

MEMO# 31497

November 26, 2018

Recent ESMA Actions on Derivatives in Advance of Brexit

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November 26, 2018 TO: Derivatives Markets Advisory Committee
ICI Global Trading & Markets Committee RE: Recent ESMA Actions on Derivatives in Advance of Brexit

The European Securities and Markets Authority (ESMA) recently took two actions designed to mitigate concerns that the impending withdrawal of the United Kingdom from the European Union will disrupt the over-the-counter (OTC) derivatives markets. On 8 November, ESMA issued a final report with draft regulatory technical standards (RTS) that would provide relief from the clearing obligation for OTC derivatives contracts that an EU market participant novates from a UK counterparty to a counterparty established in an EU Member State as a consequence of Brexit.[\[1\]](#) On 23 November, ESMA issued a public statement on managing risks of a no-deal Brexit in the market for derivatives contracts cleared through a central counterparty (CCP).[\[2\]](#)

Final Draft RTS Providing Temporary, Limited Relief from the Clearing Obligation Following Brexit

After Brexit, UK entities may no longer be able to provide investment services in the European Union under the current passport regime. Accordingly, UK counterparties to derivatives transactions may be unable engage in certain derivatives-related activities with EU counterparties, including novating or unwinding existing trades.[\[3\]](#) To address this situation, EU market participants might choose to novate their existing, uncleared derivatives contracts with UK counterparties to EU counterparties.

Novation, however, could trigger new regulatory requirements. Article 5 of the European Market Infrastructure Regulation (EMIR) establishes a clearing obligation for OTC derivatives that presently applies to certain interest rate and credit default swaps.[\[4\]](#) In general, the clearing obligation applies to swaps entered into after the obligation's effective date, but it does not apply to legacy swaps, i.e., preexisting swaps that were entered into before the clearing obligation took effect.[\[5\]](#) This means that if an EU counterparty novates a legacy transaction, the OTC derivative(s) that result from the novation would be subject to the EMIR clearing requirement. According to the final report, this "would represent a clear disincentive to transfer contracts to firms established in the EU" and would put EU counterparties facing UK counterparties at a disadvantage compared to EU counterparties facing other EU counterparties.[\[6\]](#)

The final draft RTS are designed to reduce this disincentive and facilitate the transfer of contracts to counterparties established in the EU while preserving the regulatory characteristics of the existing OTC derivatives contracts. The RTS would create a twelve-month window following Brexit for EU counterparties to novate transactions with UK counterparties to EU counterparties without triggering the application of the clearing obligation. ESMA recommends that market participants start negotiating their novations as soon as possible to ensure that they will benefit from the time-limited exemption from the clearing obligation. Should counterparties agree on the terms of a novation before the RTS take effect, they can provide that the novations “would take effect only upon the occurrence of Brexit.”^[7]

In terms of next steps, the final draft RTS have been sent to the European Commission for adoption, after which they will be subject to the scrutiny of the European Parliament and Member States.

ESMA Public Statement on Access to UK CCPs

To address potential risks of disruption in the market for centrally-cleared derivatives products, ESMA published a public statement on 23 November supporting continued access to UK CCPs in the wake of a no-deal Brexit. According to the statement, ESMA is engaging with the European Commission to take preparatory actions for the recognition process of UK CCPs in the event of a no-deal Brexit. ESMA’s announcement follows a European Commission statement asserting that the Commission would adopt a temporary and conditional equivalence decision for UK CCPs to ensure that a no-deal Brexit would not disrupt central clearing.^[8]

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endnotes

^[1] See Final Report EMIR RTS on the novation of contracts for which the clearing obligation has not yet taken effect (8 Nov. 2018), *available* at https://www.esma.europa.eu/sites/default/files/library/esma70-151-1854_final_report_on_the_co_regarding_novated_trades_to_the_eu.pdf (Final Report). ESMA did not conduct any open public consultation on these final draft RTS, “given the urgency” of reducing legal uncertainty. *See id.* At 2.2

^[2] See Managing risks of a no-deal Brexit in the area of central clearing (23 Nov. 2018), *available* at https://www.esma.europa.eu/sites/default/files/library/esma70-151-1948_managing_risks_of_a_no-deal_brexit_in_the_area_of_central_clearing.pdf.

^[3] See Final Report at 2.1.

^[4] See ICI Memorandum No. 29845 (20 Apr. 2016), *available* at https://www.ici.org/my_ici/memorandum/memo29845 (describing the compliance schedule for credit default swaps subject to the EU’s clearing obligation); ICI Memorandum

No. 29522 (3 Dec. 2015), available at https://www.ici.org/my_ici/memorandum/memo29522 (describing the compliance schedule for interest rate swaps subject to the EU's clearing obligation).

[5] As a technical matter, the EMIR clearing obligation does apply to some legacy transactions, but complying with this frontloading requirement has proven operationally difficult and the European Commission, Parliament, and Council are considering legislation that would eliminate it.

[6] Final Report at 2.1.

[7] Final Report at 2.2.

[8] See European Commission, Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: a Contingency Action Plan (13 Nov. 2018), *available at* https://eur-lex.europa.eu/resource.html?uri=cellar:3dd5b905-e829-11e8-b690-01aa75ed71a1.0001.02/DOC_1&format=PDF.

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