BREXIT: A FIRST LOOK AT THE IMPACT ON ASSET MANAGERS THAT TRADE DERIVATIVES

Date: 30 June 2016

Brexit/Investment Management, Hedge Funds and Alternative Investments Alert

Asset managers and investment funds that make significant use of derivatives will face regulatory and operational challenges in the post-Brexit vote environment. Although the Brexit vote is not expected to have an immediate impact on the legal status of derivative contracts, asset managers should be attentive to counterparty risks in this period of financial market stress

REGULATORY IMPLICATIONS—SHORT TERM

The regulatory structure of the derivatives market in the United Kingdom (UK) will not experience significant changes in the immediate future. The European Market Infrastructure Regulation (EMIR), which governs clearing, trade reporting, and other aspects of the derivative market infrastructure in the UK and the EU will remain in effect for the time being. The Financial Conduct Authority (FCA) has initially indicated that firms should be prepared to comply with elements of the European Market Infrastructure Regulation (EMIR) that are due to come into force between now and the UK's formal exit from the European Union (EU); notably, this includes the forthcoming mandate for derivatives counterparties to exchange initial and variation margin for non-centrally cleared derivatives.

Prior to the referendum, the European Commission indicated that it would not be ready to implement the first stage of these regulations by September 1, 2016, the deadline set by U.S. regulators. The first implementation date for initial margin under EMIR will likely be in mid-2017, and subsequent deadlines for posting variation margin initially set for March 1, 2017 will necessarily be pushed back as well. Industry trade groups are lobbying for a global realignment of the margin timing, which will likely delay implementation in the United States and other jurisdictions as well.

REGULATORY IMPLICATIONS—LONG TERM

In 2009, the UK separately committed to the G20 reform agenda for derivatives markets. To meet these commitments, we expect that the UK will adopt comprehensive derivatives regulation related to clearing, reporting, margin requirements, and related matters that will look very much like EMIR and/or U.S. regulations promulgated under Title VII of Dodd-Frank. The withdrawal of the UK from the EU will likely result in UK entities being considered "Third Country Entities" for purposes of EMIR, and the scope of their obligations under EMIR will be limited. On the other hand, the EU may prompt the migration of derivatives clearing organizations to the continent by requiring that instruments traded on an EU execution facility be cleared through an EU clearing organization, or by imposing punitive collateral requirements on transactions cleared through British clearing organizations. The EU may also seek to impose more general prohibitions on the clearing of euro-denominated swaps and foreign exchange transactions outside of the EU.

©2005-2026 K&L Gates LLP. All Rights Reserved.

The extent to which the EU and UK regulators will recognize clearing organizations and trade repositories in the other's jurisdiction, and any additional restrictions imposed by the EU, will likely influence where asset managers choose to trade. In addition, derivatives documentation often includes contractual recognition of insolvency regimes that will be affected by Brexit, including insolvency regimes for "too-big-to-fail" institutions in the UK and the EU, and "bail-in" authority granted to European resolution authorities by the EU Bank Recovery and Resolution Directive.

Reacting to these changes will likely require significant documentation efforts over the coming two years.

OTHER CONSIDERATIONS

Perhaps the most pressing concern is the impact that Brexit-related volatility in financial asset and funding markets could have on existing derivatives contracts. In the immediate aftermath of the Brexit vote, the equity capitalization of major British and European banks suffered precipitous declines, and CDS spreads widened rapidly. As in any period of stress, asset managers should pay close attention to the creditworthiness of their counterparties, and may want to consider establishing derivative trading and prime brokerage relationships with additional counterparties to further diversify counterparty credit risk. This will provide an opportunity to move positions quickly if financial markets deteriorate further and current trading partners approach insolvency. In addition, asset managers should take this opportunity to review their rights and obligations related to fund NAV declines and credit rating downgrades of counterparties or collateral custodians, which may trigger defaults under existing derivatives contracts.

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.