“Some reflections concerning the potential effect of Brexit on the operations of UK clearing houses”

This Briefing aims to set out in further detail a number of relevant considerations relating to Brexit and the potential effect on UK clearing houses.

Summary: 1. Introduction. 2. What are clearing houses and what is their purpose? 3. Current regulatory framework. 4. Potential impact of Brexit on clearing houses.

1. Introduction

On 23 June 2016 a referendum on EU membership was held in the United Kingdom in which a majority of those voting – 52% – voted for the UK to leave the European Union. This is commonly known as “Brexit” (being a contraction of ‘British’ + ‘exit’). While the referendum is not legally binding, the Government has stated that the procedure for the UK to leave the EU that is set out in Article 50 of the Treaty on European Union (“Article 50”) will be triggered in due course and result in Brexit.

Upon an Article 50 notice being submitted, Brexit would take place at the latest two years thereafter, unless extended by the European Council acting unanimously. During such two years it is envisaged by Article 50 itself that the UK and the EU would undertake the negotiation of a “withdrawal agreement”. The withdrawal agreement would be likely to contain transitional arrangements as well as provide for the UK’s long-term future relations with the EU.

Regarding timing for the Article 50 notification, Theresa May has stated that Article 50 will be invoked no later than the end of March 2017.

Any withdrawal agreement between the UK and the EU would have to be agreed by a ‘qualified majority’ of the European Council – being 72% of members and 65% of population – and a simple majority of the European Parliament. If the withdrawal agreement is “mixed”, i.e. involves national as well as EU competences, it would also have to be separately ratified by each member state.

The conclusion of a withdrawal agreement between the UK and the EU as contemplated by Article 50 would be likely to seek to mitigate any negative consequences of Brexit for businesses. However, it is important for businesses to undertake contingency and scenario planning in order to be fully prepared for a range of potential economic and legal outcomes.

This Briefing aims to set out in further detail a number of relevant considerations relating to the potential impact of Brexit on UK clearing houses.

2. What are clearing houses and what is their purpose?

Under Article 2 of Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories, (the “EMIR Regulation”), central counterparties (CCPs) and clearing houses are “legal persons who sit between the counterparties of contracts traded on one or more financial markets acting as buyer for each vendor and vendor for each buyer”.

As expressly stated in the EMIR Regulation, “Over-the-counter derivatives (‘OTC derivative contracts’) lack transparency as they are privately negotiated contracts and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence which can make it difficult to identify the nature
and level of risks involved” (Recital 4, EMIR Regulation).

The involvement of clearing houses in the market therefore increases transparency of transactions relating to derivative contracts, absorbing a number of risks deriving from these often complex instruments.

In particular, clearing houses act as the direct contractual counterparty; they therefore have direct knowledge of the actual contractual conditions binding each party and they favour an ever-increasing standardization of terms. Further, as they are the legal contractual counterparty for each commercial party, clearing houses protect each such commercial party from the credit risk of the other.

Indeed, it is the clearing house that deals with settlement of the derivative contract on the settlement date and with the payment obligations of the relevant party following the occurrence of a trigger event.

Clearing houses have the benefit of sizeable liquidity reserves, comprised of the payments of certain amounts made by buyer and seller when they join the CCP and other collateral margin payments made by way of surety for their contractual obligations.

3. Current regulatory framework

From the initial status of the clearing houses as a legal mechanism essentially created by private interests in order to meet the need for transparency and guarantee in the perception of the markets themselves, the European legislator has recently and increasingly tended to intervene to regulate them.

With the financial crisis of 2008 to which the proliferation of derivative contracts and the general lack of regulation of financial instruments had no doubt contributed, CCPs became increasingly common across the globe, albeit not subject to adequate prudential regulation.

Consequently, the European Union deemed it necessary to intervene to regulate this area, introducing by way of legislation guidelines, conditions and management procedures for transactions comprising derivative financial instruments.

Following the agreements made in 2009 by the G20 and recommendations of the de Larosière Group, after a relatively brief period of consultation, the EMIR Regulation entered force to ensure “efficient and sound clearing and payment systems, including CCPs” (Recital 11, EMIR Regulation).

Further, under Article 6 of the EMIR Regulation it is the ESMA (European Securities and Markets Authority) that “shall establish, maintain and keep up to date a public register in order to identify the classes of OTC derivatives subject to the clearing obligation correctly and unequivocally.”

4. Potential impact of Brexit on clearing houses

On account of their role and relative systemic importance, clearing houses have developed significantly in Europe, in particular in London.

Following the UK leaving the EU ("Brexit"), one may ask what effect such an event would have on the operations of the clearing houses based in the UK and what scenarios may play out.

Pursuant to Recital 6 of the EMIR Regulation, which is worth quoting in full:

“The Commission will monitor and endeavour to ensure that those commitments are implemented in a similar way by the Union’s international partners. The Commission should cooperate with third-country authorities in order to explore mutually supportive solutions to ensure consistency between this Regulation and the requirements established by third countries and thus avoid any possible overlapping in this respect. With the assistance of ESMA, the Commission should monitor and prepare reports to the European Parliament and the Council on the international application of principles laid down in this
In order to avoid potential duplicate or conflicting requirements, the Commission might adopt decisions on equivalence of the legal, supervisory and enforcement framework in third countries, if a number of conditions are met. The assessment which forms the basis of such decisions should not prejudice the right of a CCP established in a third country and recognised by ESMA to provide clearing services to clearing members or trading venues established in the Union, as the recognition decision should be independent of this assessment. Similarly, neither an equivalence decision nor the assessment should prejudice the right of a trade repository established in a third country and recognised by ESMA to provide services to entities established in the Union.”

In the light of this the European Commission is likely to negotiate with the UK as to conditions and obligations of the clearing houses and provide regulations for the active monitoring of such regulations.

Under Title IV of the EMIR Regulation, CCPs in the UK (being a third country following Brexit) may continue to provide clearing services if they are recognised by ESMA upon request of the CCP itself.

Recognition by ESMA will depend on whether the relevant entity meets the specific requirements of Article 25 of the EMIR Regulation including whether:

(a) the Commission has adopted an “implementing act” – this is effectively an act “determining that the legal and supervisory arrangements of a third country ensure that CCPs authorised in that third country comply with legally binding requirements which are equivalent to the requirements laid down in Title IV of this Regulation, that those CCPs are subject to effective supervision and enforcement in that third country on an ongoing basis and that the legal framework of that third country provides for an effective equivalent system for the recognition of CCPs authorised under third-country legal regimes” (Article 25(6) EMIR Regulation);

(b) the CCP is authorised in the relevant third country, and is subject to effective supervision and enforcement ensuring full compliance with the prudential requirements applicable in that third country;

(c) cooperation arrangements have been established pursuant to paragraph 7 of the EMIR Regulation (for the exchange of information and prompt notification in relation to relevant matters);

(d) the CCP is established or authorised in a third country that is considered as having equivalent systems for anti-money-laundering and combating the financing of terrorism to those of the Union in accordance with the criteria set out in the common understanding between Member States on third-country equivalence under Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.

A number of positive equivalence decisions have been taken by the European Commission under Article 25(6) of the EMIR Regulation, being (as at 5 July 2016) those in respect of Australia, Canada, Hong Kong, Japan, (South) Korea, Mexico, Singapore, South Africa, Switzerland and the U.S. [That relating to the latter is set out in the Commodity and Securities Act and the CFTC Regulations. On 2 June 2016 ESMA signed a Memorandum of Understanding with the U.S. Commodity Futures Trading Commission. While not creating any legally binding obligations, the Memorandum was entered into to reflect the requirements of Article 25 of the EMIR Regulation and provide ESMA with the tools to monitor compliance by U.S. CCPs (defined in the Memorandum as “Derivatives Clearing Organisations” or “DCOs”).]

Given the above, the existing practice of the Commission vis-à-vis third country CCPs, and given that the UK is already EMIR-compliant, the issuance of such a decision would presumably be
forthcoming in short order (subject to any political difficulties) in respect of the UK upon Brexit.

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