derivatives markets must still function and, over the past few months, the European Commission (the "EC" or the "Commission") has taken steps to mitigate the negative impacts of a possible no-deal Brexit. Nevertheless, issues and market concerns remain.

No Deal Brexit and EU Equivalence

If anything, recent activities have heightened expectations of a no-deal Brexit. For months now, investors and advisors, particularly those in the UK, have been flagging concerns about the impact of Brexit on the derivatives industry. Last October, the Bank of England warned that roughly £60 trillion worth of over-the-counter ("OTC") derivatives could be impacted if the UK leaves the EU without a deal.¹ Britain's Financial Conduct Authority (the "FCA") has warned of fragmented markets and liquidity shortfalls if the country exits the EU in March without a formal withdrawal agreement in place. Reduced liquidity would increase trading costs and make it more difficult to execute large transactions. Over time, this could have a harmful impact on the financial services market more broadly, with reduced competition and increased costs for consumers in both the European Economic Area ("EEA") and the UK.

Facing such risks to the multi-trillion-dollar derivatives market and attendant long-term impacts on its economy, the EC announced on December 12 that it would adopt an equivalence decision to address some, but not all, of the issues associated with a no-deal Brexit. The decision noted that a "disorderly close-out" of derivatives positions may pose risks to financial stability.² The EC stated it will issue temporary licenses to clearinghouses, recognizing UK laws

¹ See Bank of England, *Financial Stability Report* (Nov. 2018) available at <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/november-2018.pdf>.

² Huw Jones, *EU to act on derivatives clearing in case of no-deal Brexit: document*, Reuters, (Dec. 15, 2018), available at <https://www.reuters.com/article/us-britain-eu-clearing/eu-to-act-on-derivatives-clearing-in-case-of-no-deal-brex-it-document-idUSKBN1OA26H>.

as “equivalent” to EU standards, to ensure that derivatives markets will continue to function with minimal disruption.

The decision sets forth stringent conditions for granting such temporary “equivalence” and subsequent market access to EU customers, saying the bloc’s regulators must be able to see the inner workings of clearinghouses in a non-EU country. In other words, the European Securities and Markets Authority (“ESMA”) should have access to “all information requested” on an “on-going” basis. The exchange of information includes sensitive matters, such as setting margins or how much cash customers must post to collateralize their trades, and how “calibrated” such clearinghouses are in a crisis. Under the decision, ESMA can share the information with the European Central Bank (“ECB”) and continued clearing approval is dependent upon certain requirements being met.

The impetus for clearinghouse recognition was the fundamental issue of access to clearing services for European firms. The European Market Infrastructure Regulation (“EMIR”) requires firms to clear mandated swaps at recognized central counterparties (“CCPs”) or clearinghouses. Without recognition or equivalence in a no-deal Brexit, EU clients would be cut off from London-based clearinghouses, including ICE Clear Europe, LCH Ltd., and London Metal Exchange’s LME Clear, which are among the most important global clearinghouses.

In addition to the relief granted to UK clearinghouses, UK-based security depositories will get a 24-month reprieve as a part of the equivalence decision. This would allow operators in the EEA that currently have no immediately available alternative depository within the new UK-free EEA to fulfill their obligations under EU law. The Commission also determined it would temporarily exempt investors clearing OTC derivatives from obligations under EMIR to allow them to move such trades from the UK to the EU without additional costs or a change of status. Concurrently to issuing this decision, the EC warned, “In all sectors of financial services, firms should continue to take all the necessary steps to mitigate risks and ensure that clients continue to be served. Firms should actively inform clients about the steps they have taken and how they are implementing them. For their part, clients in the EU of UK firms need to prepare for a scenario in which their provider is no longer subject to EU law.”³

On December 20, 2018, London’s LCH Ltd. applied for equivalence under the decision, stating, “LCH Ltd. intends to continue to offer all clearing services for all products and services to all members and clients after 29 March 2019.”⁴ LCH clears more than 90 percent of interest rate swaps in Europe. London-based ICE Clear Europe also applied to ESMA, stating, “we see no reason to withdraw offering our services in the European Economic Area at this time.”⁵

³ European Commission, *Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: Implementing the Commission’s Contingency Action Plan*, (Dec. 19, 2018), available at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX%3A52018DC0890>.

⁴ LCH Group, *Letter to Customers*, (Dec. 19, 2018), available at https://www.lch.com/system/files/media_root/LCH%20Member%20circular%20Final.pdf.

⁵ Joe Parsons, *LCH applies for EU equivalence in preparation for no-deal Brexit*, *The Trade*, (Dec. 20, 2018), available at <https://www.thetradenews.com/lch-applies-eu-equivalence-preparation-no-deal-brexit/>.

Issues that Remain: Exchange Equivalence

Despite the positive outcomes of the equivalence decision, issues remain. The temporary equivalence that was granted to UK-based clearinghouses was not extended to UK-based exchanges. EU regulation defines exchange-traded derivatives as instruments traded on an EU-regulated market or on a recognized third-country venue. If the UK leaves with no deal, London-based markets would constitute unrecognized third-country venues. Many have commented that the decision not to offer temporary equivalence to both exchanges and clearinghouses is unusual.⁶ Previous third-country clearing equivalence determinations from ESMA have been extended to trading venues. Since 2016, the regulator has recognized 37 third country exchanges, across Australia, Canada, Japan, Singapore, and the U.S.

The lack of exchange recognition would particularly impact EU firms trading energy and commodities contracts accustomed to utilizing ICE Futures Europe or the London Metal Exchange (“LME”) as the EC has not made clear its intentions for UK-based exchanges post-March 29, 2019, the date of the UK’s formal separation from the EU. In the case of no action by the EU to provide equivalence to UK exchanges, EU-based firms could still access the exchanges. Under Europe’s complicated regulatory system, each national authority can decide which trading venues to recognize and in what manner. For example, Cyprus, France, Ireland, and Norway have no licensing requirements for recognition of UK venues.

But without equivalence from the EC, a listed futures contract opened by a EU bank or corporation in London will be abruptly reclassified as an OTC derivative after March 29, 2019. With such a reclassification, a user of such a contract would incur higher margin requirements and may be subject to tougher reporting obligations for a user that would normally be exempt from such activity. The distinction matters because of the distinct regimes that apply to listed and OTC derivatives – the trade details that have to be reported, for example, are different. In addition, determinations about which derivatives users have to clear their swaps are based on OTC notional thresholds; if exchange-traded contracts are added to these totals, some firms that do not currently clear may find they are suddenly required to do so. Trades used for hedging are exempt from this re-categorization, as are small derivatives users that are not banks.

Further Relief is Not Forthcoming

Market participants are making a bid to protect European users of exchange-traded derivatives. Eight industry associations recently wrote to the EC requesting relief. In their December 14 letter, the associations, which included the International Association of Oil & Gas Producers and German capital markets association, Deutsches Aktieninstitut, argued that re-categorizing exchange-traded derivatives as OTC derivatives because of a failure to provide equivalence to UK-based exchanges would represent “a material adverse cliff edge for EU non-financial counterparties”

⁶ Helen Bartholomew, *Lobbyists seek eleventh-hour Brexit relief for UK futures*, Risk.net, (Jan. 11, 2019), available at <https://www.risk.net/derivatives/6283146/lobbyists-seek-eleventh-hour-brexite-relief-for-uk-futures>.

Despite the efforts of Europe's energy firms, market watchers believe hopes for relief at this late stage may be in vain, especially considering the aforementioned EC warning and the fact that Brussels has been telling the market to prepare for over a year. LME has already "strongly encouraged" clients to consider the impact of a reclassification of their futures contracts. LME has also applied for a third-country trading venue license from regulators in Germany and the Netherlands. Finally, as further evidenced by recent, all Brexit-related negotiations have been intensely political, with the EC's equivalence decision applying only to the most systemically pressing concerns instead of ensuring a whole market solution.

Costly Alternatives and the U.S. Solution

In a bid to escape costly obligations, firms are mulling alternative products on EU-recognized venues, which is likely the EC's preference. However, this could require some firms to run basis-risk or trade in lower liquidity instruments. Listed derivatives often traded in a monopoly fashion at a single exchange. For example, ICE Futures Europe lists a contract for Brent crude oil futures, which had total open interest of 2.2 million contracts as of January 8, 2019. A CME alternative attracts only a subset of U.S. users. Many London-based metals contracts have no equivalent at EU-recognized venues.

Nevertheless, on December 20, 2018 the U.S. Commodity Futures Trading Commission ("CFTC") provided an extra safety net for U.S. institutions nervous about the UK's departure from the EU by recognizing Frankfurt's Eurex Clearing AG ("Eurex"), providing U.S. customers with another option for clearing their swap transactions.⁷ American banks will now be able to route trades from hedge funds or big institutional investors, such as Pimco and Blackrock, via Frankfurt.

Many argue that the U.S. authorization will deepen competition between Eurex and UK's LCH Ltd. According to reports from Bloomberg, 16 banks including Deutsche Bank and Commerzbank, have recently tested moving interest rate swap positions from London to Frankfurt. Union Investment, Germany's second largest asset manager, is the first European asset manager to close its existing euro-denominated swaps trades at LCH Ltd.⁸

The CFTC's recognition occurs against the backdrop of ongoing discord between regulators in Brussels and DC as to the future oversight of clearing. EU regulators want greater oversight over U.S. institutions within their borders, a stance that has ruffled more than a few feathers Stateside. The CFTC has repeatedly stressed that its authorization of the Eurozone's biggest clearinghouses was based on existing agreements and can be rescinded.

Nonetheless, CFTC officials say its approval of Eurex fulfills a key policy initiative of Chairman Giancarlo who has been consistently advocating for more choice and openness in the marketplace. Chairman Giancarlo has also called for the U.S. to show greater deference to local

⁷ CFTC Staff Acts to Expand U.S. Customer Options for Clearing Swaps, (Dec. 20, 2018), *available at* <https://www.cftc.gov/PressRoom/PressReleases/7859-18>.

⁸ Will Hadfield, Viren Vighela and Steven Arons, *Deutsche Bank, Commerzbank Test Frankfurt Swaps Move*, Bloomberg, (Dec. 17, 2018), *available at* <https://www.bloomberg.com/news/articles/2018-12-17/deutsche-bank-commerz-said-to-test-moving-swaps-to-frankfurt>.

jurisdictions overseas. Regardless of the outcome of Brexit negotiations across the Atlantic, it is evident that the CFTC is trying to mitigate harmful impacts on U.S. market participants. Meanwhile, as European and British regulators continue their conflict, market participants watch on wearily.

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