The Delta Report

Authors: Ingrid York, Charles Balmain, Eduardo Barrachina, Richard Blackburn, Nathaniel Crowley, Phillan Amin

At a glance

On the EMIR Compromise: Reflections and preliminary considerations

The Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") is currently undergoing a significant review which will result in material changes to make the key regulation of OTC derivatives in the European Union ("**EU**") more efficient and less onerous. To date, these proposed changes have been reflected in the compromise text which we analyse.

Lehman Brothers Special Financing Inc v National Power Corporation and another [2018] EWHC 487 (Comm) (12 March 2018): Can calculation statements under the 2002 ISDA Master Agreement be withdrawn and replaced once served?

This article describes the recent case in which the Commercial Court considered, in particular, whether the Determining Party of an Early Termination Amount under a 2002 ISDA Master Agreement could make a replacement determination once the original determination had been served on the counterparty.

Brexit update

Following publication of the draft 'colour coded' withdrawal agreement by the European Commission, we provide a snapshot update of where the negotiations currently stand and, in particular, look at some of the issues (based on the current wording of the withdrawal agreement) surrounding cross-border recognition and enforcement of English law judgments across the EU in a post-Brexit world. We also take a look at the newly published '2018 ISDA Choice of Court and Governing Law Guide' which offers new model jurisdiction clauses for inclusion in the 1992 and 2002 Master Agreements.

Variation margin requirements for physically settled FX forwards —EMIR update

On 24 November 2017, the European Supervisory Authorities ("**ESAs**") issued a statement as to the challenges faced by certain counterparties with regard to the exchange of variation margin for physically-settled FX forwards. The ESAs stated that until the Margin Rules are amended, they would expect competent authorities to generally apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation in a proportionate manner. This article reviews the current status of this issue.

On the EMIR Compromise: Reflections and preliminary considerations

Eduardo Barrachina

Background

On 4 May 2017 the European Commission published a proposal (the "**EMIR Proposal**") to amend certain provisions of EMIR. The EMIR Proposal caught the market by surprise and initially it introduced a number of material changes.

On 21 November 2017, during the Estonian Presidency a compromise proposal from the European Council Working Group on Compromise was agreed and published by the Council of the European Union (the "**Compromise**")[1]. As has been outlined below, a number of proposed amendments aim at reducing the burden and costs of non financial counterparties ("**NFCs**"). Many of these measures are part of the European Commission's Regulatory Fitness and Performance ("**REFIT**") programme which purports to reduce costs and simplify European policies. In particular, reporting for many NFCs with low trading activity has proved to be an onerous burden which, following 5 years since EMIR came into force, now finds little justification.

Revised FC definition

The definition introduces fewer changes that initially envisaged in the EMIR Proposal and makes a single material change by including an "alternative investment fund manager (AIFM)".

As a consequence, fund managers that are classified as NFCs will become financial counterparties ("**FCs**") once these changes come into force although the current Compromise does not provide any transition provisions.

Exclusion of SSPEs from the FC definition

The EMIR Review proposed a significant change for securitisation special purpose entities ("**SSPEs**") since it intended to reclassify them as financial counterparties. However, the Compromise proposes not to include SSPEs in the definition of FC so in principle, SSPEs will not be affected. As explained in our issue in our Delta Report issue of July 2017[2], this change posed structural challenges for SSPEs in the context of posting margin. This was likely to be one of the most contested changes of the EMIR Review and gave rise to material concerns amongst market participants.

Clearing for NFC+s

Currently, pursuant to Article 10(1)(b) of EMIR, if an NFC exceeds the relevant clearing threshold it will become a NFC+ and therefore will be subject to the clearing as well as margin exchange obligations, among other additional obligations under EMIR. EMIR currently does not distinguish between types of OTC derivatives, so for example, once the clearing threshold for interest rate derivatives has been exceeded, such entity would have to clear any other classes of OTC derivatives subject to mandatory clearing.

With the aim to reduce costs and the burden for NFCs, the scope of the clearing obligation will be reduced by limiting the clearing obligation to the particular asset class for which the clearing threshold has been exceeded. As a consequence, if only the interest rate clearing threshold has been exceeded, such counterparty will only have to clear interest rate derivatives subject to the mandatory clearing obligations and not other classes of derivatives subject to the mandatory clearing obligations.

Removal of frontloading

The Compromise finally removes the requirement for frontloading. The frontloading requirement is set out in Article 4(1)(b)(ii) of EMIR. Frontloading is the obligation to clear OTC derivative contracts (pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation) entered into or novated on or after notification by a competent authority to ESMA on the authorisation of a CCP but before such clearing obligation takes effect, if they have a remaining maturity at least equal to the "*minimum remaining maturity*" determined in the relevant technical standards.

Due to the legal uncertainty, the operational burden and pricing implications this has been one of the most discussed issues since EMIR came into force so this will be a change welcomed by all OTC market participants.

Accordingly, the clearing obligation will only apply to OTC derivatives that were entered into or novated on, or after, the date from which the clearing obligation takes effect.

1 Available at: http://data.consilium.europa.eu/doc/document/ST-14372-2017-INIT/en/pdf

2 Please see https://www.whitecase.com/publications/newsletter/delta-report-derivatives-newsletter-july-2017

Suspension of the clearing obligation

Currently under EMIR the clearing obligation only ceases to apply if a NFC+ no longer exceeds the relevant clearing threshold for a period of 30 working days. The Compromise introduces the power of the European Commission to suspend the clearing obligation in certain situations including:

- The criteria on the basis of which a specific class of OTC derivative has been made subject to the clearing obligation are no longer met.
- A CCP ceases to offer a clearing service for a specific class of OTC derivative or for a specific type of counterparty.
- In order to avoid or address a serious threat to the financial stability in the EU, and that suspension is proportional.

The suspension must be requested by the European and Securities Market Authority ("**ESMA**") to the European Commission for either a specific class of OTC derivative or for a specific type of counterparty. A new feature introduced by the Compromise is that competent authorities may also request that ESMA submits a suspension request, provided that they provide reasons and submit evidence that at least one the conditions set out above has been met. Following this, ESMA will within 48 hours have the option to either request that the European Commission suspends the relevant clearing obligation or reject the request from the competent authority provided that it provides reasons in writing.

Physically settled deliverable FX forwards, VM exemption

The Compromise introduces new wording exempting physically deliverable FX forwards from exchanging initial margin ("**IM**") and variation margin ("**VM**") except for transactions concluded between credit institutions (authorised under the Capital Requirements Directive[3] or the Capital Requirements Regulation[4]) which would still have to post VM for those trades. This change was not discussed in the initial EMIR Proposal and is the result of recent discussions as to the need to align the stricter EU regime with that of other regimes like that in the United States. These changes, if they go ahead, will permit non-financial and smaller financial counterparties to reduce the risks associated with their currency risk exposures without being subject to VM posting.

For a detailed analysis please see Phillan Amin's article in this issue of the Delta Report.

FRAND access to clearing: no obligation to contract

The Compromise introduces the novel concept of "**FRAND**" (fair, reasonable and non-discriminatory) a principle that should govern contractual and commercial relationships between clearing members and clients. The idea behind FRAND is to facilitate clearing for counterparties with a limited volume of activity in the OTC derivatives market. It is unclear what exactly FRAND involves, in particular the "*non-discriminatory*", requirement and how far a clearing house may go when refusing to provide clearing services to a particular client. As English case law illustrates, "fair" and "reasonable" remain concepts that by definition are never precise and will vary their meaning depending on the circumstances, the profile, knowledge and experience of each of the parties and the relevant market. To mitigate this uncertainty, the European Commission will be empowered to adopt a delegated act in accordance with Article 82 of EMIR in order to specify the conditions under which commercial terms in respect of clearing services are considered to be fair, reasonable and non-discriminatory

It may be argued whether a "FRAND framework" is actually needed. For example, Article 39(7) of EMIR imposes on CCPs and clearing members the obligation to offer clearing services on reasonable commercial terms. In addition, pursuant to Article 25 of the MiFID II RTS 6[5] , clearing members must apply due diligence when assessing whether they can provide clearing services to clients.

The Compromise explicitly excludes from the FRAND principle the introduction of an "*obligation to contract*" or any form of price regulation, in line with the demands of market participants. Clearing members and clients are explicitly allowed to refuse to provide clearing services on risk grounds (note these grounds are not limited to counterparty risk in the text, in either the relevant recitals or articles).

Intragroup transactions reporting exemption

Recital 12 of the Compromise explicitly extends the exemption of intragroup transactions involving only NFCs to transactions

3 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.
Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:En:PDF

4 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32013R0575

5 Commission Regulated Delegation (EU) 2017/589 of 19 July 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the organisational requirements of investment firms engaged in algorithmic trading.
Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0589&from=EN

with third-countries entities that would qualify as a NFC if they were established in the EU within the same group. Ultimately, provided a transaction constitutes an intragroup transaction between NFCs, the risk that such transaction may pose is unlikely to be significant. However, this measure is not expressly included in the articles of the Compromise.

Reporting liability

Since EMIR came into force, Article 9 was clear that *"all counterparties and CCPs shall ensure that the details of any derivative contract they have concluded and of any modification or termination of the contract are reported to a trade repository (…)"*. In practice, due to the lack of operation teams, systems and knowledge, most NFCs have relied on their FC counterparties to arrange the reporting under EMIR, albeit the NFCs remain liable for such reporting.

Generally, it has become market practice that an NFC enters into a *"Reporting Delegation Agreement"* with a FC whereby the FC agrees to report the relevant data on behalf the NFCs. However, these agreements include ample exclusions of liability other than typically in the event of negligence, wilful default or fraud. Also, the Compromise, looks at the requirement to report exchange-traded derivatives ("**ETDs**"), which in practice means a significant burden on counterparties because of the high volume of ETDs that are concluded on a daily basis. There is an ongoing debate whether when it comes to ETDs only, CCPs should be legally responsible to report on behalf of their clients.

The Compromise imposes a legal liability on all FCs that report on behalf of NFC-s although NFC-s will remain responsible for the accuracy of the data. However, this will not apply if the NFC- enters into an OTC derivative contract with a third country entity. A reflection of how sensitive this issue is the fact that the Compromise has proposed two options to deal with this, option 1 and option 2 the main difference being that under option 2, CCPs are not under the obligation to report on behalf of their clearing members' clients.

Option 1

- CCPs would be solely responsible and legally liable to reporting "*on behalf of each of themselves, the clearing members **and their clients***" details of derivative contracts that are not OTC derivative contracts as well as for ensuring the accuracy of the reported details.
- FCs will be solely responsible and legally liable for reporting on behalf of both counterparties OTC derivative contracts concluded with an NFC- as well as for ensuring the accuracy of the reported details. An NFC- will retain the right to report themselves, however, they should inform their FC accordingly. In this case, the responsibility and legal liability for reporting and for ensuring the accuracy of those details will remain with that NFC-.
- The management company of an undertaking for collective investment in transferable securities ("**UCITS**") will be responsible and legally liable for reporting the details of OTC derivative contracts to which that UCITS is a counterparty as well as for ensuring the accuracy of the details reported.
- The manager of an AIF shall be responsible and legally liable for reporting the details of OTC derivative contracts to which that AIF is a counterparty as well as for ensuring the accuracy of the details reported.

Counterparties and CCPs may also delegate the reporting obligation although the responsibility and legal liability for reporting will in this case remain with the FCs and CCPs.

Option 2

- CCPs would be solely responsible and legally liable for reporting "*on behalf of each of themselves and the clearing members*" details of derivative contracts that are not OTC derivative contracts as well as for ensuring the accuracy of the reported details.
- FCs will be solely responsible and legally liable for reporting on behalf of both counterparties details of OTC derivative contracts concluded with a NFC- as well as for ensuring the accuracy of reported details. An NFC- will retain the right to report themselves, however, they should inform their FCs accordingly. In this case, the responsibility and legal liability for reporting and for ensuring the accuracy of those details will remain with that NFC-.
- The management company of a UCITS will be responsible and legally liable for reporting the details of OTC derivative contracts to which that UCITS is a counterparty as well as for ensuring the accuracy of the details reported.
- The manager of an AIF shall be responsible and legally liable for reporting the details of OTC derivative contracts to which that AIF is a counterparty as well as for ensuring the accuracy of the details reported.

The main aspect for FCs is the degree of liability and responsibility placed upon them. There is resistance in the dealer's market to accept sole liability and responsibility for FCs, even if receiving incomplete/inaccurate data and this point is currently being discussed. Industry groups are working towards a more balanced allocation of liability and responsibility between FCs and NFC-s.

Reporting obligation for UCITS and AIF

Recital 15 of the Compromise clarifies that where one or both of the counterparties is a UCITS or an alternative investment fund ("**AIF**") it should be specified that the management company of a UCITS and the manager of an AIF are responsible and legally liable for reporting on behalf of the relevant UCITS and AIF, respectively, as well for ensuring the accuracy of the reported details.

This is a welcome clarification which previously had prompted queries to ESMA which did not fully clarify the position regarding this issue[6].

Coming into force

The EMIR Proposal states that it will take effect 20 days after publication in the Official Journal of the European Union. Although this is the average period time for EU legislation between publication and coming into force, there are concerns whether that time will be sufficient for those entities that, as a result of the proposed amendments, will be reclassified as a FC.

Next steps

The EMIR Proposal is only the first formal step of the EU legislative process and it is currently being reviewed and amended by the EU Parliament[7]. At the time of writing this article, a vote of the proposal was scheduled to take place on 16 May.

Conclusions

From a regulatory viewpoint, 2017 was primarily a year for implementing laws and regulations that had already been agreed in principle and as such, it did not bring material changes to the existing EMIR framework. 2018 is likely to be the year in which significant changes to the EMIR architecture are agreed. If finally implemented in the form of the Compromise, these changes will likely be welcome by the derivatives industry, in particular NFCs.

In 2012, EMIR was implemented with a view to reduce systemic risk and make the OTC derivatives market safer. Five years later, with a more mature derivatives market, these changes are implemented with a view to make them less onerous and to ensure proportionality.

Lehman Brothers Special Financing Inc v National Power Corporation and another [2018] EWHC 487 (Comm) (12 March 2018): Can calculation statements under the 2002 ISDA Master Agreement be withdrawn and replaced once served?

Richard Blackburn

Executive summary

- NPC was not entitled to replace its original determination of a Close-out Amount due under Section 6(e) of a 2002 ISDA Master Agreement which it had made in error.
- Where a manifest numerical or mathematical error has been made, correction would need to be made by way of mutual agreement or in some cases by court or tribunal rather than a fresh determination.
- There may be a basis for replacing an original determination where it was not a determination within the meaning of the Agreement. In the context of the 2002 ISDA Master Agreement, the test for this will be whether the requirement for using "*commercially reasonable procedures in order to produce a commercially reasonable result*" in respect of the Close-out Amount was complied with.
- The Close-out Amount determined on the basis of a replacement transaction satisfied the "commercially reasonable" requirement of the definition of Close-out Amount. The use of an indicative quotation when a firm quotation and actual transaction were shortly to be available would not have satisfied such a requirement. As such the original determination of the Close-out Amount had been made validly.

6 See Questions and Answers. Implementation of the Regulation (EU) No 648/2012 on OTC derivatives,central counterparties and trade repositories. (EMIR) General Question 1: Funds, counterparties. Available at: https://www.esma.europa.eu/press-news/esma-news/esma-updates-its-emir-qa-3

7 In addition, the works of the ECON Committee of the European Parliament have also resulted in the draft Report on the EMIR Proposal. Available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bCOMPARL%2bPE-616.810%2b01%2bDOC%2bPDF%2bV0%2f%2fEN

Background

- Lehman Brothers Special Financing Inc. ("**LBSF**") and National Power Corporation ("**NPC**") had entered into a forward currency swap under a 2002 ISDA Master Agreement (the "**Agreement**"), whereby LBSF agreed to pay US$100 million to NPC in 2028 whilst NPC had to pay the US dollar equivalent of an amount in Philippine Pesos. Further NPC agreed to pay semi-annual coupons to LBSF at a fixed rate.

- An option was granted by LBSF to NPC under which NPC could choose to prepay US$1 million on 15 May 2008 instead of paying the US dollar equivalent of the specified Philippine Peso amount.

- After Lehman Brothers group collapsed in 2008, LBSF filed for bankruptcy, constituting an Event of Default under the 2002 ISDA Master Agreement and NPC served a notice on LBSF on 17 October 2008 designating an Early Termination Date of 3 November 2008 (the "**ETD Letter**").

- As Determining Party, NPC was required to determine the Close-out Amount under the Agreement using "commercially reasonable procedures in order to produce a commercially reasonable result" and sought on two occasions three third-party quotations for replacement transactions. On 3 November 2008 NPC received indicative quotations and on 7 November 2008 it received firm quotations. On 14 November 2014 NPC then entered into a replacement swap with UBS (the "**UBS Replacement Swap**").

- NPC calculated the Close-out Amount based on the cost of the UBS Replacement Swap, resulting in an amount payable by LBSF of around US$3.5 million (the "**Original Determination**"), which did not include an accrued amount representing a sum due to LBSF under the LBSF transaction from 15 May 2008 to 15 November 2008, which had accrued prior to the effective date of the UBS transaction (the "**Accrued Amount**"). NPC demanded such payment by LBSF on 26 January 2009, enclosing its calculations by way of an annex (the "**Calculation Statement Letter**").

- The Original Determination was challenged by LBSF which commenced legal proceedings against NPC based on mark-to-market valuations provided by LBSF from July and September 2008 which showed that NPC was out-of-the money.

- NPC then purported to withdraw the Original Determination and to replace it with a new determination dated 27 October 2016 (the "**Replacement Determination**") which included a "Primary Determination" of around US$10.8 million and an "Alternative Determination" of around US$2.1 million, both in NPC's favour.

- Whilst the "Primary Determination" was based on the indicative quotations by UBS for the replacement swap (which did not include a prepayment option), the "Alternative Determination" was based on the actual UBS Replacement Swap (which did include a prepayment option despite the fact that NPC's prepayment option in the LBSF transaction had already expired in 2008) but deducted the Accrued Amount.

The parties' views

- NPC argued, in summary, that:
  - since the Original Determination did not account for the Accrued Amount, it was not calculated in accordance with the requirements of the Agreement and as such was invalid and not contractually binding as between the parties;
  - the availability of an indicative quotation on 3 November 2008 made it commercially reasonable to determine the Close-out Amount as of that date instead of 7 November 2008; and
  - the calculations described in the Calculation Statement Letter were not in accordance with the requirements of the Agreement and the determination of Close-out Amount by 26 January 2009 was invalid and not contractually binding as between the parties; it was only by making the later Replacement Determination and serving the revised calculation statement that it had complied with its obligation under Section 6 of the Agreement to make a valid and binding determination of the Close-out Amount.

- LBSF argued, in summary, that Section 6(d)(i) of the 2002 ISDA Master Agreement did not entitle NPC to withdraw and replace a determination once served without LBSF's consent. The natural meaning of the language of the Section suggested that such a statement would be provided only once.

The Court's decision

Robin Knowles J also drew attention to the Court of Appeal's findings in the case of *Videocon Global Ltd v Goldman Sachs International [2016] EWCA Civ 130, [2017] 2 All ER (Comm) 800* that the service of a notice designating an Early Termination Date and a calculation statement setting out the amount payable in respect thereof both give rise to legal obligations. The debt obligation in respect of an Early

Termination Date "*arises, or accrues due on, or as at*" the Early Termination Date, and that the obligation to pay the relevant amount arises on the day on which notice of the amount payable, given in a manner described in Section 12 to the address or number provided in the Schedule, will be deemed effective in accordance with Section 12. Such obligations were therefore not reversible except by mutual agreement or in some cases by order of a court or tribunal.

Robin Knowles J noted that there were some circumstances in which the determination of an Early Termination Amount could be replaced by a subsequent determination. Where a determination was made that was not a determination within the meaning of the ISDA Master Agreement (for example, because it was based on a misinterpretation of the Agreement), a later determination provided by a party within the meaning of the ISDA Master Agreement could be said to be the first such determination.

However, he cautioned that a repeated remittance back to the Determining Party to make a compliant determination could not be the approach objectively intended under the ISDA Master Agreement. Additionally, the case of manifest numerical or mathematical error would require correction by way of mutual agreement or in some cases by court or tribunal rather than a fresh determination.

In light of the above, the Court approached the question of whether the determination under the Calculation Statement Letter was capable of being corrected by analysing the following factors: (a) whether the Accrued Amount should have been taken into account and (b) whether the requirement for "commercially reasonable procedures in order to produce a commercially reasonable result" was complied with, as required under the Agreement.

(a) The Accrued Amount

The parties did not dispute that the Accrued Amount should have been taken into account however Robin Knowles J found that the determination set out in the Original Determination was a valid determination for the purposes of the ISDA Master Agreement nonetheless. Robin Knowles J also disagreed with NPC's assertion that that its failure to take into account the Accrued Amount was a manifest error entitling it to make a fresh determination. He found that this was the type of error that could only be corrected by agreement between the parties or by court or tribunal and only in respect of which there was an error. As such, NPC's Replacement Determination would only be validly served if the second argument in (b) could demonstrate that the Original Determination was invalid.

(b) "Commercially reasonable"

The Court considered the question of whether the requirement to use "*commercially reasonable procedures in order to produce a commercially reasonable result*", as required by definition of Close-out Amount in the 2002 ISDA Master Agreement, was complied with.

The Court interpreted the above phrase as requiring the Determining Party to adhere to an objective standard of reasonableness. In comparison, the equivalent wording as set out in the definition of "Loss" in the 1992 ISDA Master Agreement, "*an amount that party reasonably determines in good faith to be its total losses and costs*" produced a different and lower standard of reasonableness, often referred to as "*Wednesbury*"[8] reasonableness, and would require a rational decision with reference to the relevant decision maker i.e. a subjective standard. Additionally, the supporting user's guide for the 2002 ISDA Master Agreement explains that the change to the wording was specifically designed to achieve greater objectivity compared to the 1992 ISDA Master Agreement.

In considering the sequential indicative and firm quotations obtained by NPC, Robin Knowles J noted that NPC had intended to enter into a replacement transaction:

"NPC proposed to enter into a transaction and for that purpose would and did seek firm quotations a short while later. The indicative quotations were preparatory to that."

…

"Where a firm quotation existed from UBS it was appropriate to regard that as having superseded the indicative quotation from UBS."

Taking the foregoing into consideration, Robin Knowles J found that the Original Determination did satisfy the "commercially reasonable" requirement and as such was a valid determination for the purposes of the ISDA Master Agreement. As such, for the Replacement Determination to be valid, the consent of the parties would be required or otherwise the decision of a court or tribunal.

(c) Evidential value of a revised calculation statement

Robin Knowles J also noted that whilst the Replacement Determination could not substitute the Original Determination, it would nevertheless provide evidence for a commercially reasonable determination.

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8 *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* (1948) 1 KB 223

Brexit Update

Ingrid York, Charles Balmain, Nathaniel Crowley

Overview

In our previous Delta Report Brexit update, we provided an overview of recent developments, set out some of the emerging issues necessitating amendments to core derivatives documentation and also considered the impact of Brexit on choice of law and jurisdiction and the enforcement of judgments. Since the end of 2017, the shape that Brexit will likely take—at least in the next few years—has become somewhat clearer. However, uncertainty remains, and the consequences for the derivatives market has yet to fully emerge; a concern given the time period now left for users to implement contingency plans[9]. Likewise, as of the date of publication, the UK and EU negotiating teams have had just one preliminary meeting to begin framing the negotiations over the UK's future relationship with the EU following any transition period.

For this update, we consider the potential impact of the latest developments—in particular the now published draft of the withdrawal agreement (see further below)— and also look at some of the proposed changes to the jurisdiction clause contained in the 1992 and 2002 versions of the ISDA Master Agreement as published by the International Swaps and Derivatives Association, Inc. (ISDA) (the "**Master Agreements**") contained in the newly published '2018 ISDA Choice of Court and Governing Law Guide[10].

Key developments: December 2017 – April 2018

Conclusion of Phase I—sufficient progress

The first major development in the Brexit talks between the UK and EU negotiating teams came on 8 December 2017 with a recommendation by the European Commission (EC) to the European Council that '*sufficient progress*' had been made in the first phase of the Article 50 exit negotiations.

The '*sufficient progress*' recommendation was based on the conclusions of a Joint Report agreed between the EC and the UK government, which noted the progress made in the three priority areas of: (i) rights of EU citizens' residing in the UK, (ii) the dialogue on the Republic of Ireland/ Northern Ireland border issue, and (iii) the financial settlement payable by the UK[11].

Subsequently, on 15 December 2017, the European Council (in an EU 27 format) unanimously indicated their agreement to the recommendation[12]. This enabled the European Council to adopt draft guidelines to move to Phase II—focusing on a transition arrangement and the framework for the future relationship between the UK and the EU[13]. While hailed as an important milestone for the UK in the negotiations, it was clear that the wording of the Joint Report—particularly on the matter of the border between the Republic of Ireland and Northern Ireland and the implications for cross-border trade in goods and services—still left much to be done in terms of reconciling the desire of the UK government to leave the EU's single market for goods and services and customs union on the one hand and, on the other, its desire for no physical border between the Republic of Ireland and Northern Ireland and a maintenance of the status quo for priority trade areas such as financial services.

Phase II of the negotiations commenced in January 2018 and has, to date, focused on the transitional arrangements that are intended to come into effect on the UK's formal date of exit (29 March 2019). The UK was keen to have this agreed as early as possible to provide clarity for businesses (particularly financial services) operating cross-border between the EU and the UK.

It was previously posited by the EU that any transitional arrangements would be documented in the 'withdrawal agreement'—a treaty containing the operative provisions relating to the UK's exit from the EU (e.g. in terms of citizens' rights, the obligation to fund further payments into the EU budget, the areas and institutions where the UK may retain an 'opt-in' etc.). However, it is expected that such agreement will not be formally signed until October 2018.

9 At present, the UK will formally exit the EU on 29 March 2019, absent any agreed transitional arrangements (see below).

10 Available at: https://www.isda.org/a/7YsEE/180130_ISDA-Choice-of-court-and-governing-law-guide-prepublication-fina.._02262018.pdf

11 http://europa.eu/rapid/press-release_IP-17-5173_en.htm

12 https://www.consilium.europa.eu/en/meetings/european-council/2017/12/15/

13 https://www.consilium.europa.eu/media/32236/15-euco-art50-guidelines-en.pdf

The Withdrawal Agreement—general observations

"This Agreement sets out the arrangements for the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and from the European Atomic Energy Community"

On 28 February 2018[14], the EC published an initial draft of the withdrawal agreement (the "**Withdrawal Agreement**"). A further 'colour coded' draft was then published on 19 March 2018 indicating areas of agreement between the UK and EU negotiators (in green), areas where a policy point had been agreed but drafting changes were required (yellow) and the areas that remained subject to further discussion (white). A review of the colour coded version leads to the conclusion that a number of key areas covered by the Withdrawal Agreement are indeed now agreed at negotiator level.

In a joint press-conference reviewing the text, the UK and EU chief negotiators outlined the conditional agreement that had been reached for a transition period of 21 months following the official exit date of 29 March 2019[15] that would end on 31 December 2020. Although the Withdrawal Agreement remains subject to further negotiation and approval by the UK and EU27 (and is hence not legally binding), clearly this is a decisive step towards providing some certainty—at least until the posited end of the transition period.

The general conclusion to draw from review of the 'green' articles of the Withdrawal Agreement is that there will essentially be maintenance of the status quo until 31 December 2020, albeit that the UK will no longer hold any formal voting rights at EU level. This would include in respect of passporting rights for UK banks/ investment firms to provide services in EU member states.

The Bank of England announced on 28 March 2018 that even this informal agreement meant banks and investment firms could rely on the transition period to adjust to Brexit, indicating that such institutions may "*plan… to continue undertaking [their] activities during the implementation period in much the same way as now*"[16]. The UK position therefore seems clear that non-UK financial institutions operating in the UK relying on passporting arrangements for trading within the UK can continue to do so—at least until the end of the transition period. The UK's Financial Conduct Authority also announced on 28 March 2018 that such institutions need not apply for authorisation at this stage[17]. Likewise, the UK Government has stated that even if the Withdrawal Agreement is not entered into, separate UK legislation will be passed creating a 'temporary permissions regime' to allow EU financial institutions to continue operating in the UK[18].

However, as at the date of publication, no corresponding statement has been made by the European Central Bank (ECB) or any of the other European Supervisory Authorities. The ECB has also publicly stated that financial institutions should continue to prepare for a Brexit without any transition arrangements[19] based on the principle of "nothing is agreed until everything is agreed". Likewise, media coverage has commented that the EC has drafted up 30 to 40 proposals to amend laws and give special powers to regulators so that the EU can manage a 'no-deal' scenario (i.e. where the Withdrawal Agreement is not executed).

Crucially, the Withdrawal Agreement, while dealing with a multitude of procedural matters concerning the UK's exit from the EU and the transition period, does not address what the UK's future trading relationship with the EU will look like after the end of such period. 'To be continued' is the overriding message to take away on that subject.

The Withdrawal Agreement—Applicable law, jurisdiction and recognition of judgments

Regarding the Withdrawal Agreement and current EU regulations concerning applicable governing law (Rome I[20] and Rome II[21]) and jurisdiction and recognition of judgments (Brussels I Recast[22]), it is clear that, on the assumption a transition period is agreed, the status quo vis-à-vis the UK and the EU27 will be preserved for that period[23].

14 https://ec.europa.eu/commission/sites/beta-political/files/draft_withdrawal_agreement.pdf

15 https://ec.europa.eu/commission/sites/beta-political/files/draft_agreement_coloured.pdf

16 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2018/firms-preparations-for-the-uk-withdrawal-from-the-eu-update-march-2018.pdf?la=en&hash=FD310274EDB28E2A0440228F3DD928E4BB725457
https://uk.reuters.com/article/us-britain-eu-banks/bank-of-england-reassures-finance-companies-on-brexit-transition-deal-idUKKBN1H41V1

17 https://www.fca.org.uk/news/statements/fca-statement-eu-withdrawal-following-march-european-council

18 https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2017-12-20/HCWS382/

19 https://www.ft.com/content/1e9dcb10-2c52-11e8-9b4b-bc4b9f08f381

20 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I)

21 Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II)

22 Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters

23 Note that this only applies to the 27 EU Member States of the EU. As noted in our previous Delta Report Brexit update, the UK's relationship with non-EU Member States (including EEA and EFTA member states) is governed by the Lugano Convention and the Hague Convention. Currently, the UK is only a party to these conventions by virtue of its EU membership and not in its own right.

As set out in our previous Delta Report Brexit update, both the UK and the EU had recognised in their formal negotiating positions on this subject[24] that there was an urgent need for grandfathering provisions to preserve the integrity of contracts entered into and litigation commenced prior to the UK's exit from the EU.

The Withdrawal Agreement includes numerous provisions that seek to address these concerns although, at least in the current draft, it is clear that the EU's stated negotiating position has been applied over that of the corresponding positions previously posited by the UK government. The key articles of the Withdrawal Agreement in this regard are as follows:

- **Article 62.** Rome I and Rome II will continue to apply in respect of contracts concluded prior to the end of the transition period and, in the case of any event giving rise to damages, where such event occurred before the end of the transition period.
- **Article 63(1)(a).** The jurisdiction provisions of the Brussels I Recast will continue to apply in the UK and across the EU27 to any court proceedings instituted before the end of the transition period.
- **Article 63(2)(a).** Jurisdiction clauses in contracts entered into prior to the end of the transition period in the UK and the EU27 should continue to apply in accordance with the provisions of the Brussels I Recast.
- **Article 63(3)(a).** Regarding recognition and enforcement of judgments, Brussels I Recast should continue to apply in the UK and the EU27 to any judgments handed down before the end of the transition period.

It should be noted that all of Article 63 remains a 'white' area of the colour coded draft (indicating that the UK negotiators have yet to accept the current text). This is likely to be the case for two key reasons. Firstly, as noted in our previous Delta Report Brexit review, the UK was looking for the Withdrawal Agreement to include a future framework for these matters "*which reflects closely the substantive principles of cooperation under the current EU framework*"[25]. This request has not been accommodated by the EU thus far. A major impediment to agreement on this point is the future role of the Court of Justice of the European Union (ECJ) and its jurisprudence in the UK post-Brexit in those areas covered by Brussels I Recast.

Secondly (and as a related point), the UK wished to avoid a scenario where parties were obliged, prior to the formal date for the UK's exit and during the transition period, to sue in a particular jurisdiction (due to the manner in which their jurisdiction clauses had been framed to accommodate the provisions of the Brussels I Recast) but with no certainty as to the outcome (following the end of the transition period) by different Member State courts across the EU of their own rules as to the recognition of judgments from an English court (assuming the Brussels I Recast no longer applied).

Rather, the UK's desire was that the recognition and enforcement of judgments provisions of the Brussels I Recast should apply both in respect of proceedings instituted before the end of the transition period and also in respect of jurisdiction clauses in contracts entered into prior to the end of the transition period. Likewise, such request has not been accommodated thus far.

Choice of law and jurisdiction—the ISDA Master Agreement

As also noted in our previous Delta Report Brexit update, one of the key concerns arising for derivatives documentation in light of Brexit was in relation to the governing law and jurisdiction clauses in the documents that govern the vast majority of cross-border OTC derivative transactions —the Master Agreements.

Even without the overlay of issues created for English law governed Master Agreements by the UK's impending exit from the EU, it has often been commented that the jurisdiction clauses contained in Section 13(b) of the Master Agreements were in need of revision. Such clauses were drafted to take into account the laws and other cross-border instruments dealing with courts' jurisdiction at the time such agreements were published. However, the advent of Rome I, Rome II, the Brussels I Recast, the Lugano Convention and the Hague Convention, meant the position had evolved significantly since then for both English law and New York law governed Master Agreements.

In particular, the standard form of both the Master Agreements meant they fell outside of the Hague Convention (given this seeks to promote the use of exclusive jurisdiction clauses by restricting the application of the convention to contracts containing an exclusive jurisdiction clause in favour of the courts of a signatory state to the convention).

24 For the UK, see documents at links: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/639271/Providing_a_cross-border_civil_judicial_cooperation_framework.pdf
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/639609/Enforcement_and_dispute_resolution.pdf
For the EU, see document at link: https://ec.europa.eu/commission/publications/position-paper-judicial-cooperation-civil-and-commercial-matters_en

25 See footnote 24

In response, following a consultation period with members, on 27 February 2018 ISDA published the '*Choice of Court and Governing Law Guide*' (the "**Guide**"). The Guide provides new model clauses (supplemented by non-binding guidance as to their use) with which users may choose to replace the current Section 13(b) in the Master Agreements. The Guide is similar in format and approach to ISDA's 2013 '*Arbitration Guide*'[26], which includes various model clauses for different arbitration forums such as the London Court of International Arbitration and the International Chamber of Commerce.

The model clauses in the Guide include:

- two exclusive jurisdiction clauses[27] (one in favour of the English courts and one in favour of the New York courts)—note that this is the first time an exclusive jurisdiction clause has appeared in either of the Master Agreements; and
- a simplified non-exclusive jurisdiction clause (drafted to accommodate both English law governed and New York law governed agreements).

Inclusion of both an exclusive and non-exclusive model clause was done primarily to allow a greater degree of flexibility and to ensure that where parties still continued to apply non-exclusive jurisdiction clauses that these were as consistent as possible across the market.

In its consultations with members, ISDA recognised that while, historically, the overarching principle for choice of court was that of non-exclusivity, the market now appears to have moved in favour of exclusivity. However, as stated in the Guide, ISDA was of the view that it would be premature to do away with the option of non-exclusivity altogether at this stage—particularly for counterparties contracting with entities in jurisdictions where recognition of both arbitral awards and English or New York court judgments was challenging.

The Guide also contains:

- an expanded definition of 'Proceedings' to cover disputes relating to non-contractual rights or obligations that arise from, out of or in connection with the relevant Master Agreement; and
- an expanded governing law clause, again expressly covering the choice of law for non-contractual obligations (an oft made amendment in the Schedule to the Master Agreements in view of the coming into force of Rome I and Rome II), which corresponds to the expanded governing law clause seen in the 2013 ISDA Arbitration Guide.

It should be noted that the Guide has not been published in protocol form and will therefore only apply to the extent that parties include the model clauses when negotiating the Schedule to the Master Agreements or by amending existing Master Agreements.

Variation margin requirements for physically settled FX forwards —EMIR update

Phillan Amin

Background

On 24 November 2017, the European Supervisory Authorities ("**ESAs**") issued a statement[28] on the variation margin requirements in respect of physically settled FX forwards under Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 with regard to risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty[29] (the "**Margin Rules**" and, as the Margin Rules apply to physically settled FX forwards, the "**FX VM Requirements**"). The ESAs acknowledged that: (i) the globally agreed framework (i.e. the framework developed by the Basel Committee on Banking Supervision ("**BCBS**") and the International Organisation of Securities Commissions ("**IOSCO**")) for the margining of physically-settled FX forwards had been applied on a more limited basis in other key jurisdictions (such as the United States, Japan, Singapore and Canada); and (ii) the FX VM Requirements had created challenging obligations for certain end-users.

As a result, the ESAs announced that they were undertaking a review of the Margin Rules in order to align the FX VM Requirements with the margin requirements of other key jurisdictions. The ESAs stated that they expected competent authorities to generally apply "*their risk-based supervisory*

26 Available at: https://www.isda.org/a/6JDDE/isda-arbitration-guide-final-09-09-13.pdf

27 Note that these have been drafted to ensure the clauses now fall within the scope of the Hague Convention.

28 *Variation Margin exchange for physically-settled FX forwards under EMIR, 24 November 2017.*
Available on this link: https://esas-joint-committee.europa.eu/Pages/News/Variation-margin-exchange-for-physically-settled-FX-forwards-under-EMIR-.aspx

29 Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty). For more background on margining under Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, please see "*European Margin Rules for Non-cleared OTC Derivatives—The Margin Big Bang*", Nathaniel Crowley, Delta Report, 24 January 2017.
Available on this link: https://www.whitecase.com/publications/article/european-margin-rules-non-cleared-otc-derivatives-margin-big-bang

powers in their day-to-day enforcement of applicable legislation in a proportionate manner." Prior to this statement, financial counterparties, non-financial counterparties above the clearing threshold and equivalent non-European Union ("**EU**") entities had expected the FX VM Requirements to apply from 3 January 2018.

On 7 December 2017, the Financial Conduct Authority ("**FCA**") issued a statement confirming that it supported the ESAs's statement[30]. Whilst the FCA noted that the proposed amendments to the Margin Rules were not clear, the proposals outlined in the ESAs's statement could be used by firms as an indication of what the amended requirements may look like. The FCA therefore confirmed that they would not require firms whose physically settled FX forwards are likely to be outside the scope of the amended requirements to continue putting processes in place to exchange variation margin.

Draft amendment to the Margin Rules

On 18 December 2017, the ESAs published draft regulatory technical standards to amend the existing Margin Rules (the "**Draft RTS**")[31]. They acknowledged that:

- the EU is the only jurisdiction to directly include physically settled FX forwards within the scope of its variation margin requirements;
- if the FX VM Requirements were not amended, there was a risk that EU market participants might accept the negative consequences of leaving their currency risk unhedged;
- this risk was particularly true for smaller clients for which the amount of variation margin exchanged would be small, but the cost of implementing margining systems and procedures would be disproportionately high; and
- clients outside the EU may decide to trade away from EU banks to avoid the FX VM Requirements.

The ESAs considered that a full exemption from the FX VM Requirements for all counterparties would "*contradict the BCBS and IOSCO guidance that encourages the exchange of variation margin*" and concluded that their preferred option would be to restrict the FX VM Requirements to transaction between "institutions", as described below. Accordingly, they have proposed to amend the Margin Rules by adding in the following provision:

"Article 31a
Treatment of physically settled foreign exchange forward derivatives

By way of derogation from Article 2(2), counterparties may provide in their risk management procedures that variation margins are not required to be posted or collected for physically settled foreign exchange forward contracts in any of the following cases:

(a) where one of the counterparties is a counterparty other than an 'institution' in the sense of point (3) of Article 4(1) of Regulation (EU) No 575/2013;

(b) where one of the counterparties is established in a third country and would not meet the definition of 'institution' in the sense of that Article, if it were established in the Union."

An "institution" is a "credit institution or an investment firm" as defined in the Capital Requirements Regulation[32].

Implementation in the EU

In the Draft RTS, the ESAs acknowledged that the amendments to the Margin Rules would only take effect after 3 January 2018 (the date on which the FX VM Requirements would be in force). The ESAs therefore stated that "*for institution-to-non-institution transactions, the competent authorities should apply the EU framework in a risk-based and proportionate manner until the [Draft] RTS enter into force*". The *"Summary of responses to the stakeholder group consultation and the ESAs' analysis*" in the Draft RTS clarifies that this "*risk-based and proportionate*" approach will only apply in the period between 3 January 2018 and the date on which the Margin Rules are amended.

Given the urgency with which it is necessary to amend the Margin Rules, the Draft RTS states that it will come into force "*on the day following that of its publication*" in the Official Journal of the European Union (not the usual 20 days).

30 For more information, please see: https://www.fca.org.uk/markets/emir

31 Draft regulatory technical standards on amending Delegated Regulation (EU) 2016/2251 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 with regard to physically settled foreign exchange forwards.
Available here: https://esas-joint-committee.europa.eu/Publications/Technical%20Standards/Joint%20Draft%20RTS%20on%20margin%20requirements%20for%20non-centrally%20cleared%20OTC%20derivatives%20(JC-2017-79).pdf

32 Point (3) of Article 4(1) of Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

European Parliament's Economic and Monetary Affairs Committee ("ECON Committee")—Draft report

The European Parliament's ECON Committee has published a draft report dated 26 January 2018 (the "**ECON Draft Report**")[33] on the proposal to amend Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**"). It may be worth noting that the ECON Draft Report agrees that "*the mandatory exchange of variation margins (VM) for physically-settled FX forwards should be limited to certain counterparties (banks and investment firms), via a modification of the [Margin Rules]*." In addition, it recommends that in order to achieve a perfect alignment with other international jurisdictions, the ESAs's proposal should be extended to physically settled FX swaps. For a detailed analysis of the proposed amendments to EMIR, please see Eduardo Barrachina's article in this issue of the Delta Report.

Conclusion

Whilst the exact timing of the implementation of the Draft RTS is not clear and the FX VM Requirements have technically been in force since 3 January 2018, the statements from the ESAs and the FCA and the move to restrict the FX VM Requirements to "institutions" will come as welcome relief to many in the market. The Draft RTS, if implemented in its current form, should level the playing field as against other jurisdictions (such as the United States).

33 For more information, please see: http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-616.810&format=PDF&language=EN&secondRef=01

Authors

Ingrid York
Partner, London

T +44 20 7532 1441
E iyork@whitecase.com

Charles Balmain
Partner, London

T +44 20 7532 1807
E cbalmain@whitecase.com

Eduardo Barrachina
Associate, London/Madrid

T +44 20 7532 1554
E ebarrachina@whitecase.com

Richard Blackburn
Associate, London

T +44 20 7532 1571
E rblackburn@whitecase.com

Nathaniel Crowley
Associate, London

T +44 20 7532 1542
E ncrowley@whitecase.com

Phillan Amin
Associate, London

T +44 20 7532 1931
E phillan.amin@whitecase.com

LON00518054-05