The Impact of a No-Deal Brexit on the Cleared Derivatives Industry

December 2017

The Impact of a No-Deal Brexit
on the Cleared Derivatives Industry

CONTENTS

INTRODUCTION 2

EXECUTIVE SUMMARY 2

PART 1: THE IMPACT OF "NO DEAL" AND POTENTIAL WAYS IN WHICH TO MITIGATE THE CONSEQUENCES........ 4

PART 1A: UK MARKET ACCESS FROM THE EU27 7

PART 1B: EU27 MARKET ACCESS FROM THE UK 15

PART 2: TRANSITIONAL ARRANGEMENTS 24

PART 3: CONCLUSION – FIA MEMBERS' PREFERRED OUTCOMES 27

ANNEX: SUMMARY OF THE CONSEQUENCES OF "NO DEAL" AND POTENTIAL MITIGANTS 30

About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry.

FIA's mission is to:

- *support open, transparent and competitive markets,*
- *protect and enhance the integrity of the financial system, and*
- *promote high standards of professional conduct.*

As the leading global trade association for the futures, options and centrally cleared derivatives markets, FIA represents all sectors of the industry, including clearing firms, exchanges, clearing houses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry.

© FIA, December 2017

INTRODUCTION

FIA is the leading global trade association for the regulated and cleared derivatives industry and publishes this white paper to inform policymakers on the operational and market impact of a no-deal Brexit scenario on these markets. FIA strongly welcomes the recent announcement by the European Union that sufficient progress has been made on Brexit negotiations so as to enable discussions to move to phase two negotiations, focusing on the transition period. On the basis that these phase two negotiations remain to be concluded, it remains necessary to consider the possible consequences of a no-deal scenario.[1]

EXECUTIVE SUMMARY

The primary purpose of the global cleared derivatives industry is to provide efficient tools that enable businesses to manage their risk in a way that promotes financial stability. The potential loss of EU27 or UK derivatives market access for UK- and EU27-based businesses in a no-deal scenario could lead to a significant increase in costs for pension funds, asset managers, insurers, corporates and other businesses, with knock-on effects for the real economy. It is therefore imperative to identify mitigating steps to ensure that UK and EU27 users of cleared derivatives markets are not cut-off from global pools of liquidity and thus unable to manage risk effectively.

The purpose of this paper is to promote a better understanding by FIA's members, policymakers and regulators of:

1. the impacts on the global cleared derivatives industry of the United Kingdom (**"UK"**) and the remaining members of the European Union (the **"EU27"**) reaching no agreement (**"no deal"**) as to the terms of their future relationship on or prior to 29 March 2019;
2. the ways in which policymakers and participants in the cleared derivatives industry can each potentially seek to mitigate the impacts of a no-deal scenario; and
3. the actions that the industry would take during a transition period.

As the parties enter into the phase 2 negotiations, FIA strongly recommends the following key steps that can be taken in order to minimise disruption and maintain end user access to these global markets:

(i) transitional arrangements by the UK and EU 27 are agreed as soon as possible and put in place, comprised of a standstill period and an adaptation period – the latter should last at least two years;
(ii) grandfathering[2] of the EMIR and QCCP status of UK CCPs as at exit day by the European Commission and ESMA is confirmed, as soon as possible, pending such UK CCPs becoming recognised CCPs under EMIR following exit day and grandfathering

1 The sections of this paper below that highlight the impact of such a no-deal scenario assume that no mitigating action is taken by the UK, the EU27, the European Commission or the European Securities and Markets Authority (ESMA), nor by the industry itself.

2 Along the lines of Article 89(3) and (4) of EMIR, but without reference to the national laws of Member States – these articles were adopted at the outset of EMIR with the precise purpose of mitigating these types of cliff-edge consequences of non-recognition under Articles 14 and 25 of EMIR.

© FIA, December 2017

of the EU regulatory approvals of non-CCP UK market infrastructure (trading venues and trade repositories) as at exit day by the EU27, European Commission and ESMA to be confirmed, as soon as possible, pending such UK trading venues becoming equivalent third country trading venues under MiFID II and such UK trade repositories becoming recognised under EMIR;

(iii) equivalence and recognition under UK law by UK regulatory authorities is granted to the following on and from exit day:

a. EU27 CCPs authorised under EMIR;
b. EU27 trading venues authorised under MiFID II; and
c. EU27 trade repositories registered under EMIR;

(iv) necessary cooperation arrangements are entered into by ESMA and the UK regulatory authorities to promote bilateral access to one another's market infrastructure work on those arrangements can already be commenced and does not need to wait until the UK withdraws from the EU;

(v) equivalence is granted to the UK by the European Commission under MiFIR, so as to enable ESMA to register UK firms as third country firms and thereby enable such firms to continue to offer their services to EU27 clients from the UK;

(vi) corresponding permission is granted under UK law (Overseas Persons Regime) by UK authorities to EU27 firms, enabling such firms to continue to offer their services to UK clients from the EU; and

(vii) bilateral recognition arrangements are discussed and agreed by the UK with third countries to avoid loss of market access to and from such countries.

In Part 1 below, the paper sets out the impact of a no-deal scenario and potential mitigants.

In Part 2, the paper sets out in detail arrangements for a transition period.

In Part 3, the paper concludes with FIA's recommendations to bring about FIA members' preferred outcomes.

A table summarising the issues arising from "no deal," potential impacts and potential mitigants is annexed to this paper.

The issues identified in this paper apply to listed derivatives (futures and exchange traded options) and cleared swaps, unless otherwise indicated.

© FIA, December 2017

PART 1: THE IMPACT OF "NO DEAL" AND POTENTIAL WAYS IN WHICH TO MITIGATE THE CONSEQUENCES

In this section, we set out the detail of the detrimental consequences of a no-deal scenario under current UK and EU laws, and the ways in which legislators, regulators and/or the industry can potentially seek to mitigate such impacts.

Many of the legal consequences of a no-deal scenario can be mitigated by legislators, regulators and/or industry, but significant increases in capital, legal and operational costs for all industry participants appear unavoidable.

It is to be expected that as part of their contingency planning for the worst case scenario, execution and clearing brokers will provide an increasing amount of their business to EU27 clients from EU27 affiliates. In many cases, global financial institutions may end up duplicating their memberships of market infrastructure, such that they have both EU27 affiliates and UK affiliates as members. The geographic spread of clients serviced by each such affiliate will vary from institution to institution.

Overarching issues resulting from a no-deal scenario

FIA strongly supports the work of the G20, CPMI-IOSCO and the Financial Stability Board over the last decade, insofar as it relates to over-the-counter, exchange-traded and cleared derivatives. Such co-ordination bodies have provided the basis for CCP requirements globally, which have then been transposed into regional and national regulation around the world.

Such a "top-down" approach is designed to facilitate the provision of cross-border financial services.

The greater the alignment of the laws of each jurisdiction, the fewer the potential conflicts of law. Such alignment also enables regulators to defer to one another, rather than seeking to enforce their rules extra-territorially, on the basis that firms in the applicable third country comply with legally binding requirements that are equivalent to domestic laws, which are subject to effective supervision and enforcement in that third country.

Impact on the real economy – the net impact of all of the consequences that would flow from a no-deal scenario, even after mitigation, would be a significant increase in costs for end users such as pension funds, asset managers, insurers and corporates, with knock-on effects for the real economy. This results from a combination of factors, including but not limited to increases in margin calls due to fragmentation of portfolios that reduce netting benefits; increases in regulatory capital costs for service providers as they seek to increase the amount of business that they conduct from their EU27 affiliates; and a passing on to end users of at least some of the transition costs of moving portfolios from UK service providers and market infrastructure to EU27 ones – not just the actual transfer costs themselves, but also the costs to the clearing members of having to increase their default fund contributions at the CCPs to which they provide access on behalf of clients.

© FIA, December 2017

The challenges of transferring existing portfolios from UK CCPs to EU27 CCPs – the bulk transfer to EU27 CCPs of all derivatives transactions cleared at UK CCPs on behalf of EU27 clients[3] would involve significant market, operational and liquidity risk and is unprecedented. There is no established industry process for effecting such a migration. Position and collateral transfers of this type have only ever been performed within the same legal jurisdiction (examples in the UK in the last 10 years include the transfer of cleared derivatives at LCH Limited to LME Clear and at LCH Limited to ICE Clear Europe, but these relate to futures and options, not to cleared swaps). Due to the constraints imposed on clearing brokers through application of the leverage ratio, it is not clear that the market has sufficient volume and balance sheet capacity to support the entry into of the very large volume of new trades that would be required to offset the existing portfolios held at UK CCPs as part of the transfer process.

Reduced access to clearing and significant increases in costs for all participants in the cleared derivatives market – it is foreseeable that clearing brokers may need to provide their services through an EU27 affiliate for EU27 clients, whilst still remaining free to provide clearing services for other clients from a location of their choice (e.g. the UK). Equally, one can foresee a situation with respect to a given contract (e.g. euro-denominated repos or interest rate swaps) whereby some of the clearing broker's clients wish to clear such products on-shore at an EU27 CCP whereas others, to the extent still legally permitted, wish to do so offshore. This bifurcation in the clearing of clients' portfolios leads to increased capital requirements for clearing members and clients;[4] increased implementation and running costs for clearing members; increased leverage ratio requirements that reduce balance sheet capacity of clearing members to clear for clients;[5] increased leverage ratio usage for prudentially regulated clients;[6] increased margining and default fund requirements; and may lead to the closure of their business by some clearing members.

UK loses benefits of EU equivalence arrangements with other third-countries – UK firms could be cut off from accessing global pools of liquidity at third country trading venues if the UK loses the benefit of substituted compliance and mutual recognition decisions that were made whilst the UK was a member of the EU. As regards clearing — because there are no bilateral equivalence arrangements between the US and UK that set that out the extent to which one jurisdiction is prepared to defer to the rules of the other — it is currently unclear as to whether, post-exit day, (i) a US entity clearing on a UK CCP can do so in compliance with its domestic US legislation (e.g. the Dodd-Frank Act) rather than applicable UK legislation post-exit day and (ii) a UK firm clearing on a US CCP can

3 Which would be required (i) as a matter of law if EMIR Article 4(3) should be construed such that the CCPs through which trades that are subject to the EMIR mandatory clearing obligation have to be either authorised or recognised for the life of the trade or (ii) commercially, if UK CCPs became neither authorised nor recognised, and clients wish to transfer their existing legacy portfolios that are cleared on UK CCPs over to the EU27 CCPs that they use to clear such derivatives post-exit day.

4 Because they have to capitalise both a UK and an EU27 affiliate and lose some netting benefits.

5 Because the leverage ratio calculation takes into account the netting benefits across a portfolio to determine the clearing firm's exposures. If the portfolio becomes fragmented across two affiliates through whom clearing services are provided, the netting benefits are reduced, the leverage ratio increases and, accordingly, the amount of balance sheet capacity for the group providing the clearing service also increases as a whole – even though the portfolios that are actually being cleared have not changed, merely the identity of the clearing brokers being used to clear those portfolios.

6 Because of the fragmentation of its portfolio across two or more clearing brokers.

© FIA, December 2017

be considered to have met the derivatives clearing obligation that will exist under UK law post-exit day.

Contractual uncertainty – the extent to which contracts documenting clearing arrangements could be terminated by reason of an entity's loss of EU regulatory authorisations or market access[7] is far from clear.

7 Whether on the grounds of illegality, force majeure or otherwise.

© FIA, December 2017

PART 1A: UK MARKET ACCESS FROM THE EU27

Mandatory trading obligation

Worst case scenario

Without the requisite equivalence arrangements in place,[8] EU27 firms would no longer be permitted to meet their mandatory trading obligation for derivatives by trading on UK trading venues.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: The European Commission and ESMA could grandfather the regulatory authorisations of UK Regulated Markets, MTFs and OTFs and agree co-operation agreements with UK regulatory authorities, pending such UK trading venues becoming equivalent third country trading venues under MiFID II, so that such UK trading venues can continue to service EU27 members and users without immediate disruption.

Possible mitigation by industry

Global exchange groups with trading venues in both the UK and EU27 could dual-list their exchange traded derivatives contracts on exchanges within the group in the UK and in the EU27, thereby enabling EU27 firms to continue to trade the relevant contracts via their EU27 trading venue. The downside of such an arrangement is that it would potentially fragment liquidity between the UK trading venue and the EU27 trading venue, to the detriment of liquidity in both. It would also lead to increased costs and potential inter-operability issues.

Exchange groups without an EU27 trading venue could consider establishing a new EU27 trading venue in order to continue to facilitate the continued trading of such products by EU27 users within their group. There may be insufficient time remaining to do this ahead of exit day. Alternatively, they may look to the end-users to restructure their own business models in such a way that preserves access to the trading venue in the UK.

Absent the above steps, firms subject to the MiFIR mandatory trading obligation for derivatives could meet their mandatory trading obligation through execution on EU27 MTFs, OTFs or equivalent third country trading venues.

8 Per MiFIR Art 28(4).

© FIA, December 2017

Loss of "authorisation" under EMIR and failure to gain "recognition"

Worst case scenario

As a result of UK CCPs being neither "authorised"[9] as an EU27 CCP nor "recognised"[10] as a third country CCP in a no-deal scenario:

- EU27 firms become legally prohibited from using UK CCPs to meet their mandatory clearing obligation for derivatives[11] and would instead have to use EMIR authorised or recognised CCPs to satisfy such obligations going forward. For euro-denominated interest rate swaps, this could result in a highly liquid offshore market based in the UK[12] (open to all but EU27 users) and a one or more fragmented, illiquid, markets in EU27 jurisdictions;
- UK CCPs become legally prohibited under European law[13] from providing clearing services to clearing members or trading venues established in the EU27. Such outcome would be detrimental not only to the UK CCPs, but also to those EU27 clearing members, as they could be rendered less competitive than their peers due to their inability to access as wide a range of CCPs for their clients' as their third country competitors whom provide client clearing services;
- UK CCPs all become "non-QCCPs" under the Capital Requirements Regulation (CRR), with the result that the risk weightings that EU27 firms that are subject to prudential regulation have to apply under CRR to their exposures to such CCPs increase from 2-4% to 20% and the risk weightings that apply to their default fund contributions increase very significantly;
- this increase in capital requirements may be so punitive as to render it economically unviable for such EU27 participants to continue to use UK CCPs to clear their derivatives;
- it is anticipated that prior to exit day, if a no-deal scenario remained a realistic prospect, then EU27 clearing members and EU27 clients would seek to close-out their legacy portfolio of derivatives that are subject to the EMIR mandatory clearing obligation and cleared at UK CCPs. They may then seek to re-open such positions at one or more EU27 CCPs. Such action would be necessary in order to ensure that such firms do not (i) find it legally impossible to risk manage down their portfolios at UK CCPs, on the basis that they are legally prohibited from clearing new trades on UK CCPs in satisfaction of their EMIR clearing obligations nor (ii) suffer significantly increases in capital requirements for such trades post-exit day. This process would involve significant costs, market risk and operational risk for EU27 clearing members and clients; and
- As with trading venues, there are some asset classes that are cleared at UK CCPs for which no EU27 equivalent exists (e.g. LME Clear for certain commodities) or only one EU27 equivalent venue currently exists (e.g. LCH.Clearnet Limited's SwapClear

9 Per EMIR Article 14.

10 Per EMIR Article 25.

11 Article 4(3) of EMIR: "*The OTC derivative contracts that are subject to the clearing obligation pursuant to paragraph 1 shall be cleared in a CCP authorised under Article 14 or recognised under Article 25....*"

12 Although note that these products are also successfully cleared on the Chicago Mercantile Exchange in the US too, albeit in smaller volumes.

13 Per EMIR Article 25(1): "*A CCP established in a third country may provide clearing services to clearing members or trading venues established in the Union only where that CCP is recognised by ESMA.*"

© FIA, December 2017

service relating to interest rate and inflation swaps, for which Eurex Clearing is the only current EU27 substitute).[14] This would therefore go beyond the currently proposed scope of potential forced relocation, as it would require EU27 firms to move all cleared derivatives (not just euro-denominated repos and interest rate swaps) to one or more EU27 CCPs, denying EU27 firms access to a potentially deeper liquidity pools located in the UK for those products.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: FIA strongly encourages the European Commission and ESMA to confirm as soon as possible that they will grandfather[15] the EMIR authorisation of UK CCPs as at exit day and seek to agree cooperation agreements with UK authorities, pending such UK CCPs becoming recognised CCPs under EMIR. Such a policy approach would ensure that UK CCPs can continue to service EU27 clearing members and trading venues without immediate disruption on exit day, improve the quality of industry's contingency planning and avoid unnecessary fragmentation of markets. In this scenario, UK CCPs would then be required to submit an application for recognition under Article 25 of EMIR. In the interests of minimising disruption, UK CCPs should be able to submit complete applications to ESMA for EMIR recognition prior to exit day.

Should the European Commission and ESMA alternatively proceed with the decision not to grandfather nor "recognise" UK CCPs, one has to consider how to address the legacy portfolios still cleared through UK CCPs. In this scenario, the European Commission and ESMA could consent to EU27 entities remaining as clearing members of UK CCPs insofar as is necessary to facilitate them and their clients exercising risk management tools such as "compression" with respect to their legacy portfolios cleared at UK CCPs and/or close out those legacy portfolios (whether pursuant to the process of transferring those positions to an EU27 CCPs or otherwise).

As an additional consequence, if a contract subject to the EMIR clearing obligation[16] is only capable of being cleared at UK CCPs (or possibly just one UK CCP and one EU27 CCP), ESMA would need to give consideration as to whether to suspend the clearing obligation with respect to that contract.

Mitigation by clearing members

EU27 clearing members could in principle voluntarily choose to:

- transfer their membership and their (and their clients') current book of cleared derivatives portfolios from the current EU27 entity to a UK subsidiary ahead of exit day;
- seek to move their and their clients' existing portfolios from a UK CCP to an equivalent EU27 CCP (where one exists); and/or
- increase the extent to which they clear new trades on EU27 CCPs rather than UK CCPs (note that this is not possible for commodities such as metals that are cleared on LME

14 Although note that Eurex Clearing is not current set up to clear USD CPI inflation swaps.
15 Along the lines of Article 89(3) and (4) of EMIR, but without reference to the national laws of Member States – these articles were adopted at the outset of EMIR with the precise purpose of mitigating these types of cliff-edge consequences of non-recognition under Articles 14 and 25 of EMIR.
16 Per EMIR Article 4(3).

© FIA, December 2017

Clear), so as to reduce their overall exposure to UK CCPs as at exit day.

As noted above, the first two of these mitigations would give rise to significant costs and resource burdens to clearing members and end users. The process of transferring memberships, positions and margin is extremely complex (especially on an unprecedented cross-border basis) and gives risk to significant operational risk. There is no industry-agreed process for effecting any such transfer.

If a number of EU27 clearing members were to resign (or otherwise terminate their memberships of UK CCPs) simultaneously, a number of questions and observations arise:

- the resigning EU27 clearing member would need to arrange (to the extent possible) for all non-EU27 clients to continue to clear at the UK CCP via a replacement clearing member, which may or may not be a UK-incorporated affiliate of the resigning EU27 clearing member;
- would the EU27 clients of such EU27 clearing member be required to transfer their positions to an authorised or recognised CCP or can their legacy portfolios remain cleared at the UK CCPs through a back-up clearing broker, notwithstanding the lack of authorisation or recognition of such CCPs?[17]
- would the EU27 clearing members be able to successfully port their proprietary (non-client) business to one of the remaining clearing brokers of such UK CCP? It is unclear whether there is enough balance sheet capacity[18] in the rest of the clearing membership of UK CCPs to absorb those portfolios.

Mitigation by UK CCPs

Some UK CCPs also have EU27 CCPs within the same corporate group. In theory, positions and assets could therefore be transferred from the UK CCP to the EU27 CCP on the basis of an intra-group transfer. However, in practice, such a cross-border transfer is both untested and unprecedented – CCP migrations in the last 10 years have taken place in the same legal jurisdiction, rather than cross border, e.g. the migration to ICE Clear Europe of some derivatives contracts previously cleared at LCH.Clearnet Limited and the migration to LME Clear of other derivatives contracts previously cleared at LCH.Clearnet Limited. In those two examples, unlike today, there were also no other significant structural market issues occurring such as the various changes that may result from the UK/EU27 Brexit negotiations, the EMIR Review and the ESA Review. There are currently no industry-standard processes to effect such a migration.

The process of transferring across positions to those EU27 CCPs from the UK is complex, involves various legal jurisdictions, takes significant time and could involve material levels of operational risks. Some of market infrastructure groups do not currently have the necessary infrastructure in place in their EU27 affiliate to clear certain products (e.g. LCH. Clearnet S.A. in Paris currently has no infrastructure or other resources to enable it to clear interest rate swaps). Others (e.g. the London Metals Exchange) do not have an EU CCP affiliate at all. In each case, if they wished to, they would effectively need to build a European CCP from scratch in the next 15 months or to find an alternative way of clearing

17 EMIR Art 4(3) is silent on whether the CCP used by firms to meet their mandatory clearing obligations has to be authorised or recognised for the life of the transaction being cleared, or only at the point in time that the transaction is initially cleared.

18 Given the constraints imposed by the leverage ratio under Basel III/the EU's Capital Requirements Regulation, among other factors.

© FIA, December 2017

via EU27 CCPs – that appears to be unfeasible in the time available. Some UK CCPs have suggested that they would consider migrating some of their UK business to the U.S. rather than to the EU27.[19]

Alternatively, market infrastructure groups could in theory seek to inter-operate their UK CCP with another authorised or recognised CCP (whether one that is within their corporate group or otherwise), but again this is extremely complicated, involves complicated cross-border legal and regulatory issues that are difficult to predict without an understanding of the legal and regulatory relationship between the EU27 and the UK post-Brexit, making this, in effect, an unrealistic solution in the remaining time available. From a clearing member and client perspective, it is inefficient to build out a contingency that may not be needed in the long run, given the opportunity cost.

FIA are not aware of any current plans by the CCPs established in the UK to operate a smaller clearing operation in continental Europe for EU27 clearing members and clients. It is in the interests of the market to have a broad set of high credit quality members, rather than a reduced and fragmented number of clearing members. The level of participation of EU27 clearing members and clients, and their activity levels, varies significantly across CCP services established in the UK.

If they cannot remain cleared at a UK CCP, how would the EU27 clients move their portfolios to an alternative authorised or recognised CCP, given that no existing industry mechanic exists to "de-clear" trades and collateral from one CCP in order to move them to another CCP in another jurisdiction? EU27 clients and EU27 clearing members could still access UK CCPs for non-mandatorily cleared trades via UK clearing members, but (if no solution is provided by the European Union) mandatorily cleared trades would need to be transferred to another CCP. This would involve entering into (i) offsetting trades to close out positions then cleared at the UK CCPs and (ii) equivalent new trades cleared through EU27 CCPs (where the contracts are available, although FIA are not aware of any mandatorily cleared contracts that are only capable of being cleared at UK CCPs currently). This would need to be completed before exit day, so as to avoid restrictions on dealing with UK CCPs thereafter. This would be time consuming and expensive, in part due to the bid/offer spreads relating to the close-out of the existing trades and entry into new trades. It would also require complex returns of collateral to clearing members and clients from the UK CCP back up the clearing chain and delivery of collateral to the EU27 CCP. Time constraints are likely to result in short-term double margining (at some considerable cost to those involved) and stresses to the financial markets infrastructure in making such large transfers of notional amounts of contracts, posing possible systemic issues.

Settlement finality issues for UK CCPs

A remaining major gap in the EU legislative framework for post-trade is the lack of any third country equivalence regime under the Settlement Finality Directive. Presently,

19 E.g. LCH.Clearnet Limited's CEO, in his testimony to the UK's House of Lords EU Financial Affairs Sub-Committee on 25 October 2017: *"When you start to consider that location, the answer is not necessarily relocation to Europe; the answer may be relocation going the other way—to the States. This is an internationally integrated market and, if things did need to move, it is not a fait accompli that business would move to Europe."* http://www.parliamentlive.tv/Event/Index/115feb81-17cc-4f97-967d-3d907be9b636

© FIA, December 2017

EU institutions participate in numerous non-EU27 clearing houses and settlement systems. However, in the absence of an EU regime for third country systems, there is no assurance that matters governing participation in such systems would be governed by relevant system laws (as opposed to local member insolvency laws). Insolvency claw-back challenges under EU laws following an EU27 participant insolvency could apply to unwind transactions done in non-EU systems or holdings of financial instruments held through non-EU systems. This acts as a disincentive to financial groups using EU entities for global group booking purposes and increases the risks of non-EU systems admitting or facing EU members or users. The UK has in many respects "solved" this through the protections for overseas clearing houses and EMIR-recognised third country CCPs in its Companies Act 1989, but this regime is apparently unique in Europe. After Brexit, the lack of a third country recognition regime under the Settlement Finality Directive will be exacerbated, since UK CCPs and UK CSDs will no longer benefit from EU settlement finality rules post-exit day. This means that in an EU member insolvency, UK system rules on finality may be overturned by EU Member state insolvency claw-back rules and moratorium rules, potentially meaning that UK infrastructure needs to cut off EU membership due to risks of admitting such members. The default rules of UK CCPs and CSDs would not benefit from EU27 statutory protections or deference to UK system rules in the event of an insolvency of an EU27 clearing member.

This may result in certain EU27 clearing members being unable to remain as clearing members of UK CCPs or as participants in UK CSDs.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: The Settlement Finality Directive could be updated so as to permit the "designation" of third country systems, including those in the UK.

The role of the ECB with respect to UK CCPs

It is currently unclear whether the European Central Bank and Bank of England will continue to operate their enhanced arrangements for information exchange and cooperation regarding UK CCPs with significant euro-denominated business and their swap line in the event of a no-deal scenario.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: The ECB and the Bank of England could re-affirm their commitment to their existing relationship in these areas.

© FIA, December 2017

Access to UK Trade Repositories from the EU27

Worst case scenario

- As a result of UK trade repositories becoming neither "registered"[20] nor "recognised"[21] under EMIR, EU27 firms would be legally prohibited[22] from using UK trade repositories to satisfy their EMIR reporting obligations. Five of the seven trade repositories currently registered by ESMA[23] under EMIR are located in the UK. A significant volume of derivatives transactions across Europe are currently reported to a single UK trade repository. As it stands today, post-exit day EU27 firms would only have a choice of two[24] trade repositories in the EU27, neither of which have experience of handling anything like the volume of data that would be required to be reported to them post-Brexit.
- It is unclear whether, and on what basis, EU27 regulators would continue to have access to the data previously reported to UK-located trade repositories.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: ESMA and the European Commission could grandfather the EMIR registration of UK trade repositories as at exit day and agree cooperation agreements with UK authorities, pending such UK trade repositories becoming recognised trade repositories under EMIR, so as to ensure uninterrupted access by EU regulatory authorities to the trade data stored at UK trade repositories (both with respect to legacy and future trades). In this scenario, UK trade repositories would then be required to submit an application for recognition under Article 77 of EMIR. In the interests of minimising disruption, UK trade repositories should be able to submit complete applications to ESMA for EMIR recognition prior to exit day.

Possible mitigation by industry

EU27 members of UK trade repositories could seek to transfer their membership from the current EU27 entity to a UK affiliate.

In order to ensure that they are able to continue to act as trade repositories under EMIR without disruption, UK trade repositories could seek to relocate their business to an establishment in an EU27 jurisdiction and to then seek registration of the same from ESMA.

20 EMIR Article 55.
21 EMIR Article 77.
22 EMIR Article 9(1).
23 See the list here: https://www.esma.europa.eu/supervision/trade-repositories/list-registered-trade-repositories
24 Krajowy Depozyt Papierow Wartosciowych S.A. (KPDW) and Regis-TR S.A.

© FIA, December 2017

Access to UK clients by EU27 firms

At present,[25] third-country firms are subject to the same general prohibition as UK firms in that they cannot provide investment services in the UK without authorisation from the Prudential Regulation Authority (PRA) and/or the UK's Financial Conduct Authority.

It has been reported that at least some services of EU27 banks that are currently performed in the UK via a UK branch may be required to be performed through a UK subsidiary post-exit day.[26]

The extent to which EU27 firms may be able to rely on the UK's Overseas Persons Exemption post-exit day remains to be seen. This could result in reduced access to execution and clearing services in the EU27 by UK clients and reduced revenue for EU27 execution and clearing brokers.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: The UK regulatory authorities could publicly confirm that they will continue to operate the UK's Overseas Persons Regime in the same manner as they do today.

Possible mitigation by industry

There are three main ways in which a third-country firm can engage in investment activities in the UK:

- set up a UK subsidiary and apply to the PRA and/or the FCA for authorisation in its own right;
- where a third-country firm has a UK permanent place of business in the form of a UK branch, it can provide investment services in the UK once its branch has been authorised by the PRA and/or the FCA; or
- some third-country firms do not require regulatory approval to provide investment services in the UK, particularly if they fall within the exclusion for "overseas persons."[27]

UK clients may need to find alternative service providers ahead of exit day if their existing EU27 execution or clearing broker does not have the necessary authorisations or exemptions under UK law post-exit day to continue to service them from outside of the UK.

25 http://www.shearman.com/~/media/files/newsinsights/publications/2016/05/mifid-ii-access-to-eu-markets-for-third-country-investment-firms-fiafr-050916.pdf
26 http://www.telegraph.co.uk/business/2017/10/04/brexit-transition-deal-needed-christmas-says-bank-england/
27 Financial Services and Markets Act 2000 (Regulated Activities) Order 2011, Article 72.

© FIA, December 2017

PART 1B: EU27 MARKET ACCESS FROM THE UK

Loss of passporting rights

Worst case scenario

UK firms lose rights of freedom of establishment in the EU, the freedom to provide services in the EU[28] and MiFID II/MiFIR/CRDIV passporting rights.[29]

If no equivalence is granted under MiFIR Article 46 and none of the EU27 Member States permit access to EU27 wholesale clients from the UK under the domestic laws of those EU Member States, then:

- for wholesale EU27 clients: save for those EU27 clients that approach a UK-established service provider on a reverse enquiry basis,[30] the UK entity will be unable to service its EU27 wholesale clients from the UK; and
- for retail EU27 clients and opted-up professional clients: the UK service provider may still be able to service such EU27 clients from the UK, but not if the local EU27 regulator in which such EU27 client is located exercises its right[31] to require the UK service provider to establish a branch in such Member State. The service provider would only be able to service clients in that one Member State from that branch.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: This can in theory be completely mitigated by way of national regulation within each EU27 member state: in order to ensure that clients in their jurisdiction can continue to receive services from the UK without disruption, each EU27 member state could permit such cross-border service to continue to operate post-Brexit, in accordance with its national regime.[32]

We set out briefly below our understanding of the current national regimes in two of Europe's biggest markets - France and Germany:

FRANCE: The regime in France will follow the MiFIR Article 46 regime for wholesale clients and the MiFID II Article 39 regime for retail and elective professional clients: article L532-48 of the Monetary and Financial Code implements the provision of Article 39 of MiFID II that provides Member States with the power to require third-country firms to establish a branch in their jurisdiction in order to provide services to retail and elective professional clients in that jurisdiction.

28 Per TFEU Articles 49 and 56.
29 MiFID II Article 34.
30 Per Article 42 of MiFIR.
31 Per Article 39 of MiFID II.
32 This is explicitly catered for in the final paragraph of MiFIR Art 46(4).

© FIA, December 2017

GERMANY: Under domestic German law, a UK firm wishing to service the German market has the following options:

- establish a branch of the UK entity in Germany (needs to be licenced);
- establish a subsidiary of the UK entity in Germany (needs to be licenced);
- establish a subsidiary in another EEA member state and (i) obtain a cross-border passport or (ii) establish a passported branch of that subsidiary in Germany; or
- service clients directly from the UK under a waiver (section 2(4) of the German Banking Act, from January 2018 section 2(5)).

As to the waiver, the following should be noted:

- A waiver from the authorisation requirement for cross-border business into Germany will require the following:
    - the firm is effectively supervised in its non-EEA home state in accordance with international standards;
    - the firm's home regulator(s) cooperate satisfactorily with BaFin (e.g. through an memorandum of understanding);
    - where the firm submits a certificate from the home state regulator(s) confirming that it is properly licensed for the services it intends to provide cross-border into Germany and that the commencement of the cross-border services raises no concerns and that, in case such concerns arise at a later stage, the home state regulator(s) will inform BaFin; and
    - the firm appoints a process agent in Germany.

- Although the BaFin stresses that each waiver decision is based on case-by-case assessment, according to its guidance, the following applies as to the extent of the waiver:
    - Institutional investors/interbank business:
        - For institutional investors/interbank business, a waiver can generally be granted for all licensable activities under the KWG;
        - Institutional investors comprise the Federal Republic, the federal states and local authorities and their facilities; credit and financial services institutions within the meaning of the KWG, private and public insurance undertakings and stock corporations with a balance sheet of at least EUR 20m, an annual turnover of at least EUR 40m or an annual average of 250 employees (or a combination of these factors), or if its shares or other financial instruments issued by it are listed on a regulated market;
    - Private clients:
        - For private clients, a waiver can generally be granted for all licensable activities under the KWG if the business is brokered by a German credit institution or an EEA institution whose licence is comparable to a German credit institution and its activities are covered by the CRD/MiFID passport;
        - Once the business relationship is established, the non-EEA firm may address the client directly within the confines of the existing business relationship.

© FIA, December 2017

Possible mitigation by industry

In practice, it is likely that different EU27 Member States will take different national approaches – some may permit access, others may not. The conditions of such access would also likely vary from Member State to Member State. As a result, firms are unwilling to rely on this as part of their worse-case scenario planning and are instead considering servicing their EU27 clients out of their EU27 affiliates by exit day.

Service providers established in the UK that provide services to EU27 clients could seek to transfer those relationships to an EU27 subsidiary, so as to avoid any disruption in their ability to service their clients.[33]

This is extremely disruptive to business, requires significant changes to legal and operational processes and entails significant costs:

- the EU27 subsidiary would need to be established (if it does not exist already) and be appropriately capitalised;
- additional staff and office space would be needed in connection with the EU27 subsidiary's servicing of EU27 clients going forward. Human and other resources in the UK would likely be correspondingly reduced;
- existing client relationships would need to be repapered. This is a very significant exercise and potentially involves hundreds or thousands of clients and thousands of contracts. Previous experiences of repapering exercises suggest that it could take two or three years to complete with respect to all clients. Whilst larger clients would likely be prioritised, there is a very real risk that smaller clients would receive a lower prioritisation and thus potentially be excluded from the market until repapering could be achieved;
- indirect clearing chains may become longer depending upon circumstances, which would require further documentation and increase the complexity of the process of clearing for the EU27 client; and
- if the UK entity is no longer able to remain as the clearing member of EU27 CCPs, such that the EU27 subsidiary has to perform that role going forward for EU27 clients, then numerous additional consequences and costs flow from such event. These are explored in more detail above.[34]

33 E.g. Terms of Business, Give Up Agreements etc.

34 See the section of this paper entitled "Changing clearing memberships of EU27 CCPs from a UK affiliate to an EU27 affiliate."

© FIA, December 2017

Changing clearing memberships of EU27 CCPs from a UK affiliate to an EU27 affiliate

There are currently no blanket EU regulatory requirements that members of EU27 CCPs must be located in an EU member state.[35] Whilst the provision of client clearing services is not, *per se*, an investment service or activity under Annex I to MiFID II, it requires the provision of investment services and activities that are so regulated. So, it would appear that in order for UK affiliates of clearing brokers to continue to provide client clearing services as a clearing member of an EU27 CCP post-exit day, they will need to be registered by ESMA as a third-country firm on and from exit day pursuant to Article 46 of MiFIR (with respect to their wholesale business).

Worst case scenario

UK affiliates of clearing brokers are not capable of registration by ESMA as a third-country firm on and from exit day pursuant to Article 46 of MiFIR (with respect to their wholesale business) and are therefore effectively prohibited from offering their services to EU27 clients from the UK.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: In the short term, EU27 Member States could confirm that they will continue to permit, under their national laws, UK firms to service EU27 wholesale clients and to conduct MiFID II investment activities and investment services in their EU Member State, without the need to establish a local affiliate or branch. In the medium term:

- **the European Commission could adopt an equivalence decision under Article 47 of MIFIR with respect to the UK;**
- **the UK regulatory authorities and ESMA could enter into co-operation arrangements under Article 47(2) of MiFIR; and**
- **ESMA could then register UK affiliates as third-country firms under Article 46 of MiFIR.**

Possible mitigation by industry

Rather than continuing to use their UK affiliate to act as clearing member of EU27 CCPs for all client business, clearing brokers could in principle:

- use an EU27 affiliate going forward to act as clearing broker on EU27 CCPs with respect to their client clearing business for EU27 clients; and
- continue to use a UK affiliate to act as clearing broker on EU27 CCPs with respect to their client clearing business for third country clients.

35 However, we understand that at least one EU27 CCP is considering imposing a requirement that the clearing members of its CCP must be located in an EU27 member state.

© FIA, December 2017

However, such bifurcation of entities through which client clearing services are with respect to an EU27 CCP leads to:

- **fragmentation of liquidity:** either because (i) some clients are cleared through a UK affiliate and others through an EU27 affiliate or (ii) some trades are cleared through a UK CCP whereas other equivalent trades are cleared through an EU27 CCP;
- **increased capital costs:** because the service provider needs to capitalise both a UK affiliate and an EU27 affiliate, rather than just a UK affiliate, and existing netting benefits of having all business cleared through a single entity are reduced;
- **increased balance sheet usage due to the negative leverage ratio impact:** because the fragmentation of the client portfolio across two affiliates reduces the netting benefits, thereby increasing the clearing broker's leverage ratio, such that the amount of balance sheet used to clear the client portfolio via the two affiliates is significantly greater (due to the loss of netting benefits) than would have previously been the case with respect to the same portfolio when it was cleared through a single affiliate;
- **increased margin requirements:** due to loss of netting benefits across the entire client portfolio – the extent to which a loss of cross-currency portfolio margining benefits on a UK CCP is mitigated through the efficiencies that result from clearing a variety of euro-denominated products (e.g. swaps, repos, futures etc.) varies from portfolio to portfolio;
- **increased default fund requirements:** because of the loss of netting benefits and as a result of the clearing broker now having to main two memberships (i) for the same CCP: a UK affiliate clearing member and an EU27 affiliate member or (ii) for two different CCPs: a UK CCP and an EU27 CCP;
- **significant operational risk:** (i) in the event of seeking to port client positions and assets from one CCP to another and/or (ii) as a result of needing to manage client portfolios across two portfolios rather than in a single location. This includes not just pure operational aspects but also changes to legal agreements, etc.; and
- **liquidity risk:** to the extent that new liquidity arrangements need to be put in place for an EU27 affiliate that is to provide client clearing services, all of which may render such business not economically viable. In such event, clearing brokers may decide to exit the business rather than remodel their business in this way. This would further reduce access to clearing by end users.

Another alternative, which potentially mitigates some of the above on-going concerns relating to fragmentation and leverage ratio, would be for the clearing broker to provide client clearing services for all EU27 CCPs for all clients (not just EU27 clients) out of its EU27 affiliate.

Any transfer of client relationships from a UK affiliate to an EU27 affiliate would not only require a re-documentation of the client-broker relationship but also of the give-up agreements between the client, the executing broker and the clearing broker. More importantly, this may also require the transfer/rebooking of positions and related collateral where the CCP does not operate a non-default porting process (often such services are not available for net omnibus accounts because the consequence of breaking netting sets demands increased collateral). This is an extremely resource-intensive exercise – the experience of one clearing broker that moved clients from one affiliate to another was that this process can take up to two years.

© FIA, December 2017

Loss of Direct Electronic Access to EU27 trading venues from the UK

Worst case scenario

There are currently no blanket requirements that members of EU27 trading venues must be located in an EU member state.

However, under MiFID II, EU27 Regulated Markets must require their members/participants that are providers of Direct Electronic Access to be authorised either as investment firms or credit institutions. An ESMA Q&A has recently clarified that non-EU firms (including non-EU firms licensed in an equivalent jurisdiction) cannot provide Direct Electronic Access. A non-EU27 firm (a "third-country firm") cannot be authorised as an investment firm or a credit institution. Without appropriate mitigation, a UK-based member of an EU27 trading venue that acts as a DEA provider would therefore no longer be able to continue doing so from an entity established in the UK.

This policy requirement could result in reduced access to EU27 trading venues, thereby leading to lower liquidity and/or concentration of activity through a smaller number of DEA providers.

In terms of relative importance and scale of impact, these types of execution issues are ultimately less disruptive than the issues set out elsewhere in this paper relating to clearing, but the two are interlinked.

Increased costs would result from a restructuring of a DEA providers business in the way set out below.

Possible mitigation by industry

Absent some form of regulatory relief, a UK-based member of an EU27 trading venue that acts as a DEA provider may find that it is required either to:

- establish a presence in an EU27 Member State so that it can become authorised as an investment firm or credit institution (and thereby continue to provide DEA services to the group's clients with respect to EU27 trading venues); or
- restructure its business in a way that it is no longer a DEA provider.

If it does not already exist, such EU27 affiliate would need to be established, capitalised, staffed and otherwise resourced. The EU27 affiliate providing DEA would need to establish its own clearing broker relationship (if not in place already), to apply for membership of the applicable EU27 trading venues (if not already a member) and to comply with local conduct of business requirements. Existing give up documentation would also need to be amended to reflect the change in executing broker, from the UK affiliate to the EU27 affiliate.

© FIA, December 2017

Loss of access to UK-established market participants by EU27 trading venues

As a matter of UK law post-Brexit, the extent to which EU27 trading venues will be able to service entities located in the UK is currently unclear: will firms established in the UK be able to execute derivatives transactions on EU27 trading venues in satisfaction of an UK law mandatory trading obligation for derivatives? Will an equivalence assessment, mutual EU27 recognition and UK/EU cooperation agreements be required as a condition precedent to the granting of such access? FIA understands that the approach of the UK government is to completely align with EU legislation as at exit day, as part of the process of migrating EU law into UK law – given these steps are required under MiFIR in respect of the EU mandatory trading obligation, FIA assume that these requirements will apply with respect to any EU27 trading venue that wishes to be capable of use by UK firms to satisfy their UK law mandatory trading obligation for derivatives under the UK law equivalent of MiFIR post-exit day.

It remains to be confirmed by UK authorities precisely how, if at all, the UK will amend its Recognised Overseas Investment Exchanges (ROIE) regime and the extent to which the UK will continue to permit UK firms to act as trading members of EU27 trading venues.

Worst case scenario

Loss of access for UK market participants to EU27 trading venues, resulting in reduced liquidity at such trading venues and a more limited choice of trading venues for UK firms when seeking to comply with UK law mandatory trading obligations.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: FIA encourages the UK regulatory authorities to publicly confirm (i) how they expect the ROIE regime to operate post-exit day; (ii) if, and on what basis, they will continue to permit UK firms to participate as members of EU27 trading venues; and (iii) if, and on what basis, UK firms will be able to meet any future UK mandatory trading obligation by executing in-scope derivatives transactions on EU27 trading venues.

The simplest approach may be to automatically “recognise” under UK law all trading venues that are Regulated Markets, MTFs and OTFs or are third country trading venues under MiFID II as at exit day.

Possible mitigation by industry

In order to mitigate a potential loss of access to the UK market, EU27 trading venues may consider set up a trading venue in the UK in order to preserve access. Doing so before 30 March 2019 would be challenging, given the operational and commercial complexities, and regulatory approvals required.

UK firms could seek to conduct the relevant business through an EU affiliate.

© FIA, December 2017

Access to EU27 CCPs from the UK

In remains unclear whether, as a matter of UK law, EU27 CCPs will again become capable of being designated Recognised Overseas Clearing Houses.

Worst case scenario

Loss of access for UK market participants to EU27 CCPs, resulting in reduced liquidity at such CCPs and a more limited choice of CCPs for UK firms when seeking to comply with UK law mandatory clearing obligations.

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: In order to address these and other areas of uncertainty under UK law, HMTreasury and UK regulatory authorities could:

- **provide clarity as to whether and how they will enable their Recognised Overseas Clearing House regime to apply to non-UK central counterparties: will they amend their rules so that the UK's Recognised Overseas Clearing House regime under s292 FSMA 2000 can once more apply to central counterparties (this has not been possible since EMIR was implemented in 2013), in order to retain ability to serve UK firms, or will some other mechanic apply?**
- **to the extent necessary, permit EU27 CCPs to submit applications for the relevant UK regulatory authorisations/exemptions now, so that they can be in place in time for exit day - The simplest approach may be to automatically "recognise" under UK law all trading venues that are Regulated Markets, MTFs and OTFs or are third country trading venues under MiFID II as at exit day;**
- **establish the relevant regulatory co-operation agreements with EU27 regulatory authorities in time for exit day; and**
- **confirm that, as a matter of UK law, UK firms will be permitted to be members of EU27 CCPs and can use recognised EU27 CCPs to satisfy any future UK law mandatory clearing obligation.**

Access to EU27 Trade Repositories from the UK

As noted above, 5 of the 7 trade repositories authorised by ESMA to-date are located in the UK. It is therefore typically the case that UK established firms are reporting to UK located trade repositories. There will be exceptions, however. We are not aware of any public statements made by the UK government nor regulatory authorities regarding the future access of UK-established firms to EU27 trade repositories, nor of any EU proposals to limit UK firms' access to EU27 trade repositories post-exit day.

Worst case scenario

It is unclear whether, and on what basis, UK regulatory authorities would continue to have access to the data previously reported to EU27-located trade repositories or whether UK firms could continue to use EU27 trade repositories.

© FIA, December 2017

Possible mitigation by legislators and regulators

PREFERRED OUTCOME: ESMA, the European Commission and UK regulatory authorities could start the process of agreeing co-operation agreements with UK regulatory authorities, with a view to such agreements being in place by exit day. Such an approach would also help ensure uninterrupted access by UK regulatory authorities to the trade data stored at EU27 trade repositories (both with respect to legacy and future trades).

Possible mitigation by industry

In order to ensure that they are able to continue to service UK clients without disruption, EU27 trade repositories could seek to relocate their business to an establishment in the UK.

© FIA, December 2017

PART 2: TRANSITIONAL ARRANGEMENTS

In this section, we set out FIA's view as to how transitional arrangements should operate. As regards the policy rationales for implementing a transition period, please see the written evidence[36] submitted on 31 January 2017 by FIA to the UK Parliament's Treasury Select Committee in relation to its consultation on Brexit transitional arrangements.

In summary, FIA considers that a transition period is essential in order to minimise disruption and to procure a smooth and orderly transition to the post-Brexit legal and regulatory environment.

Such transition period would be hybrid in nature, essentially comprising two parts:

1. **a bridging period:** it would comprise standstill and grandfathering arrangements in order to mitigate the "cliff effect" of the UK's withdrawal from the European Union; and
2. **an adaptation period:** it would also afford the global cleared derivatives industry the time it needs in order to make the necessary adjustments in a way that minimises disruption, promotes financial stability and mitigates operational risk.

An adaptation period of at least two years would significantly improve the likelihood of firms being compliant with the new UK and EU27 requirements in a timely manner and in a way that mitigates concerns regarding financial stability and operational risk.

Critically, industry should only have to adjust to one set of regulatory changes.

The adaptation part of any transition period can only commence once the new arrangement has been agreed and enacted into law so that the industry can prepare itself and transition towards the new regulatory framework. It is not possible to use a transition period to "transition" if the final outcome remains uncertain.

What would the industry do during a transition period?

The actions required during a transition period will depend upon the eventual end-state and the steps taken by policy makers. Some of the steps below would not be required if there is full equivalence, recognition and if UK firms can successfully register as third-country firms under Article 46 of MiFIR, for example.

Execution and clearing brokers

Execution and clearing brokers would move some or all of their client and market infrastructure relationships from their UK entities to their EU27 affiliates. This is an extremely complex legal and operational process that involves:

- obtaining the necessary domestic and international regulatory approvals and licences to enable their EU27 affiliate to perform the role of execution and clearing broker;
- the movement of positions and collateral from UK CCPs to EU27 CCPs;

36 https://fia.org/articles/fia-comments-brexit-transitional-arrangements

© FIA, December 2017

- establishing funding and liquidity arrangements necessary to meet the increased demands for liquidity, collateral and default fund contributions as a result of the fragmentation of portfolios;
- increasing the capitalisation of EU27 affiliates;
- moving and/or establishing from ground-up entire IT architectures for EU27 affiliates and connectivity of the same to group architecture;
- staff relocations and local hiring at EU27 subsidiaries;
- acquiring new office space in EU27 locations and expanding any existing office space;
- novating give-up documentation from the UK entities to the EU27 entities;
- replacing customer documentation, to govern the relationship between the client and the EU27 subsidiary – and updating existing template documentation in order to comply with the new legal and regulatory regimes in the UK and EU27;
- in some instances, the complete legal and operational re-wiring of intra-group relationships of the execution and clearing brokers, in particular with respect to:
  - the execution and clearing of trades on a trans-Atlantic basis (indirect clearing);
  - intra-group funding and liquidity requirements etc.;
  - the movement of data across group companies in accordance with the EU's Global Data Protection Regulation (GDPR);
- to the extent possible and not already in place, the establishment of memberships on EU27 trading venues and CCPs – this is a significant legal and operational task that requires significant testing prior to go-live;
- to the extent possible and not already in place, the establishment of relationships with replacement trade repositories;
- obtaining updated netting and enforceability opinions;
- decommissioning of some existing resources in UK; and
- as noted above in this paper, the various challenges of moving legacy trades, if required.

Those firms who decide that all of the above steps render their client cleared derivatives service insufficiently profitable (or not profitable at all) in relation to clients in the EU27 would use the transition period to "off-board" clients, transfer client relationships to alternative providers and to decommission their existing franchise. Retaining access to EU27 trading venues and CCPs via EU27 affiliates for non-EU27 clients, if required, would likely be a simpler and less expensive process.

UK trading venues, CCPs and trade repositories

UK trading venues, CCPs and trade repositories would:

- apply for the applicable regulatory approvals under EMIR and MiFIR to enable them to service EU27 market infrastructure, members and end-users;
- amend their rulebooks to reflect the new UK (and, potentially, EU) laws that apply to them from the end of the transition period; and
- consider and implement new membership applications, carrying out KYC and AML checks, IT testing etc.

© FIA, December 2017

EU27 trading venues, CCPs and trade repositories

EU27 trading venues, CCPs and trade repositories would:

- apply for the applicable regulatory approvals and/or exemptions under the new UK regulatory regime to enable them to service market infrastructure, members and end-users established in the UK;
- amend their rulebooks to reflect the new EU laws that apply to them from the end of the transition period; and
- consider and implement new membership applications, carrying out KYC and AML checks, IT testing etc.

© FIA, December 2017

PART 3: CONCLUSION - FIA MEMBERS' PREFERRED OUTCOMES

In this section, we conclude with FIA members' preferred outcomes and the key steps necessary to bring them about. Whilst the industry is able to take some of the mitigating actions set out above in this paper, such mitigants are not perfect solutions. Their implementation would in all cases result in significant expense, fragmentation and potential reduced access to the trading and clearing of derivatives, in both the UK and the EU27.

A significant amount of action can be taken now by the EU27 and the UK to promote fair and safe markets in accordance with their regulatory objectives, without needing to wait for transitional arrangements to be agreed. Such an approach by policy makers would improve the quality of industry's contingency planning, avoid unnecessary cost expenditure and avert undue fragmentation of markets.

As set out in more detail above, the EU27, the UK and third countries all have a mutual interest in:

- **minimising the potential disruption that could be caused by Brexit:** this objective can be achieved through a combination of (i) the UK and EU27 agreeing to a transition period, comprised of a standstill period and an adaptation period – the latter should last at least two years, (ii) regulatory mitigation; and (iii) to some extent, mitigating actions taken by industry participants;
- **avoiding fragmentation of cleared derivatives markets:** this objective can be achieved through bilateral equivalence and recognition arrangements, and by the UK and EU27 entering into enhanced information-sharing, regulatory co-operation and co-ordination arrangements; and
- **maintaining full access to global pools of liquidity:** this objective can be achieved by the UK and EU27 granting equivalence with respect to one another's regulatory regimes, recognition of their respective market infrastructure and by permitting clients in their jurisdiction to be serviced by execution and clearing brokers located in the other's jurisdiction. UK regulatory authorities should also agree bilateral recognition arrangements with other third countries, so as to avoid loss of market access to and from such countries from exit day.

Accordingly, FIA members' preferred outcomes are as follows:

Minimise disruption

Throughout 2017, FIA has strongly encouraged UK and EU27 leadership to agree a clear, bilateral, deal on transitional arrangements before the end of this year and to establish a future UK/EU27 relationship that addresses the concerns set out in this paper. Such a deal on transitional arrangements should be agreed as soon as possible.

Such transition period would be hybrid in nature, essentially comprising two parts:

1. a bridging period: it would comprise standstill and grandfathering arrangements, in order to mitigate the "cliff effect" of the UK's withdrawal from the European Union; and

© FIA, December 2017

2. an adaptation period: it would also afford the global cleared derivatives industry the time it needs in order to make the necessary adjustments to comply with the future regulatory regime.

An adaptation period of at least two years' duration would significantly improve the likelihood of firms being compliant with the new UK and EU27 requirements in a timely manner and in a way that mitigates concerns regarding financial stability and operational risk.

Critically, industry should only have to adjust to one set of regulatory changes, so no new regulatory requirements should apply during such transition period.

As regards the policy rationales for implementing a transition period, please see the written evidence[37] submitted on 31 January 2017 by FIA to the UK Parliament's Treasury Select Committee in relation to its consultation on Brexit transitional arrangements.

Co-operation, rather than forced fragmentation

FIA strongly advocates for the UK and EU27 regulatory and supervisory authorities to enter into enhanced information-sharing, regulatory co-operation and co-ordination arrangements to address one another's valid and legitimate concerns, rather than promoting regulatory policies (such as the "forced relocation" of derivatives clearing) that would lead to the detrimental fragmentation of markets, capital, collateral and liquidity. Such arrangements have been successfully implemented by the UK with other third country regulatory authorities and could serve as a template for a UK-EU27 arrangement.

Maintain full access to global pools of liquidity

The primary *raison d'être* for the global cleared derivatives industry is to provide efficient tools that enable companies to manage their risk, in a way that promotes financial stability. The deep pools of liquidity that enable firms to trade in and out of derivatives positions at competitive prices, as and when needed, are concentrated at various trading venues and clearing houses (CCPs) around the world. Depending upon the product, that liquidity may be concentrated in market infrastructure in the EU27, in the UK or in third countries. The UK and/or EU27 may have no substitutes at which one can currently trade or clear those specific risk management products. It is therefore imperative to ensure that UK and EU27 users of cleared derivatives markets are not cut-off from their ability to access such global pools of liquidity.

On and from exit day, FIA members therefore recommend the following key steps:

i) the EU27, ESMA and the European Commission grandfather the EU regulatory approvals of UK market infrastructure (trading venues, CCPs and trade repositories) as at such date, pending the completion of the application process for recognition of UK CCPs and trade repositories under EMIR and approval of UK trading venues as third country trading venues under MiFID II - in the interests of minimising disruption, UK market infrastructure should be permitted to submit complete applications to ESMA for recognition as soon as possible, rather than waiting until the UK has left the European Union. It is essential that UK CCPs retain their "QCCP" status under the Capital Requirements Regulation during such grandfathering period;

37 https://fia.org/articles/fia-comments-brexit-transitional-arrangements

© FIA, December 2017

ii) the UK regulatory authorities grant equivalence and recognition under UK law to the following, on and from exit day:

- EU27 trading venues authorised under MiFID II;
- EU27 CCPs authorised under EMIR; and
- EU27 trade repositories registered under EMIR.

iii) ESMA and the UK regulatory authorities enter into the necessary cooperation arrangements required under EMIR, MiFID II and MiFIR to promote bilateral access to one another's market infrastructure. Work on those arrangements can already be commenced and does not need to wait until the UK withdraws from the EU;

iv) the European Commission grant equivalence to the UK under Article 47 of MiFIR, so as to enable ESMA to register UK firms as third country firms under MiFIR, thereby permitting such firms to continue to offer their services to EU27 clients from the UK;

v) the UK regulatory authorities correspondingly permit market access to UK clients by service providers located in the EU27, in reliance upon the UK's Overseas Persons regime; and

vi) the UK regulatory authorities discuss and agree bilateral recognition arrangements with other third countries, so as to avoid loss of market access to and from such countries. Whilst acknowledging that the EU acquis remains to be incorporated into UK law (subject to amendment), those new arrangements should be in place in on and from exit day to the fullest extent possible.

© FIA, December 2017

ANNEX: SUMMARY OF THE CONSEQUENCES OF "NO DEAL" AND POTENTIAL MITIGANTS

UK market access from the EU27

Issue	Potential Impact	Potential Mitigation
Loss of MiFID II status for UK trading venues and failure to be approved as a third country trading venue	■ EU27 counterparties would no longer be permitted to use UK trading venues to satisfy their mandatory trading obligation under MiFIR.	■ **PREFERRED OUTCOME: ESMA and European Commission could agree to grandfather the regulatory authorisations of UK regulated markets, MTFs and OTFs and agree co-operation agreements with UK authorities, pending such venues becoming third country trading venues.** ■ Global exchange groups could seek to establish an EU27 trading venue for such products. ■ EU27 counterparties could instead meet their mandatory trading obligation through execution on EU27 MTFs, OTFs or equivalent third country trading venues.
Loss of EMIR authorisation for UK CCPs and failure to gain EMIR recognition	■ EU27 participants of UK CCPs will not be able to satisfy their mandatory clearing obligation for derivatives on a UK CCP. ■ UK CCPs become prohibited under Article 25(1) of EMIR from having EU clearing members and from clearing for EU27 trading venues, due to licensing restrictions. Such outcome would be detrimental not only to the UK CCPs, but also to those EU27 clearing members, as they could be rendered less competitive than their international peers due to their inability to access as wide a range of CCPs for their clients' as their third country competitors ■ If EU27 counterparties mitigate this by using EU27 CCPs to clear derivatives subject to an EMIR clearing mandate, going forward, whilst third country counterparties continue to use UK market infrastructure to clear such transactions, there is a risk of a split in market liquidity that could result in a liquid UK market and a comparatively illiquid, and therefore more expensive, on-shore EU market.	■ **PREFERRED OUTCOME: ESMA and European Commission could agree to grandfather the EMIR authorisations of UK CCPs and agree co-operation agreements with UK authorities, pending such CCPs becoming "recognised" CCPs under EMIR.** ■ As a less desirable outcome, ESMA and the European Commission could consent to EU27 entities remaining as clearing members of UK CCPs insofar as is necessary to facilitate the reduction/close out of exposures at UK CCPs. ■ EU27 clearing members could seek to close out and/or port their legacy portfolios to an EU27 CCP. A cross-border transfer of positions from a CCP in one jurisdiction to a CCP in another jurisdiction is, however, unprecedented and untested. Such a bulk transfer involves significant market, operational and liquidity risk, high costs and amendments to various existing legal relationships. It is unclear whether the market has sufficient balance sheet capacity to support such a transfer. ■ To the extent that an EU27 CCP is able to clear such products (which is not the case for certain commodities, for example), EU27 clearing members and counterparties could increase the extent to which they clear new trades on EU27 CCPs rather than UK CCPs, so as to diminish the size of any legacy portfolio as at exit day. ■ Global CCP groups that don't already have one could seek to establish an EU27 CCP for such products and port the portfolios across. ■ In theory, market infrastructure groups could seek to inter-operate their UK CCPs with another EMIR authorised or recognised CCP, but this appears extremely difficult to operate in practice. ■ EU27 counterparties could instead meet their mandatory clearing obligation through the clearing of derivatives on other CCPs that are EMIR authorised in the EU27 or recognised third-country CCPs.

Continued on next page

© FIA, December 2017

UK market access from the EU27 *(continued)*

Issue	Potential Impact	Potential Mitigation
UK CCPs become "non-QCCPs" under CRR, as a result of being neither EMIR authorised nor recognised	■ The capital requirements for EU27 firms clearing on UK CCPs (to the extent still permitted) increase significantly, to the extent that they may cease clearing on UK CCPs ■ Thereby leading to reduced clearing in the UK and reduced access to clearing in the UK	■ In a similar vein to Article 497 of CRR, ESMA and European Commission could agree to grandfather the QCCP status of UK CCPs, pending such CCPs to becoming "recognised" CCPs under EMIR.
Settlement finality issues for UK CCPs and CSDs with respect to their EU27 members	■ In the event of the insolvency of an EU27 member of a UK CCP or CSD, system rules on finality may be overturned by national insolvency claw-back and moratorium rules ■ As a result, UK CCPs and/or CSDs may cease to permit EU27 members.	■ The Settlement Finality Directive could be updated so as to permit the "designation" of third country systems.
Potential loss of the ECB/Bank of England enhanced arrangements for information exchange and co-operation regarding UK CCPs and their swap line	■ Reduced access to euro liquidity by UK CCPs.	■ The ECB and Bank of England could re-affirm their commitment to their existing relationship in these areas.
Loss of EMIR registration for UK Trade Repositories and failure to gain EMIR recognition	■ EU27 firms would become legally prohibited from using UK trade repositories to satisfy their EMIR reporting obligations ■ Significant reduction in industry choice of trade repository providers (only 2 of the 7 trade repositories have been registered within the EU27) ■ EU regulatory authorities may lose access to the data stored at UK trade repositories (being 5 of the 7 trade repositories currently registered or recognised under EMIR)	■ ESMA and European Commission could agree to grandfather the EMIR registration of UK trade repositories and agree co-operation agreements with UK authorities, pending such trade repositories becoming "recognised" trade repositories under EMIR.
Loss of access to UK clients by EU27 established execution and clearing brokers	■ Reduced access to execution and clearing services in the EU27 by UK firms ■ Reduced revenue for EU27 execution and clearing brokers ■ UK clients need to find alternative service providers	■ **PREFERRED OUTCOME: The UK regulatory authorities could publicly confirm that they will continue to operate the UK's Overseas Persons Regime in the same manner as it does today.** ■ EU27 service providers could either: ❑ Establish a UK affiliate; ❑ Establish a UK branch; or ❑ Seek to rely on the Overseas Persons Exemption. ■ UK clients could seek alternative service providers ahead of exit day.
UK loses the benefit of EU equivalence arrangements with other third countries	■ Reduced, or loss of, market access to/from the UK with respect to such third countries	■ The UK regulatory authorities could seek to agree bilateral recognition arrangements with all applicable third countries, with effect on and from exit day.

© FIA, December 2017

EU27 market access from the UK

Issue	Potential Impact	Potential Mitigation
Loss of MiFIR passporting rights and failure of the UK to gain the "third country" passport under Article 46 MiFIR	■ Fragmentation of liquidity – a bifurcation of portfolios that would result from (i) a UK affiliate of the clearing member clearing for all "third country" clients (ii) and an EU27 affiliate of the clearing member clearing for all EU27 clients ■ That bifurcation of client cleared portfolios across two affiliates could result in a duplication of clearing memberships at each CCP (one membership for the UK affiliate of the clearing member and a second membership for the EU27 affiliate that is clearing for EU27 clients), which in turn leads to increased costs for end-users and the real economy as a result of the passing on of the following costs: ❑ Increased capital requirements for clearing members and their prudentially regulated EU27 clients, which could in turn lead to reduced access to central clearing ❑ Increased leverage ratio usage for clearing members, because the leverage ratio calculation takes into account the netting benefits across a portfolio to determine the clearing firm's exposures. If the portfolio becomes fragmented across two affiliates through whom clearing services are provided, the netting benefits are reduced, the leverage ratio increases and, accordingly, the amount of balance sheet capacity for the group providing the clearing service also increases as a whole – even though the portfolios that are actually being cleared have not changed, merely the identity of the clearing brokers being used to clear those portfolios ❑ Increased margin requirements for clearing members and end users ❑ Increased default fund requirements for clearing members ❑ Increased operational risk ❑ Increased liquidity requirements	■ **PREFERRED OUTCOME:** **In the medium term:** ❑ **the European Commission could adopt an equivalence decision under Article 47 of MiFIR with respect to the UK** ❑ **the UK regulatory authorities and ESMA could enter into co-operation arrangements under Article 47(2) of MiFIR** ❑ **ESMA could then register UK affiliates as third-country firms under Article 46 of MiFIR.** **In the short term, EU27 Member States could confirm that they will continue to permit, under their national laws, UK firms to service EU27 wholesale clients and to conduct MiFID II investment activities and investment services in their EU member state, without the need to establish a local affiliate or branch.** ■ Firms could establish an EU27 affiliate and transfer over to that affiliate the legal relationships that their UK affiliate currently has in place with their EU27 clients (or all clients for whom their clear derivatives on EU27 CCPs), so as to enable them to continue to rely on the MiFIR EU passport.
Third-country firms are unable to provide direct electronic access (DEA) for clients with respect to EU27 trading venues	■ Reduction in the provision of DEA for EU27 trading venues, leading to a potential reduction in liquidity ■ Increased costs that result from a restructuring of DEA providers' business ■ Decreased market access to EU27 trading venues, leading to lower liquidity and/or concentration of activity through a smaller number of DEA providers.	■ UK-based members of EU27 trading venues could either: ❑ Establish a presence in an EU27 member state and switch trading venue memberships to that EU affiliate; or ❑ Restructure their business in such a way that they are no longer a DEA provider.

Continued on next page

© FIA, December 2017

EU27 market access from the UK *(continued)*

Issue	Potential Impact	Potential Mitigation
Uncertainty as to the extent that, post-Brexit, UK firms will be permitted under UK law to be members of EU27 trading venues or to satisfy mandatory trading obligations under UK law through the trading of derivatives on EU27 trading venues	■ Loss of access for UK market participants to EU27 trading venues ■ Reduced access to trading ■ Loss of access to liquidity at EU27 trading venues by UK firms ■ Limited choice of execution venues for UK firms when seeking to comply with UK law mandatory trading obligations	■ **PREFERRED OUTCOME: UK regulatory authorities could confirm:** ❑ **how the UK will amend its Recognised Overseas Investment Exchange regime;** ❑ **whether it proposes to automatically "recognise" under UK law all EU27 trading venues that are Regulated Markets, MTFs and OTFs or third country trading venues under MiFID II as at exit day;** ❑ **the extent to which, as a matter of UK law, the UK will continue to permit UK firms to act as trading members on EU27 trading venues; and** ❑ **if, and on what basis, UK firms can meet any future mandatory trading obligation by executing derivatives transactions on EU27 trading venues.** ■ EU27 trading venues could establish a UK trading venue to service the UK market. ■ UK firms could seek to conduct the relevant business through an EU affiliate.
Uncertainty as to the extent that, post-Brexit, UK firms will be permitted under UK law to be members of EU27 CCPs or to satisfy mandatory clearing obligations under UK law through the clearing of derivatives on EU27 CCPs	■ Loss of access for UK market participants to EU27 CCPs ■ Reduced access to clearing. ■ Loss of access to liquidity at EU27 CCPs by UK firms ■ Limited choice of CCPs for UK firms when seeking to comply with UK law mandatory clearing obligations	■ **PREFERRED OUTCOME: UK regulatory authorities could:** ❑ **confirm how the UK will amend its Recognised Overseas Clearing House regime;** ❑ **permit EU27 CCPs to submit applications for the relevant UK regulatory permissions now, so that they can be in place for exist day** ❑ **confirm whether they propose to automatically "recognise" under UK law all CCPs that are authorised or recognised under EMIR;** ❑ **enter into cooperation arrangements with EU regulatory authorities** ❑ **confirm that, as a matter of UK law, UK firms will be permitted to be members of such CCPs and to use recognised EU27 CCPs to satisfy any future UK law mandatory clearing obligation.** ■ EU27 CCPs could establish a UK CCP to service the UK market. ■ UK firms could seek to conduct the relevant business through an EU affiliate.
Contractual uncertainty resulting from possible illegality of the continued offering of clearing services to EU27 clients from a UK affiliate	■ Termination of agreements between end users, executing brokers and clearing brokers, with a corresponding loss of market access	■ Executing brokers and clearing members could seek to migrate their legal relationships with their EU27 clients from their UK affiliate to an EU27 affiliate.
Loss of UK access to EU27 trade repositories	■ UK regulatory authorities may lose access to the data stored at EU trade repositories	■ ESMA and European Commission could agree co-operation agreements with UK authorities and the UK could recognise EU trade repositories

© FIA, December 2017

LONDON
Level 28, One Canada Square
Canary Wharf
London E14 5AB
Tel +44 (0)20.7929.0081

SINGAPORE
Level 21, Centennial Tower
3 Temasek Avenue
Singapore 039190
Tel +65 6549.7333

WASHINGTON
2001 Pennsylvania Avenue NW
Suite 600
Washington, DC 20006
Tel +1 202.466.5460

FIA.org