

# Structured Capital Markets & Derivatives

London

BAKER & MCKENZIE

## Client Alert



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## Brexit: Three key stages for structured financial markets participants to consider

On 23 June 2016, a referendum was passed in the UK for it to exit from the European Union (EU), so called "Brexit". Whilst the result of the Brexit referendum had an immediate impact on global equity, bond and currency markets there should be no immediate *legal* impact from the referendum decision. As the UK's Financial Conduct Authority (FCA) stated in its [statement](#)<sup>1</sup> in response to the referendum result:-

*"Much financial regulation currently applicable in the UK derives from EU legislation. This regulation will remain applicable until any changes are made, which will be a matter for Government and Parliament.*

*Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect."*

More detail on the short, mid and long term impact of Brexit on the structured finance market is given below. In summary it is important to note that:-

- It is likely that the UK legal position will remain unchanged for at least two years (if not longer), during which time securitisation, derivatives and capital markets business, from a legal perspective at least, will continue as usual.
- A UK withdrawal from the EU should not have any significant impact on decisions concerning the popular use of English governing law clauses and/or English court jurisdiction clauses, as further explained below.

For a fuller description of the potential models and possible outcomes of the UK vote to leave the EU see our [Brexit website](#).

<sup>1</sup> <https://www.the-fca.org.uk/statement-european-union-referendum-result>

## Short Term

### *Legal position*

Following the referendum result for Brexit, a financial market participant's ability to transact with UK counterparties, to choose English law as the governing law for those contractual arrangements and to agree to submit to the jurisdiction of the English courts, remains unchanged (see our [Brexit Blog](#) for full discussion). The Brexit vote was an advisory vote and has no direct effect on any English legislation or statutory instrument presently in force in the UK. Even following a formal Brexit, the UK government will still have to be mindful of its international commitments<sup>2</sup>. Moreover there is unlikely to be any incentive for the UK government to amend UK financial regulations in a way that would make the UK uncompetitive, or to remove protections provided to financial markets<sup>3</sup>.

As the FCA makes clear, any new EU legislation coming into force in the near future will still come into force and must be adhered to by market participants. Therefore market participants must continue to implement such EU legislation in accordance with the current timetable. Importantly for the financial markets, this includes:-

- **Liquidity Coverage Ratio (LCR)** provisions under the Capital Requirements Regulation - which is in force and subject to on-going phase-in;
- **EMIR Clearing obligation** - which is in force and subject to on-going phase-in for some interest rate products - Category 2 entities from 21st December 2016, and is scheduled to extend to cover certain credit derivatives and other interest rate products during 2017;
- **MAR (Market Abuse)** - the new regime takes effect on 3rd July 2016;
- **EMIR Margin for uncleared derivatives** - recently delayed and expected to commence phase-in from mid 2017;
- **MiFID II / MiFIR** - the new framework takes effect on 3rd January 2018;
- **STS (simple transparent and standardised) securitisation** - there is on-going work to establish a set of EU Criteria governing STS securitisation, likely to be agreed in early 2017; and

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<sup>2</sup> For example those made as part of the G20 Pittsburg Summit in 2009 with respect to derivatives, on clearing, transaction reporting, risk mitigation for uncleared derivatives and electronic trading, which were later supplemented by commitments with respect to margin for uncleared transactions as part of the BCBS/ IOSCO WGMR process.

<sup>3</sup> Such as the UK Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) which implement the EU Financial Collateral Directive in the UK to support the taking of financial collateral by protecting close-out netting, clarifying conflict of laws and disapplying certain insolvency mechanisms.

- **CMU (Capital Markets Union)** - the package of measures including a new Prospectus Regulation; an EU-wide insolvency regime and the STS framework - recently announced.

#### *Market Impact*

In the run up to the vote and following the result there was increased volatility in the financial markets generally as well as in property and mortgage markets more specifically. While there is no need to change the legal framework for financial market transactions simply by virtue of the Referendum outcome, there are some short term impacts to consider:-

- **Two year withdrawal process** - may impact the appetite of issuers and investors to participate in the UK structured finance market and we may expect a slowdown in market activity in the short term;
- **UK Sovereign downgrade by the rating agencies** - since issue ratings are typically capped at the Sovereign rating ceiling, will lead to rating agency review of existing deals and, subject to the particular contractual terms of a deal, may have an impact on UK based asset backed securitisation (ABS) transaction counterparties' involvement;
- **Risk disclosure** - we expect language will be incorporated into new issuance transaction documents to reflect the uncertainty over the impact of Brexit;
- **Margin calls** - the value of derivatives transactions will be impacted which may lead to consequences for the derivatives market including an increased number and size of collateral calls and collateral eligibility issues. Subsequent counterparty creditworthiness concerns may follow;
- **Triggering of Market Disruption Events** - the movement in the underlying markets may lead to triggering of specific provisions in derivatives documentation (if applicable) such as Market Disruption Events, Change in Law or Increased Costs of Hedging provisions; and
- **Passporting arrangements** - potential loss of passporting rights may impact: (i) issuers considering listing on UK markets (although this may be mitigated by the ability to list on exchange-regulated markets thus avoiding the full Prospectus Directive regime); (ii) the cross EU provision of banking services and authorisation of branches (for detailed coverage of this area see our Financial Services [Client Alert](#)).

## Mid Term

In the next couple of years, specific legislation may be put forward to replace the present legislative framework that has been derived from EU Regulations. See our [Brexit website](#) for an explanation of the difference between EU Regulations and Directives. It may be that there is insufficient time for the entirety of the financial regulations to be revisited and amended or replaced by the time the UK formally withdraws from the EU. Indeed there is little incentive for the UK to do so, given that it has played a leading role in the development of those regulations. It seems reasonable to assume that in order to have a smooth transition the UK might introduce legislation to provide continuity of EU financial regulation for a period of time after its exit from the EU. Given the cross border nature of the derivatives markets and the importance of the financial markets to the UK economy, it also seems reasonable to conclude that the UK will be mindful of international standards and harmonisation so as not to prejudice UK entities in the global market place. Harmonisation efforts globally already provide a framework for mutual recognition, equivalence, substituted compliance in many of the regulatory requirements which the UK government would want its UK-based businesses to be able to avail themselves of.

Possible areas where the structured finance markets may be impacted on a mid term basis include:-

- **Potential non-eligibility of ABS for ECB repo** - the eligibility criteria governing issuers' access to the European Central Bank repurchase facility (under which certain securities may be used as collateral for ECB funding) requires that: (i) the issuer, seller and obligors are based in an EEA jurisdiction; and (ii) the acquisition of the underlying assets is governed by an EEA law;
- **Potential non-eligibility of certain assets for LCR purposes** - the LCR allows some ABS and RMBS to be classed as "high quality liquid assets" and therefore eligible for use in a bank's LCR calculations, however certain asset classes<sup>4</sup> must be originated in an EU Member State;
- **Potential non-eligibility of UK based transaction counterparties for STS purposes** - the current draft STS Regulations require the originator, sponsor and special purpose vehicle all to be established in the EU. This could impact both UK issuers' appetite to issue ABS and investors' appetite for non-EU ABS;
- **Counterparties seeking to pre-empt the triggering of contractual provisions** - such as ISDA Tax Event Termination Event if parties are relying on UK/EU Tax Treaties to obtain favourable withholding tax treatment;

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<sup>4</sup> Specifically SME loans, auto loans, consumer loans and consumer credit assets.

- **Concern over triggering of ISDA Termination Events** - Counterparties may seek to question whether Illegality or Force Majeure provisions are triggered which, although unlikely since it would require performance to be prevented or become unlawful, impossible or impracticable, may lead to an increase in management of disputes;
- **ISDA/FIA Addendum triggered** - whilst not directly impacted a given CCP's rules will need to be considered; and
- **ISDA Representations** - whether certain representations and agreements continue to hold true may need to be considered.<sup>5</sup>

## Long Term

The long term implications for the UK of a Brexit are likely to be profound however the direct effect on structured finance markets is likely to be limited. Any transitional continuity financial regulation may be revisited on a prioritised basis by the UK government. The UK may seek to replace any positions with which it strongly disagreed in the EU negotiations (for example the bonus cap). In the longer term it is to be hoped that the position regarding a number of areas of cross border impact will be formalised such as:

- Choice of laws, submission to jurisdiction and enforcement of judgments;
- Cross border insolvency proceedings, and recovery & resolution regimes for financial market participants; and
- Harmonisation of financial regulation. It is to be hoped that, notwithstanding any UK withdrawal from the EU, efforts to harmonise global financial regulation will continue such that compliance with key regulatory requirements affecting cross border financial market participants will be facilitated through the use of mutual recognition / equivalence / substituted compliance regimes.

Until such time the English common law and existing financial legislation in the UK will continue to provide a commercial, predictable and respected framework for on-going derivatives trading and structured capital markets activity.

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<sup>5</sup> For example Section 3(a)(iii) (no Violation or Conflict with laws) & Section 3(a) (iv) (Compliance with Consents); Section 4 (Agreements).

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## Baker & McKenzie's Structured Capital Markets Practice - London

Baker & McKenzie is one of the world's leading international structured capital markets practices and we have developed a vast wealth of experience and talent around the world which we harness to provide an unparalleled global service to our clients. Our approach is to provide practical, professional and cost-effective advice. We act for a diverse client base including corporate end-users both multinational and domestic, investment and commercial banks, governmental and supranational entities, insurance companies, financial market intermediaries, funds and investors. Our wide client base gives us a unique view of all aspects of the global structured finance markets. We advise on derivatives regulation, clearing and the full range of derivative products from OTC derivatives and exchange traded products to debt capital markets instruments and securitisation structures.

### Our Brexit website and client resources

As a leading global law firm, Baker & McKenzie is closely following Brexit developments and evaluating the implications of what this means for our clients.

We have also developed resources to assist our clients to better understand the implications of Brexit on their businesses, which can be accessed via this [link](#). We will be updating these resources as more information becomes available so that it remains a relevant and useful resource to our clients.

### How we can help

Baker & McKenzie has extensive experience in assisting international businesses to operate, trade and invest in the UK and EU. We have established a Working Group across a range of offices, practice and industry groups to monitor developments regarding Brexit and assist our clients to understand and manage the implications of the UK withdrawing from the EU.

Please feel free to contact any of your usual SCM contacts or the members of the Working Group listed on our [Brexit website](#).

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