Contractual Continuity in OTC Derivatives

Challenges with Transfers

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Introduction and summary

The issue of contractual continuity in the over-the-counter (OTC) derivatives market following the exit of the UK from the EU (referred to herein as '**Brexit**') is a subject of considerable concern to firms and their clients and counterparties and should, we believe, be of considerable concern to UK and EU-27 regulators and policymakers alike.

In the context of Brexit, contractual continuity relates to existing transactions and refers to both:

- The ability to perform contractual obligations agreed under existing transactions. In other words, is it still legally permissible to perform these contractual obligations? And if not, are the contracts still valid and enforceable?
- The ability to perform other important lifecycle events (including risk management activities) for such transactions. Such lifecycle events are important both to regulators (EMIR RTS mandate market participants to seek to engage in portfolio compression exercises, for example) and market participants.

As we have said previously, we do not believe Brexit will make it illegal for firms to perform contractual obligations under existing contracts in most (if not all) Member States, and thus should not affect the legal validity of existing transactions.

However, if performance of lifecycle events on existing contracts between UK and EU-27 market participants is not legally permissible following Brexit, this is likely to impair the ability of UK and EU-27 counterparties to existing contracts to manage their exposures and risks.

Thus, the loss of EU financial passporting rights after Brexit will have implications for cross-border OTC derivatives contracts between UK and EU-27 firms and their EU-27 and UK clients and counterparties respectively where those firms currently rely on an EU passport to trade cross-border in the EU-27 or the UK. Similar issues may also arise in relation to OTC derivatives contracts between some EU-27 firms operating through a branch in the UK and their EU-27 clients and counterparties to the extent that the EU passport is no longer available in relation to continuing activities of the UK branches after Brexit.

The implications of Brexit for future cross-border OTC derivatives contracts entered into by UK and EU-27 firms with their respective EU-27 or UK clients and counterparties after Brexit will be subject to the political negotiations surrounding the Withdrawal Agreement under Article 50 of the Treaty on European Union and on the future long-term relationship between the UK and EU. The treatment of ‘new business’ as part of the future long-term relationship is for the UK and EU negotiators to address and is not within the scope of this paper.

However, UK and EU-27 firms are also seeking to address the local licensing requirements that may be triggered if they retain and run off their stock of 'legacy' cross-border OTC derivative contracts with their respective EU-27 or UK clients and counterparties that may be outstanding when the UK exits the EU in March 2019. ISDA's analysis shows that additional regulatory uncertainty would ensue from the need to consider the different legal and regulatory approaches across each individual EU-27 Member State if firms retain and run off their portfolio of legacy cross-border contracts after Brexit.

A transition period under the Withdrawal Agreement would be important for the mitigation of these risks. However, there is no certainty that the UK and the EU will conclude a Withdrawal Agreement. In addition, even if the parties do conclude a Withdrawal Agreement that makes provision for an appropriate transition period, firms may still have OTC derivative contracts that extend beyond the end of the transition period to which the same considerations will apply as are discussed in this paper. Many market participants will seek to enter into new contracts from and through EU entities during this transition period, but the significant legal, operational and financial challenges that some sell- and buy-side firms will confront before they can execute new transactions in post-Brexit EU structures means that some new contracts will have to be entered into through existing structures (i.e. involving UK entities) and will expire post-Brexit or post-end transition period rather than rolling off after 2 years.

The focus of this paper is on the challenges faced by UK and EU firms and their clients seeking to avoid these uncertainties by transferring their legacy cross-border OTC derivative contracts to an appropriately licensed EU-27 affiliate in advance of Brexit.

Some UK firms' plans for relocating their business to an EU-27 affiliate may make use of statutory mechanisms that facilitate a transfer of legacy contracts without the need to seek the consent of each affected client or counterparty. However, these mechanisms are not available to or appropriate for all UK firms that conduct cross-border OTC derivatives business with EU-27 clients and counterparties.

The only alternative for many firms with respect to legacy contracts affected by these uncertainties is to seek the individual consent of each client or counterparty to the transfer of the rights and obligations of the UK firm under the relevant contracts to its EU-27 affiliate (the mechanism known as 'novation') in advance of Brexit. Firms have already carried out significant preparatory work on their novation projects and, in many cases, have already begun their outreach to clients and counterparties.

However, their progress in completing their novation projects is being affected by extrinsic factors outside their control, including possible regulatory actions (due to local law being unclear on whether authorization would be required) adversely affecting firms' assumptions about the treatment of lifecycle events and client cooperation and agreement. There are significant practical execution and timing challenges to completing such an exercise before Brexit, not least because of the scale and complexity of the process and because there are many reasons why clients may delay or even refuse their consent to a novation.

ISDA and AFME (the 'Associations') therefore consider that there is a strong case for action to address these risks by the official sector through the Withdrawal Agreement or by legislative or regulatory actions by the EU or individual Member States. The Associations consider that there should be an agreed solution for both the UK and the EU-27 that adequately protects clients and counterparties from disruption to their business and ensures financial stability. The Withdrawal Agreement should contain appropriate provisions both facilitating contract transfers or novations to EU entities and allowing firms to continue to service legacy contracts after the end of the transition period at least to the extent such transfers or novations cannot be effected within an appropriate amount of time. However, there should also be coordinated backstop arrangements that apply if a Withdrawal Agreement is not concluded. The UK has already indicated that it will act, if necessary, to address continuity of contract issues for EU-27 firms conducting business in the UK (for example, the UK Treasury has already announced that it is giving the UK regulators the power to grant temporary authorisation to EU-27 firms currently carrying on business in the UK, to enable them to carry on doing that business until they have obtained permanent authorisation). The Associations consider that the EU and its regulators should envisage putting in place comparable arrangements as appropriate.

The Risks to Legacy Contracts

The contractual continuity issue arises because, after Brexit, UK and EU-27 regulated firms will no longer benefit from the single market passport which currently allows them to engage in regulated activities in the EU-27 and the UK respectively without the need for an additional local licence. This raises issues for certain longer-dated OTC derivative contracts, which were entered before Brexit, when the entity held the relevant passport, but where the contract continues beyond Brexit. In such cases, some so-called 'lifecycle events' that arise during the life of the contract may be regarded as constituting regulated activities in the jurisdiction where the client or counterparty is located, thus triggering the application of local licensing requirements if the firm retains those contracts after Brexit.

ISDA has previously commissioned legal analysis of the likely post-Brexit regulatory treatment of certain events during the life of a transaction, which may involve more than the mere performance of existing contractual obligations. The analysis covers legacy cross-border derivatives contracts in six jurisdictions – France, Germany, Italy, The Netherlands, Spain and the UK. The analysis focuses on typical lifecycle events with respect to outstanding contracts, such as the performance of obligations, exercise of options, rolling of open positions, transfers of collateral, increases or decreases in notional amount and other amendments, novations, unwinds and portfolio compression. The full lifecycle analysis can be found in the Documents library available at this link. Further details on the passporting regime, including a summary of the equivalence and exemptions regimes can be found at FAQ 16 available at this link.

Whilst there are variances amongst the jurisdictions, the key message is that some common lifecycle events may constitute regulated activities in EU-27 jurisdictions triggering local licensing requirements.

Therefore, in order to engage in these activities post-Brexit, a UK firm may need to obtain a local licence or exemption - but this may not be available to it as a third country firm - or register with ESMA under the third country regime under the Markets in Financial Instruments Regulation (MiFIR) – but this depends on the Commission adopting an equivalence decision with respect to the UK. Alternatively, the UK firm may be able to respond to EU-27 client or counterparty requests under 'reverse solicitation' exemptions but there are inherent uncertainties in and limitations on reliance on these exemptions.

This creates uncertainty as to how UK firms who have contracted with EU-27 counterparties and clients could retain and run off their portfolios of legacy cross-border contracts post-Brexit in a practical way that meets the requirements of their clients and counterparties while complying with licensing rules in the EU. The ultimate risk is that if a UK firm is unable to comply with licensing rules in the EU after Brexit, it would be unable to continue to meet all the requirements of EU-27 clients and counterparties with respect to those legacy contracts. Therefore, it may need to transfer those contracts to an EU-27 affiliate, bring the contracts to an end or, where this is consistent with local law, retain and run off the contracts without engaging in lifecycle events that would trigger licensing requirements.

This paper focuses on the uncertainties arising from licensing restrictions affecting OTC derivatives contracts between a firm and its clients and counterparties, including those that may apply to firms acting as a clearing member for clients and counterparties on cleared OTC derivative contracts. In addition, there are uncertainties for EU-27 clients about their ability, after Brexit, to continue to clear legacy contracts on UK central counterparties (CCPs) or to treat exposures to UK CCPs for capital purposes in the same way as before Brexit in the absence of appropriate transitional arrangements (which are outside the scope of this paper). EU-27 clients and counterparties may also have other uncertainties with respect to legacy contracts with UK firms, such as whether they can continue to risk weight exposures to UK institutions in the same way as before in the absence of an equivalence decision with respect to the UK.

While, in principle, similar risks may arise with respect to EU-27 firms' legacy cross-border contracts with UK clients and counterparties, there are existing UK exemptions from licensing requirements (in particular, the 'overseas persons' exemption) that would mitigate the risks in many cases. In addition, the UK government has already announced that, if necessary, it will address the issues for market participants through a temporary permissions and recognition regime.

A transition period under the Withdrawal Agreement would be important for mitigation of these risks in relation to legacy cross-border contracts. It would give firms more time to run off, transfer or terminate affected contracts. However, there is, at present, no certainty that the EU and the UK will finally ratify and conclude a Withdrawal Agreement providing for an appropriate transition period and EU-27 regulators insist that firms' Brexit planning must assume that there will be no such agreement. In addition, even if the parties do conclude a Withdrawal Agreement that makes provision for an appropriate transition period, firms may still have contracts that extend beyond the end of the transition period to which the same considerations will apply as are discussed in this paper.

Availability and Operation of Statutory Transfer Mechanisms

The contingency plans for some UK firms may involve the transfer of their business, including their derivatives business, with EU-27 clients and counterparties to an affiliate in the EU-27 using one of the statutory mechanisms available under UK law. These statutory mechanisms facilitate the transfer of legacy contracts because they allow the transfer of existing contracts with third parties without the necessity for the individual consent of the third party. However, these mechanisms are complex and involve court processes that present significant execution and timing challenges for firms. A firm intending to use one of these mechanisms would now need to be well-advanced with its plans if it is to complete the transfer by Brexit.

In any event, these mechanisms are only available to or appropriate for some UK firms that conduct cross-border derivatives business with EU-27 clients or counterparties.

Part VII Scheme

Part VII of the Financial Services and Markets Act 2000 allows the UK courts to approve a scheme under which a bank transfers all or part of a business which includes a significant volume of deposit-taking activity to a transferee bank, including a transferee bank in another Member State. A scheme can transfer the bank's rights and obligations under its contracts with third parties without the need for the individual consent of third parties and can amend the terms of contracts to facilitate the transfer (e.g., to reflect that the transferee is incorporated and tax resident in a different jurisdiction).

Schemes are subject to a specific regulatory scrutiny process, two court hearings, the right for interested parties to object and final approval by the High Court. The Court will not grant the order until it is satisfied that clients will not suffer detriment. The transferee may require new licences or changes to its licences in order to carry on the transferred business.

This mechanism is not currently available to or appropriate for all UK firms conducting cross-border derivatives business with EU-27 clients or counterparties, in particular because they may not be deposit-taking banks or may not be transferring businesses which include a sufficient deposit-taking element.

Cross-Border Merger

The Companies (Cross Border Mergers) Regulations 2007 allow a UK company to merge into a company incorporated in another Member State in accordance with the EU company law directive providing for the cross-border merger of limited-liability companies. The merger results in the transfer to the surviving company of all the merging company's assets and liabilities by operation of law, including the contracts of the merging company, without the need for individual consent of third parties. The merger also results in the dissolution of the merging company without a winding up. The merger is subject to the approval of the UK courts and the scrutiny of the court or other authority in the other Member State concerned and interested parties can object. In addition, the surviving company must be appropriately licensed to carry on the merging company's business, which may require new licences or changes to its existing licences (and it may need to seek a licence in the UK if it will retain a UK branch post-Brexit).

A merger cannot be used only to transfer a part of the business of a UK company to a transferee. In addition, a cross-border merger does not in itself relocate the business activities that the UK company carries on in the UK. Additional steps may be needed to move staff, assets and business activities within the merged company from the UK to the merged company's EU-27 offices.

This mechanism is not available to or appropriate for all UK firms conducting cross-border derivatives business with EU-27 clients or counterparties. In particular, there may be structural or supervisory issues if the merged entity would conduct a relatively small volume of EU-27 business from its offices in the EU and a very large volume of UK and other non-EU business from a branch in the UK. The UK firm may first have to transfer some non-EU business to another UK company. This would require the consent of third parties whose contracts are affected, removing one of the key potential advantages of using this mechanism.

European Company Statute

The EU regulation on the statute for a European company allows a UK company to convert itself into a *societas europae*a (SE) and subsequently to move its head office to another Member State. The company must first be or become a public limited company (plc) and must have had a subsidiary in another Member State for at least two years. The conversion and move of head office do not involve any change in the legal personality of the company.

The process requires compliance with specific rules on employee participation as part of the conversion process. The SE will need to obtain a new licence to conduct its business in the Member State in which it is to be headquartered (and may need to seek a licence in the UK if it will retain a UK branch post-Brexit).

The conversion of a UK company to an SE would result in the SE carrying on all the business of the UK company. In addition, the relocation of the SE's head office to the EU-27 does not in itself relocate the business activities that the SE carries on in the UK. Additional steps may be needed to move staff, assets and business activities within the SE from the UK to the SE's EU-27 offices.

This mechanism is not available to or appropriate for all UK firms conducting cross-border derivatives business with EU-27 clients or counterparties. In particular, there may be structural or supervisory issues if the SE would conduct a relatively small volume of EU-27 business from its offices in the EU and a very large volume of UK and other non-EU business from a branch in the UK. The UK firm may first have to transfer some non-EU business to another UK company. This would require the consent of third parties whose contracts are affected, removing one of the key potential advantages of using this mechanism.

There are other routes to formation of an SE including a cross-border merger with an entity in another Member State but these may not offer advantages over a cross-border merger under the company law directive on cross-border mergers.

Scheme of Arrangement

Part 26 of the Companies Act allows the UK courts to approve a scheme of arrangement which can transfer the contracts of a company to a transferee or merge a company into another company. However, the court can only approve a scheme affecting the rights of creditors if the scheme is approved by resolutions passed by a majority in number and 75% in value of each class of affected creditors at class meetings creditors convened for the purpose. This makes this route unattractive for most purposes.

In any event, even where a firm can make use of one of the statutory mechanisms discussed above, it may in some cases still be necessary for it to obtain the consent of clients or counterparties to give effect to the transfer of some legacy contracts or to reflect the changes to the firm's business. For example, parties to a cross-border merger or a company converting to an SE and relocating to the EU-27 may need to obtain the consent of clients or counterparties to change the designation of a UK 'Office' under an ISDA master agreement to an office in the EU-27 or to change other UK-specific provisions in their contracts.

Significant Challenges to Transfers by Novation

Therefore, many UK firms that decide that they need to transfer legacy OTC derivative contracts to their EU-27 affiliates before Brexit will need to seek the individual consent of the relevant clients and counterparties to the transfer of the UK firm's rights and obligations to its affiliate (the mechanism known as 'novation'). However, this is not a 'silver bullet' and there are significant execution and timing challenges to a large-scale novation of OTC derivative contracts in favour of an entity in a different Member State.

Large scale novations require significant preparatory work

As with the statutory mechanisms, the transferee entity will need to be appropriately licensed in its Member State which may require new licences or changes to existing licences. It may not be possible to start the formal novation process until these have been granted. The transferee will also need to address whether the transferred portfolio meets its own risk requirements and how it will manage the operational and other risks on the portfolio, particularly as this process is likely to lead to a much more rapid scaling up of its operations than if it were to confine itself to new business. The transferee needs to discuss with its supervisors and implement a capital plan that reflects the impact of the novations on the regulatory capital requirements of the transferee and that takes into account the uncertainties of the timing and extent of client and counterparty agreement to the transfers of legacy contracts. In addition, the transferee needs to put in place a new clearing, payments and custody network duplicating that of the transferor.

The transferor and transferee need to conduct due diligence on the portfolio which is likely to be more extensive and demanding than when using a statutory mechanism. They need to identify the individual contracts to be transferred and the individual contractual and operational changes necessary and to prepare the individualised communications and documentation appropriate for each client or counterparty.

Firms have already carried out significant preparatory work and, in many cases, have already begun their outreach to clients and counterparties. However, their progress in completing their novation projects is affected by extrinsic factors outside their control, including possible regulatory actions adversely affecting firms' assumptions about the treatment of lifecycle events and client cooperation and agreement.

Regulatory actions may adversely affect firms' assumptions about the treatment of lifecycle events

As discussed under ‘The Risks to Legacy Contracts’, there is currently no consistent view across Member States determining which lifecycle events for legacy contracts would be considered regulated activities triggering licensing requirements. The outcome depends on the position in individual Member States and in many cases the law is unclear and regulators have not provided clear guidance about the treatment of particular activities. Therefore, firms must prepare for and execute their novation projects based on assumptions about how these activities will be treated under local licensing rules and their legal advice to date.

Firms are at risk that regulatory changes or new regulatory guidance could adversely affect the assumptions on which their novation projects are based. These could significantly change the scope of the contract continuity issue and mean that firms require more flexibility and time to complete their projects.

Progress depends on client and counterparty cooperation and agreement

In any event, the initial outreach is only the beginning of the discussions between firms and their clients and counterparties. Firms' progress with their novation projects depends on client and counterparty cooperation and agreement. Lack of cooperation or delay or refusal of consent may have a significant impact on firms' projects.

Under the ISDA master agreement, outside the context of a merger or similar business reorganisation, a party cannot transfer its rights and obligations to a third party, even if it is an affiliate, without the prior written consent of the other party to the agreement. In addition, any required changes to the agreement to reflect the status of the transferee also must be in writing and executed by both parties (or the electronic equivalent). In some cases, the transfer would take place by the transferee agreeing a new ISDA master agreement and related margin, reporting, clearing, general terms of business and other arrangements with the client or counterparty and the transferor, transferee and client or counterparty agreeing in writing on the transfer by novation of the transactions from the old ISDA master agreement to the new.

The transfer will need to be synchronised with operational and other changes that also need to be agreed with the client or counterparty, for example, to move existing collateral held by the parties or with a third party custodian, to handle the flows of collateral and payments or to address new clearing arrangements for the contracts. In many cases, the OTC derivative contracts will be linked to other transactions (e.g., prime brokerage or other arrangements) so that it will be necessary to reach agreement on the transfer of the OTC derivative contracts as a package with other transactions, at the same time as making changes to that other documentation.

The scale and complexity of the process is significant. Preparing and carrying out the novation process with clients and counterparties will take a significant time.

Large market participants have many thousands of relationships for their derivatives business, but the underlying number of clients and counterparties will be much larger. Many of those relationships are with asset managers acting on behalf of multiple underlying funds or segregated accounts or large corporate groups with multiple counterparties, in many cases with differing documentation.

Clients and counterparties will themselves have relationships with multiple firms and are likely to have multiple contracts in place with each firm. Clients and counterparties will also need to manage complex parallel discussions with limited resources.

Clients and counterparties may delay or refuse consent to novation

In addition, there are many reasons why clients and counterparties may delay or even refuse their consent to a novation of legacy contracts:

- **Due diligence.** The client or counterparty may wish to carry out its own due diligence as to the credit standing and status of the transferee before it agrees to the novation. Even if the transferee has a similar credit rating to the transferor, it will have different credit characteristics that may be significant to particular clients or counterparties.
- **Exposure limits.** The client or counterparty may have country or other concentration or exposure limits that restrict its ability to deal with the transferee.
- **New legal opinions.** The client or counterparty may need to obtain new legal opinions on netting or collateral with respect to the transferee or the new documentation before it agrees to the novation.
- **New clearing and margin requirements.** Clients and counterparties may not be willing to agree to a novation when it would trigger clearing or margining requirements for transactions that currently benefit from the grandfathering arrangements under EMIR. Novation creates new transactions which will need to be cleared or margined as appropriate, as well as triggering new reporting requirements. The requirement to clear or margin previously uncleared or unmargined

transactions will have an impact on the client and counterparty as well as the firm. Any sudden demand for additional margin could have a significant market impact as firms and counterparties seek to locate appropriate collateral.

- **Uncertainty as to EU clearing rules.** EU-27 clients and counterparties may delay their decision on their requirements with respect to cleared OTC derivatives because of continued uncertainty about whether EU rules will allow them to continue to clear legacy transactions on UK CCPs or about the risk weighting of exposures to those CCPs and the significant operational and pricing issues involved in moving cleared contracts from one CCP to another.
- **Tax impact.** The novation may lead to an acceleration of losses or profit on derivatives for tax purposes (depending on whether the client or counterparty accounts for the derivatives on a fair value basis or otherwise and whether the client or counterparty is respectively 'out of the money' or 'in the money' on its derivatives position). The acceleration of losses may be advantageous to the client or counterparty (albeit at a cost to its national tax authority) but the acceleration of profit may mean that the client or counterparty is unwilling to agree to the novation (at least not without compensation).
- **Structural restrictions.** In some cases, there may be structural reasons that make it difficult to transfer contracts, such as in the case of securitisation swaps where the securitisation documentation prevents the swap counterparty transferring the swap to an affiliate whose credit ratings are also below the original credit rating of the transferor at the time the swap was created.
- **Scope of regulatory restrictions.** Clients and counterparties may wish to obtain a detailed understanding of why they cannot keep their existing relationship for the legacy contracts and the implications for them of not agreeing to the proposed novations. They may have differing views of how the regulatory restrictions on lifecycle events affect their relationship with the firm. Some may not wish to agree to novation at all or may wish to novate fewer legacy contracts. Others may wish to novate their entire portfolio of contracts, not just those affected by the regulatory restrictions, because they wish to preserve netting efficiencies or because of uncertainty as to their regulatory treatment under EU rules in the absence of equivalence decisions with respect to the UK.
- **Agreement of new documentation.** There will be inevitable changes to the documentation that the client or counterparty may wish to discuss, such as differing tax representations or new wording for agreements governed by English law on the recognition of bail-in or resolution stays to anticipate that English law will, after Brexit, be the law of a third country for the purposes of Article 55 of the Bank Recovery and Resolution Directive or national rules.
- **Commercial negotiation.** Clients and counterparties may simply wish to use the opportunity to renegotiate the commercial and other terms of their relationship with the firm or possibly the terms of individual transactions.
- **Multiple parallel negotiations.** Clients and counterparties will likely be receiving documentation packs and proposals from other UK firms which will be different and require individual attention (not least because different UK firms are relocating to different EU-27 jurisdictions). Each proposal will also require separate operational implementation. This places significant burdens on the business, legal and operational resources of clients and counterparties seeking to engage with multiple firms and (in the case of asset managers) their underlying clients. This may lead to bottlenecks and delays. For example, during variation margin repapering, there were delays in putting in place documentation because of the operational challenges in processing large number of clients.

Implementing large complex novation programmes takes time, even with good planning. The PriceWaterhouseCoopers paper *Planning for Brexit – Operational impacts on wholesale banking and capital markets in Europe* (January 2017), prepared for the Association for Financial Markets in Europe[1], gave a number of examples of banks executing complex changes to booking structures illustrating that these took between two and five years to carry out (see section 3 of the paper).

[1] https://www.afme.eu/en/reports/publications/planning-for-brexit/

Transfers of contracts between different offices of same legal entity raise similar issues

Similar execution and timing challenges may be encountered where an EU-27 firm decides to move business from a UK branch to its head office or another office in the EU-27 or a UK firm decides to move business from its UK head office to a branch in the EU-27. This move does not involve a novation of contracts, as the same legal entity remains the contractual counterparty. However, the change of office and booking arrangements may involve changes to the contracts or changes to the operational changes which require the consent of clients and counterparties.

Solutions

As discussed in this paper, there are significant execution and timing challenges to the transfer of legacy contracts to affiliates in advance of Brexit. While firms are working through these challenges to ensure that they can continue to service client requirements in a prudent manner, policymakers and regulators should minimise the risks and provide certainty to the market by permitting continued maintenance, risk management, performance, termination or disposal of existing contracts after Brexit.

There are a range of solutions that policymakers and regulators could consider.

The EU and the UK could seek to give firms and their clients and counterparties the highest level of legal certainty by including in the Withdrawal Agreement provisions allowing firms to continue to service these existing contracts after the end of the transition period and until their final maturity, disposal or completion. This solution would align with the treatment of the ECB and EIB under the current draft of the Withdrawal Agreement. It would ensure that where clients or counterparties do not or cannot agree to a novation or (where necessary) the termination of a legacy contract, firms can continue to service their requirements until the contract runs off.

A less optimal solution would be to place a time-limit on the ability to service legacy contracts after the end of the transition period. This would at least give firms more time to run off, terminate or transfer these contracts. There are challenges to this approach, as it may be difficult to identify an appropriate time-frame and there may still be longer-term legacy contracts affected by the regulatory restrictions on lifecycle events that are difficult to terminate or novate.

Measures should be taken which would facilitate transfers and novations in this case. For example, the UK authorities could consider whether it could extend Part VII of the Financial Services and Markets Act 2000 beyond deposit-taking banks to all entities managing a legacy derivative book with EU-27 clients. While it may not be possible to effect such a legislative change in time for Brexit, such a change could – if in effect sufficiently early in any time-limited period permitted for run off, termination or transfer of these contracts - be helpful for the purpose of transfer of some contractual relationships from a UK to an EU entity.

In addition, the Withdrawal Agreement should provide common solutions on issues such as the recognition of existing UK and EU-27 CCPs and the treatment of outstanding exposures for capital purposes to mitigate the 'cliff edge' effects of the UK becoming a third country at the end of the transition period.

However, the market would also need an effective backstop arrangement against the risk that the EU and the UK do not, in the end, conclude a Withdrawal Agreement including a transition period. The UK plans to put in place its temporary permissions and recognition regime in advance of Brexit. The Associations consider that the EU and EU-27 legislators and policymakers should put in place a comparable solution – at least to the extent such transfers or novations cannot be effected within an appropriate amount of time - to protect EU-27 clients and counterparties from disruption to their business and to ensure financial stability.

ISDA and AFME members also intend to provide more detailed additional proposals to EU and UK regulators in due course on measures which could be considered by both sides which would facilitate the transfer or novation of legacy contracts. ISDA and AFME will share more concrete proposals for such measures as they are developed.

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About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA.

About AFME

The Association for Financial Markets in Europe (AFME) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work. Further information is available at www.afme.eu.

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