U.K. Withdrawal from the E.U.: Issues of Legal Uncertainty Arising in the Context of the Robustness of Financial Contracts

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Financial Markets Law Committee

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1. INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. On 23 June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (this process is known, colloquially and hereafter in this paper, as "**Brexit**"). On 29 March 2017, HM Government officially served notice to the E.U. of the U.K.'s withdrawal under Article 50 of the Treaty on European Union ("**TEU**"), beginning the two-year "notice period". Legislation—the European Union (Withdrawal) Bill (the "**Withdrawal Bill**")—was introduced into the House of Commons in July 2017, aimed at repealing the European Communities Act 1972 and incorporating into U.K. law all applicable E.U. law. The Bill was enacted on 26 June 2018 as the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**").

1.3. Negotiations between the U.K. and the E.U. about the nature of their post-Brexit relationship are also underway. On 7 December 2017, it was announced that the U.K. and E.U. had concluded the first part of the Article 50 negotiations. The U.K. had tentatively agreed to pay a financial settlement and to protect the rights of E.U. citizens resident in the U.K.[2] In March 2018, the U.K. and E.U. published a draft Withdrawal Agreement which included the possibility of a transitional period running from 29 March 2019 to 31 December 2020, during which the U.K. will continue to participate in the single market and customs union.[3] This has not yet, however, been confirmed. As per HM Government's most recent White Paper, the U.K. will cease to be a Member State of the E.U. at the end of the Article 50 notice period on 29 March 2019 (defined in the Withdrawal Act as "**Exit Day**").[4] If the 21-month transitional period is ratified, E.U. laws will continue to apply in the U.K. for its duration.

2 Barker, A. and Brunsden, J., "Brexit divorce deal: the essentials", *Financial Times*, (8 December 2017), available at: https://www.ft.com/content/21c5d076-dbee-11e7-a039-c64b1c09b482.

3 Blitz, J., "UK and EU agree 'decisive step' with 21-month Brexit transition", *Financial Times*, (19 March 2018), available at: https://www.ft.com/content/f418a8b2-2b69-11e8-9b4b-bc4b9f08f381.

4 Department for Exiting the European Union, *Legislating for the Withdrawal Agreement between the United Kingdom and the European Union*, (24 July 2018), available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/728436/6.4737_Cm9674_Legislating_for_the_withdrawl_agreement_FINAL_230718_v3_WEB_for_gov.uk_.pdf.

1.4. Little has been agreed in relation to the long-term relationship between the U.K. and the E.U. and there remains a possibility that the U.K. will leave the E.U. without having successfully negotiated a plan for the future (this has been referred to as a "cliff edge" scenario or a "hard" Brexit). In the event of a hard Brexit of this severity, U.K. firms will lose their ability to access the E.U. single market on the basis of the "passporting" rights by which a significant degree of access is currently ensured.[5] U.K. and E.U. firms will be limited in their ability to provide financial services to E.U. and U.K. clients, respectively. U.K. firms may look to exemptions in local law which allow for access by firms from non-E.U. countries ("**Third Countries**") or apply for permission from the European Commission or other E.U. bodies under the access regimes for Third Countries provided in E.U. legislation (the "**Third Country regimes**"). The concerns in this respect include not only the provision of services to new customers in the E.U. but also the smooth continuity of provision of services to existing customers.

1.5. A related question which has been raised by many market participants and observers, in the context of a hard Brexit, is whether the performance of existing—sometimes called "**legacy**"—financial contracts would continue or whether Brexit would make their performance illegal, impractical or impossible in some way.[6] This paper takes an in-depth look at the question of the continuity of legacy contracts and highlights the legal uncertainty which will arise if there is no clarity as to the future of the U.K.-E.U. relationship post-Brexit. In section 5 of the paper, the FMLC suggests a number of ways by which these uncertainties might be reduced or avoided.

Scope and Executive Summary

1.6. This paper focuses on existing contracts, although some of the points discussed below may be equally relevant to wholly new contracts concluded after Exit Day.

1.7. It is also important to note that this paper exclusively concerns contractual rights and obligations. As explained in subsequent sections, however, the problem outlined herein is not confined to contractual rights and obligations and may arise in the context of

[5] Supervisory authorities in the E.U. are requiring firms to plan for the possible outcome of a hard Brexit. See: European Central Bank, "Relocating to the Euro Area", (25 June 2018), available at: https://www.bankingsupervision.europa.eu/banking/relocating/html/index.en.html.

[6] See, for example:

- Bank of England, "Record of Financial Policy Committee meeting held on 20 September 2017", (published on 3 October 2017), available at: https://www.bankofengland.co.uk/record/2017/financial-policy-committee-september-2017.
- House of Lords European Union Committee, *Report—Brexit: acquired rights*, (published on 14 December 2016), available at: https://publications.parliament.uk/pa/ld201617/ldselect/ldeucom/82/82.pdf.

activities performed in connection with a contract, for which there is no express contractual provision made. While questions about the continued performance of these services and activities are integral to the assessment of business continuity, they are not the primary focus of this paper.

1.8. Another matter which is beyond the scope of this report is the question of regulatory continuity and mutual market access for E.U. and U.K. firms across the Brexit divide. The FMLC has dealt with legal complexities arising from Brexit in relation to access for British firms to the E.U. financial markets under the Third Country regimes.[7] In a later publication, the Committee considered the relation to rules of cross-border trade set by the World Trade Organization ("**WTO**") in previous papers.[8] It has also examined the freedom of establishment and the freedom to provide services in relation to the provision of insurance services in the E.U.[9] This paper focuses, therefore, on the legal—rather than regulatory or commercial—implications of Brexit on contracts between participants in the U.K. and E.U.

1.9. Two fields in which some thought has already been given to the particular issues addressed in this paper include i) derivatives dealing; and ii) insurance provision. This may have something to do with the size of these financial markets or the sophistication of the market participants but it is more likely to arise from the fact that services in these fields can raise unique—or, at least, distinctive—questions concerning regulatory authorisation and permission in the ongoing performance of the contracts.[10] For this reason, these markets receive a higher degree of attention in this report than some other financial services and most illustrative examples of market standard contractual obligations have been drawn from one or other of these fields. The general rule of thumb, however, is that the analysis provided is intended to cover all financial contracts incorporating the obligation in question unless the contrary is stated.

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7 FMLC, Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U. the Provision and Application of Third Country Regimes in E.U. Legislation, (13 July 2017), available at: http://www.fmlc.org/fmlc-paper-on-brexit-and-third-country-regimes.html.

8 FMLC, Issues of Legal Uncertainty Arising in the Context of the U.K.'s Withdrawal from the E.U.—the Application and Impact of World Trade Organization Rules on Financial Services, (22 December 2017), available at: http://www.fmlc.org/brexit-and-wto-paper.html.

9 FMLC, *Report: Establishment of an E.U. Insurer in Another Member State*, (12 July 2018), available at: http://fmlc.org/report-establishment-of-an-e-u-insurer-in-another-member-state-12-july-2018/.

10 For a more in-depth analysis of contractual continuity in relation to over-the-counter derivatives, see International Swaps and Derivatives Association ("**ISDA**") and the Association for Financial Markets in Europe ("**AFME**"), *Contractual Continuity in OTC Derivatives: Challenges with Transfers*, (July 2018), available at: https://www.isda.org/a/EEjEE/Contractual-Continuity-in-OTC-Derivatives-Challenges-with-Transfers.pdf.

1.10. The paper adopts the following structure: section 2 comprises an explanation of the current arrangements which enable financial contracts to be agreed and performed across the E.U. (including with the U.K.), an overview of the impact of Brexit on financial services business and an exploration the various options available to U.K. firms, post-Brexit, which might enable them to continue to access the E.U. market and fulfil pre-existing contracts. Section 3 is a note on contractual arrangements to forestall illegality. Section 4 considers the uncertainties arising from Brexit in relation to contracts, surveying any general law, contractual and penal/administrative consequences. In section 5, the FMLC discusses some ways by which these uncertainties might be reduced or avoided.

1.11. It is important to recognise that, where the U.K.'s withdrawal does not include mutual "passporting" or similar recognition arrangements, the issues identified here will affect E.U. firms as well as U.K. firms, and in both cases the impact will have a knock-on effect on E.U. customers. This paper, however, focuses on U.K. firms and E.U. customers for the purposes of illustration.

1.12. In the European Commission's most recent Communication, it observed that there does not currently appear to be a general concern related to contractual continuity as, in principle, the performance of existing obligations can continue.[11] It has advised, however, that each type of contract should be assessed separately. Thus, it remains important to take account of the legal implications of Brexit, the possible loss of authorisation, and the content of market standard terms in financial services contracts worldwide so as to identify any potential legal issues relating to the continuity of financial contracts. The FMLC has attempted such an analysis below. If contractual continuity is a desired end, for the E.U. and U.K. alike, then mutual "passporting" or similar recognition arrangements are particularly important.

2. THE U.K.'S WITHDRAWAL FROM THE E.U.

2.1. Currently, firms authorised in one Member State of the E.U. may carry out permitted activities in any other Member State without requiring further authorisation on the basis of the "passporting" rights to which the U.K. is entitled qua Member State.[12] The E.U.

[11] European Commission, *Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic And Social Committee, the Committee of the Regions and the European Investment Bank: Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019*, (19 July 2018), available at: https://ec.europa.eu/info/sites/info/files/communication-preparing-withdrawal-brexit-preparedness.pdf.

[12] Although this paper refers consistently to access by U.K. financial services providers to E.U. markets under E.U. law, this should be understood to include, *mutatis mutandis*, access to E.E.A. markets by virtue of the provisions of the Agreement on the European Economic Area (1994).

"passport" is not a homogenous right which applies across the financial services—E.U. legislation governing each sector of the financial services market sets out the activities which are "passportable", and therefore permitted across the E.U.[13]

2.2. Upon Brexit, the U.K. will lose these benefits of membership of the E.U. and become, from the perspective of E.U. law, a Third Country. The European Commission has announced that when the U.K. leaves the E.U., the "passporting" rights provided for in MiFID II will no longer apply[14]— access rights in other areas may also be rescinded. In a truly "hard Brexit" scenario, without treaty provisions establishing mutual access arrangements between the U.K. and E.U.—and in the absence of any other applicable exemptions under local Member State law—U.K. firms will require an additional layer of authorisation to provide services in the E.U.[15]

13 "Passporting" rights are written into several regulations which govern the operation of cross-border financial services business. In relation to investment services and activities, Directive 2014/65/E.U. of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments ("**MiFID II**") establishes market conduct rules. Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance ("**Solvency II**") provides passporting rights to (re)insurers to establish a branch or provide services across the E.U. Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms ("**CRD IV**") allows banks authorized in one Member State to provide, inter alia, advisory services, lending or custody or deposit services to a business in another E.U. state. Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") establishes a framework for clearing of over-the-counter (OTC) derivatives and for the functioning and governance of central counterparties (CCPs), which clear OTCs. Under passporting, CCPs can offer clearing services across the E.U. Several other "passports" are available for banks and financial services. A complete account of the Third Country Regimes can be found in the following report: International Regulatory Strategy Group, *The E.U.'s Third Country Regimes and Alternatives to Passporting,* (23 January 2017), available at: https://www.thecityuk.com/assets/2017/Reports-PDF/The-EUs-Third-Country-Regimes-and-Alternatives-to-Passporting.pdf

14 See, European Commission, *Notice to Stakeholders: Withdrawal of the United Kingdom and E.U. rules in the field of markets in financial instruments*, (8 February 2018), available at: https://ec.europa.eu/info/sites/info/files/180208-notice-withdrawal-uk-financial-instruments_en.pdf.

15 The effects of the U.K.'s withdrawal from the E.U. will, of course, also be felt by E.U. firms wishing to access the U.K. market. Statements from HM Government, however, seem to indicate that E.U. firms' ability to access the U.K. market is less dependent on the form of the future relationship. The U.K. has a permissive regulatory perimeter for Third Country cross-border wholesale investment business, enshrined in the so-called "overseas persons exclusion" ("**OPE**") in Article 72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. The OPE allows wholesale investment business to be carried out between foreign firms on the one hand and large corporates, sophisticated investors or regulated firms on the other hand, without coming under local regulation in the U.K. It is expected that the basic scheme of authorisation for investment firms under the Financial Services and Markets Act 2000 (the "**FSMA 2000**") and the regulations made under it will be left in place—subject to amendment by secondary legislation made under the Withdrawal Act so far as is necessary to keep them workable—which means E.U. firms are likely to be able to continue to avail of the U.K.'s permissive regulatory perimeter.

While an E.U. investment firm, which has upon Brexit lost its authorisation to carry on investment business in the U.K., will need to obtain authorisation from either the Prudential Regulation Authority or the Financial Conduct Authority, it is hoped that this will not be very onerous. On 24 July 2018, HM Government published a draft statutory instrument—the draft EEA Passport Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018—which will amend references to "passporting" rights in received/retained legislation and will implement a temporary permissions regime to allow E.E.A. firms and funds operating in the U.K. under a financial services "passport" to continue their operations for the planned transitional period. The draft Regulations are available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/728567/EEA_passport_rights_draft_SI.pdf, and the explanatory notes are available at: https://www.gov.uk/government/publications/financial-services-legislation-under-the-eu-withdrawal-act/eea-passport-rights-amendment-etc-and-transitional-provisions-eu-exit-regulations-2018. In conjunction with this, the Bank of England and the FCA have published statements. Please see: Bank of England, *Temporary permissions and recognition regimes*, (24 July 2018), available at: https://www.bankofengland.co.uk/news/2018/july/temporary-permissions-and-recognition-regimes, and FCA, *The temporary permissions regime for inbound passporting EEA firms and funds – our approach*, (24 July 2018), available at: https://www.fca.org.uk/markets/eu-withdrawal/temporary-permissions-regime.

2.3. Market participants have identified three ways by which U.K. firms might be able to continue providing business in the E.U. Under the first of these options, U.K. firms would have to apply for access to the E.U. market in respect of each activity under the relevant Third Country regime derived from the relevant E.U. legislation (or otherwise comply with the conditions of that regime). The scope, process and timing of this has been analysed in depth by the FMLC in a previous paper, which concluded that the patchwork of Third Country regimes was complex and an inadequate replacement to "passporting".[16] A second method would require firms to make arrangements with clients such that the E.U. client initiates the transaction, setting up a so-called "reverse solicitation" arrangement, which might avoid triggering a licensing requirement.[17] While the process and implications of such a setup are beyond the scope of this paper—the FMLC intends to examine the utility and legal complexities of reverse solicitation in a future publication—it is important to note that this option is not available to all firms (see footnote 17, below). A third way by which U.K. firms might access the E.U. markets is by providing only those activities which are not caught by the relevant Member State's regulatory perimeter (i.e., services which do not constitute regulated activities in the Member State of the customer). Most E.U. Member States, however, do not have a wide-ranging and permissive regulatory perimeter and the practicality of relying on such a regime also tends to vary considerably by country.[18]

2.4. These options, individually and in sum, do not provide as comprehensive access to the E.U. markets as "passporting" currently does, not least because there may not be equivalent provisions for all the types of financial services that are covered by the various "passporting" rights that exist at present. This is likely to present problems for existing financial contracts—i.e., contracts made before Exit Day (or during a transitional period during which "passporting" rights were maintained) and which upon Brexit remain wholly or partly unperformed, or which the parties expect to be serviced through further agreements and the provision of further activities.

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16 See s*upra*, n. 7.

17 This is permitted, at least, in the case of firms regulated by the MiFID II package and by the AIFMD through provisions which allow a Third Country firm to deal with customers in the E.U. if the client initiates the transaction. See, Article 42 (Provision of services at the exclusive initiative of the client) of MiFID II, Article 46 of MiFIR and Recial 70 of the AIMFD.

18 In the past the European Commission has given guidance as to when and how particular activities are regarded as being regulated in particular places of business involved in the relevant activity. For example, traditionally, deposit-taking has been regarded as only taking place in a regulated manner in the place of business of the branches of the institution taking the deposit but not in the place of business of the depositor: Commission interpretative communication: Freedom to provide services and the interests of the general good in the Second Banking Directive (97/C 209/04)). In contrast, insurance is often regarded as being provided in the place of business of the insured. It is not clear whether this guidance will be revisited following Brexit.

Important distinctions

2.5. If a firm deals on its own account (or "**as principal**") in a kind of business and in a manner that requires regulatory authorisation, it must be authorised at the time it enters the contract—this applies even when the individual contract is made within the framework of an existing agreement between the same parties, such as the Master Agreements published by the International Swaps and Derivatives Association ("**ISDA**"). The general view has been that the performance of transactions which were covered by an authorisation at the time they were made will not be affected by a subsequent loss of authorisation.[19] On that basis, loss of authorisation will not affect the firm's performance of existing obligations under a transaction made as principal, such as making or collecting payments that become due, the provision or return of collateral (even in the form of transferable securities, including under a title transfer financial collateral arrangement), or the termination of an existing transaction. In some cases, the exercise of option rights under an existing transaction may also fall into this category.

2.6. The status of other pre-existing obligations, however, is less clear. This includes, for example, where an exercise of rights under a derivative transaction results in a subsequent transaction which might also require authorisation in its own right, such as the exercise of an option to cause a swap to come into effect, or where discretion is afforded to a party or to a calculation agent, which some have argued may fall into the category of portfolio management or the provision of advice. On the lending side, further drawdowns under revolving or, indeed, term loans, in a loan agreement with a term which extends beyond the date at which authorisation ceases (in Member States where lending is a regulated activity), could also be problematic. A financial institution which provides further services in respect of an existing contract may need to be authorised at the time the services are requested even if the services are "required" or referred to by the contract in question.

2.7. Where a firm is acting for a client, authorisation may be required for a wider range of activities: for the reception and transmission of orders in relation to financial instruments, the execution of orders on behalf of the client, portfolio management and the provision of advice; on-going services to be performed in respect to insurance contracts; payment services; and custody and investment management agreements. Even though the firm may have undertaken to provide services of these kinds in an

[19] See: ISDA, *Brexit and Contractual Certainty* (9 October 2017), available at: https://www.isda.org/2017/10/09/brexit-and-contractual-certainty/.

existing contract, it is not clear whether the firm still needs authorisation at the time the further service is arranged. If it does, loss of authorisation is likely to affect its ability to provide the services.

2.8. The practical problem affecting existing contracts is, however, wider than this. Where a firm is dealing on its own behalf, the parties may expect the firm to carry out some routine operations that the contract does not require or provide for: for example, under a derivatives contract, "rolling" an open position by agreeing to terminate a transaction prior to the scheduled termination date and entering into a new transaction on similar terms, except for a longer maturity date; varying the terms of a transaction (for example by agreeing to increase or decrease the notional amount); novating a transaction to a third party (which includes clearing derivatives *via* a central counterparty); agreeing a consensual termination of a transaction; and entering into an offsetting transaction to close-out a position (in whole or in part). The same seems to be true of portfolio compression—i.e., replacing a number of offsetting transactions with a smaller number of transactions having the same overall economic profile. Depending on the applicability of EMIR, there may be a regulatory requirement to carry out this process as it is perceived to reduce the operational risk associated with derivative transactions and therefore reduce the risk in the financial markets. Thus all these activities will constitute either dealing by a firm when it is acting as principal, or providing investment services to a client, and therefore in principle require authorisation at the time, even if they relate to an existing contract.[20]

2.9. Thus there are some cases in which further agreements or activities are to be carried out under the terms of an existing contract but which will not be covered by an authorisation at the time the contract was made; and there will be many cases in which further agreements or activities in connection with an existing contract were contemplated but clearly involve fresh investment activities or services. But both types of case, compendiously referred to in this paper as "further activities", would be affected by loss of authorisation. It has been pointed out that even the notion of providing further activities in respect of an existing contract does not capture the dynamic relationship between investment firms and their counterparties that may arise from the need to manage their positions. This may involve new, arms-length transactions with the same counterparty—anything beyond the servicing of existing contracts is, however, beyond the scope of this paper.

20 That is, unless they can be brought within one of the regimes, such as third-country firm, reverse solicitation, etc. discussed earlier.

3. A NOTE ON CONTRACTUAL ADJUSTMENTS TO FORESTALL ILLEGALITY

3.1. Financial contracts commonly contain clauses which apply if the performance of the contract becomes unlawful or impossible through *force majeure*. These clauses may also allow for the method of performance to be adjusted in a way such that operations which require authorisation may still be carried out lawfully. For example, while the 1992 ISDA Master Agreement provides for termination in the event of illegality (if that has occurred: on this, see below), it also anticipates, as a first step, that the party affected by the illegality will use reasonable efforts to transfer relevant transactions to another of its offices or to an affiliate so that the illegality ceases to exist. If the party in question does not effect such a transfer within a certain time frame, the other party has a further period of time within which to make a transfer. It is only at the end of this combined time period that, in case no transfer has occurred, the relevant transactions may be terminated.[21]

3.2. Similarly, the 2002 ISDA Master Agreement includes provisions, further developed from the 1992 Agreement, which have been designed to give the parties time to mitigate the effect of an illegality or *force majeure* event. These provisions include greater clarity on the interaction with other ISDA Master provisions relating to the role of a head office in a branch scenario and a waiting period which must expire before the relevant transactions may be terminated. Although the Agreement does not specify the use to which the waiting period must be put, it gives time for the relevant illegality or *force majeure* to be resolved, where this is possible, or for the parties to take steps to transfer transactions to avoid termination where possible. It is conceivable that some such clauses give the firm the right to adjust the contract (e.g. by substituting other,

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21 It is worth pointing out that the parties, and particularly financial institutions, may be reluctant to raise illegality. If a financial institution is held to be wrong to have claimed the existence of an illegality so as to justify no longer performing the contract, it risks exposure for breach of contract and a claim for substantial damages as well as possible regulatory action.

authorised parties as counterparties),[22] and consequently the right to prevent the loss of authorisation from affecting future operations, without the need to obtain the consent of the other party. Such a route based on consent would probably be impractical because of the significant numbers of transactions and counterparties involved for each regulated firm.[23]

4. LEGAL UNCERTAINTIES RELATING TO CONTRACTUAL CONTINUITY

4.1. The possible consequences of a "hard" Brexit, involving a wholesale loss of authorisations, may be divided into three broad categories: (1) consequences under the general law in those cases where the contract may be affected by illegality or frustration; (2) any consequences according to the terms of the contract itself, as, for example, in those cases where loss of authorisation may breach a representation and trigger a termination event; and (3) consequences under criminal law or similar sanctioning regimes which might come into play were the firm considered to be carrying on a regulated activity without authorisation. Each of these is considered in turn in this section.

General law consequences

4.2. The consequences of loss of authorisation for further agreements or activities depends on (a) the governing law of the contract; (b) whether the further agreements or activities are to be or have been carried out in the European counterparty's home Member State in a manner that requires local regulation under the laws of the Member State in

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22 For example, the Loan Market Association's standard form agreements make provisions for illegality such that:

> If, in any applicable jurisdiction, it becomes unlawful for any Lender to perform any of its obligations as contemplated by this Agreement or to fund or maintain its participation in any Loan [or it becomes unlawful for any Affiliate of a Lender for that Lender to do so]:
>
> that Lender shall promptly notify the Agent upon becoming aware of that event;
>
> upon the Agent notifying the Company, each Available Commitment of that Lender will be immediately cancelled; and
>
> to the extent that the Lender's participation has not been transferred pursuant to paragraph (d) of Clause 8.6 (*Right of replacement or repayment and cancellation in relation to a single Lender*), each Borrower shall repay that Lender's participation in the Loans made to that Borrower on the last day of the Interest Period for each Loan occurring after the Agent has notified the Company or, if earlier, the date specified by the Lender in the notice delivered to the Agent (being no earlier than the last day of any applicable grace period permitted by law) and that Lender's corresponding Commitment(s) shall be cancelled in the amount of the participations repaid.

23 See Bank of England, *Record of the Financial Policy Committee Meeting on 20 September 2017*, para 49: "To continue to service their contracts firms would need to replace cross-border business by novating contracts to new entities with the necessary regulatory permissions. For each of the large dealers, this would require the agreement of 2,000-4,000 counterparties who themselves may need to secure agreement with other involved parties." (Available at: https://www.bankofengland.co.uk/record/2017/financial-policy-committee-september-2017.)

question; and (c) whether it is necessary to enforce the agreement in a court in the E.U. Member State.

4.3. While agreements made by U.K. firms are likely to be governed by English law, it is not uncommon for a U.K. firm to enter into an agreement which is governed by the law of an E.U. Member State—both instances are considered below. In the case of an English law-governed contract, it is the nature and location of the activities which might lead to illegality. Under the Financial Services and Markets Act 2000 (the "**FSMA 2000**"), the effect of a contract made by an unauthorised person is not to render it illegal: the contract is merely unenforceable against the other party, who is entitled to recover any money or other property paid or transferred by him under the agreement and compensation for any loss sustained by him as a result of having parted with it.[24] Below, the paper delves into the various circumstances in which legacy contracts might be grouped and the ways in which English and foreign courts might contemplate them.

Governed by English law and not illegal in place of performance

4.4. If the contract is governed by English law and is legal under English law, it is in general immaterial that it happens to be illegal under the law of one party's nationality,[25] of the country in which the contract was made,[26] or of the country in which performance of the contract may, but need not, take place.[27]

Governed by English law but further agreements or activities must be performed in E.U.

4.5. If the further agreements or activities have to be carried out in the E.U. Member State, there may be a problem if that Member State no longer treats the U.K. firm as having authority to conduct investment business, even if any enforcement action would be in an English court applying English law. It is a principle of English law that the court will not enforce a contract, even though the contract is perfectly legal under English law, if its performance is regarded as illegal in the place in which it has to be performed.[28] For

24 See section 28(9) and section 26 of FSMA 2000.

25 *Chitty on Contracts* (32nd edn, 2015) para 30-367, citing a number of cases including *Kleinwort Sons & Co v Ungarische Baumwolle Industrie AG* [1939] K.B. 678.

26 *Chitty on Contracts* (32nd edn, 2015) para 30-367, citing *Vita Foods Products Inc v Unus Shipping Co Ltd*[1939] A.C. 277, 297–300.

27 *Chitty on Contracts* (32nd edn, 2015) para 30-367, citing *Kahler v Midland Bank Ltd* [1950] A.C. 24, 36, 39, 48.

28 *Ralli Bros v Compania Naviera Sota y Aznar* [1920] 2 K.B. 287. The rule appears to be one of English law, related to the doctrine of frustration by illegality, rather than one of private international law (see *Eurobank v Kalliroi* [2015] EWHC 2377, *Dana Gas PJSC v Dana Gas Sukuk* [2017] EWHC 1896 (Comm) at [58] and *Dicey & Morris* (15th edition) at 32–97 to 32–101. It is thought to have survived the adoption of what is now Article 9(3) of the Rome I Regulation, see below.

this purpose it seems to make no difference whether the contract has become illegal because of a change in law since it was made or was unauthorised at the time it was made (for example because it was an agreement to service an existing contract rather than being for services required by that contract).[29] A problem is likely to arise if the following two conditions are satisfied: (i) the other State treats the performance, as opposed to merely the formation of the agreement, as illegal; and (ii) the performance has to be made in the other State.[30] Subject to whether the illegality is being regarded as sufficiently serious to trigger this rule, it will render an agreement for further activities unenforceable, at least by a party who knew that performing in the place required would be illegal.[31] A related challenge is presented by Article 9(3) of Regulation (EC) No 593/2008 on the law applicable to contractual obligations (the "**Rome I Regulation**"), which provides

> Effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render performance of the contract unlawful. In considering whether to give effect to those provisions, regard shall be had to their nature and purpose and to the consequences of their application or non-application.

It should be noted that Article 9(3) does not depend on the knowledge or intention of the parties. Whether an English court would regard the other Member State's licensing requirement as an "overriding mandatory provision" is considered below. Therefore, in circumstances where the agreements or activities have to be performed in another Member State and that Member State's law treats the performance as illegal, it seems that under English law the contract will be unenforceable by the U.K. firm and possibly by either party. Such a legal outcome will certainly affect some transactions, for example where payment has to be made into an overseas account.

29 In the *Ralli Bros* case, performance became illegal under Spanish law after the contract had been concluded, but the same (or a closely similar) principle applies to existing illegality: see Robert Goff J. in *Toprak Mahsulleri v Finagrain [1979] 2 Lloyd's Rep 98, 107, approved by the Court of Appeal [1979] 2 Lloyd's Rep 112 ,* 117, cited by Arnold J in *Lilley Icos plc v 8PM Chemists Ltd* [2009] EWHC 1905 (Ch), [2010] F.S.R. 4 at [262].

30 See *Dicey, Morris & Collins*, para 32-098.

31 Knowledge may be required because the '*Ralli Bros*' principle is closely associated with the wider principle of 'comity' relied on in cases such as *Foster v Driscoll* [1929] 1 KB 470 (see below). In those cases it is established that the comity principle affects only a party who had 'wicked intent' deliberately to flout the law of the place or performance.

Governed by English law but further agreements or activities intended to be performed in E.U.

4.6. If a contract requires an activity, or if the purpose of the contract was to enable one of the parties to carry out an activity, which the parties envisage will take place in a Member State where the activity is illegal owing to Brexit, the contract may be unenforceable. This is because it is said that "[t]he courts will not enforce a contract made between parties to further an adventure to break the laws of a foreign State."[32] This is referred to in this paper as the "comity principle". It only affects a party which had the deliberate (or "wicked") intention to break the law of the country concerned, but that would include the U.K. firm and possibly also the E.U. counterparty.

Governed by English law but further agreements or activities in fact performed in E.U.

4.7. It may be that, even though the services to be provided could have been carried out in the U.K., they are actually carried out in an E.U. Member State.[33] This would certainly trigger the "comity principle" and thus might well prevent the U.K. firm that provided the services from enforcing the contract. Further, actual performance of the services in the E.U. Member State would again bring the case within Article 9(3) of the Rome I Regulation (see above).

Uncertainties in the performance of unauthorised activities

4.8. It is, however, unclear whether the principles discussed above would be applied to an agreement that had to be, might be or was performed in a foreign state merely because under the law of the state concerned the agreement was regarded as made without the requisite authorisation. It is possible that an English court would not regard a mere lack of authorisation in the counterparty's home state as being sufficiently serious to invoke this principle. As stated above, the FSMA 2000 considers a contract made by an unauthorised person unenforceable against the other party and bestows upon the other party an entitlement to recover any money or other property paid or transferred by him under the agreement and compensation for any loss sustained by him as a result of

32 *Dicey, Morris & Collins on the Conflict of Laws* (15th edn, 2012), para 32-191. An example is *Foster v Driscoll* [1929] 1 KB 470, in which Sankey LJ said (at 521-522): 'An English contract should and will be held invalid on account of illegality if the real object and intention of the parties necessitates them joining in an endeavour to perform in a foreign and friendly country some act which is illegal by the law of such country notwithstanding the fact that there may be, in a certain event, alternative modes or places of performing which permit the contract to be performed legally.' It is not enough that the foreign law would treat performance as illegal wherever it took place. In *Ispahani v Bank Melli Iran* [1998] Lloyd's Rep. Bank. 133, 139-140, Robert Walker LJ said: "international comity is naturally much readier to accept that a country's laws ought to be obeyed within its own territory, than to recognise them as having extraterritorial effect".

33 There is a debate over whether a payment made in a currency other than sterling can be said to have been made in the U.K., or whether it is always made in the financial centre for the relevant currency. If the latter is correct, it would have a significant impact on the issue being considered. There is a particular issue over insurance contracts, see below.

having parted with it.[34] While there is no necessary connection between the way in which Parliament has chosen to treat investment contracts made without authorisation and what a court may think is required by international comity, it is doubtful whether an English court will regard the possible illegality of the contract under the law of another Member State for want of the requisite authorisation as raising a serious issue of comity.

4.9. Further, in *Laboratoires Servier Inc v Apotex*[35] the Supreme Court apparently proceeded on the basis that violations of foreign laws were to be treated in the same way as violations of local laws for the purposes of applying rules of English law founded on the maxim *ex turpi causa non oritur actio.*[36] The case involved a claim to enforce a cross-undertaking in damages given to the court. The Supreme Court held that the relevant wrongdoing (infringement of a Canadian patent) did not involve a sufficient degree of turpitude to engage the *ex turpi causa* principle. If a breach of foreign law is to be treated in the same way as illegality under English law, the subsequent decision in *Patel v Mirza* means that a "factors-based" approach is to be applied.[37] This again suggests that the court might decide that lack of a licence to engage in the relevant activity under the law of the counterparty's home state does not involve a sufficient degree of turpitude so as to render the contract claim unenforceable or in response to which denying enforcement would not be considered proportionate.

4.10. Article 9(3) of the Rome I Regulation provides a discretion to apply the "overriding mandatory provisions" of the law of the country in which the contract has to be or has been performed. From case law, it seems that the phrase "overriding mandatory provisions" is to be interpreted narrowly.[38] In light of the points made in the two preceding paragraphs, it is doubtful that an E.U. Member State's rules on authorisations needed for the provision of financial services would be treated as "overriding mandatory provisions".

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34 See section 28(9) and section 26 of FSMA 2000.

35 [2014] UKSC 55, [2015] AC 430.

36 This may be translated roughly as "no action may be founded on an immoral [or in this context, 'illegal'] act".

37 [2016] UKSC 42, [2016] 3 WLR 399.

38 See *United Antwerp Maritime Agencies NV (Unamar) v Navigation Maritime Bulgare* (C-184/12) [2014] 1 Lloyd's Rep. 161, stating that mandatory rules of law *of the forum* should be given a narrow interpretation.

4.11. There is, therefore, a risk that an agreement for further activities that is governed by English law will not be enforced because the counterparty's Member State treats the provision of further activities as unauthorised. The FMLC acknowledges that the risk is small, even where the services are not performed in the U.K., and agreements for further activities with counterparties or clients in E.U. Member States may not necessarily be affected, provided that any necessary enforcement action would fall to be heard by an English court applying English law, but unfortunately it is impossible to be certain that this would be the outcome. If it is necessary to enforce the contract in the courts of an E.U. Member State, or where the contract is governed by the law of an E.U. Member State, and the law of the relevant State regards the contract illegal for want of authorisation, there is a risk that the contract will not be enforceable, or at least be enforceable only with considerable difficulty.

Contracts governed by an E.U. Member State's law

4.12. It is not uncommon for a U.K. firm to enter into financial services contracts governed by the customer's or counterparty's law. In that case, the effect of the U.K. firm acting without authorisation would be governed by that law. Even where such a claim is heard by an English court, the court should give effect to the governing law, and the agreement for further activities might be unenforceable on the ground of illegality or an equivalent doctrine under the governing law. If the enforcement action were to take place in a court in the E.U. Member State concerned, the court would apply its own law. For example, where a lender under an existing loan contract has agreed to make a further advance at a time when it was no longer authorised, the lender might find that it can no longer recover the agreed interest or finance charges, and possibly even the further capital advanced.[39] That said, the loan agreement may well contain a provision that an advance need not be made if it were illegal to do so, either as a condition precedent to making that advance or because of a breach of a representation on the point. A degree of complexity is introduced by the fact that, as explored in paragraph 4.8, for example, what constitutes illegality may itself be in dispute.

Insurance contracts

4.13. Insurance contracts require special mention. A number of Member States (including France and Spain) treat insurance business as being carried out where the risk is situated, which, depending upon the nature of the risk, may be linked to the location of

[39] If a loan is itself unenforceable, the lender might still have a claim in restitution to recover the sums advanced; but in some legal systems supervening illegality may be seen as a bar to restitution.

the asset insured or the place of business of the insured party. Thus, post-Brexit, unless special arrangements are agreed, those laws will regard U.K. insurers as unauthorised to effect insurance of risks in those Member States, even if the policy is taken out in the U.K. and both premiums and any claims are payable there. The effect will depend on the governing law, which court would have to consider any claim for enforcement and the effect of lack of authorisation under the relevant law. In some countries, such as Germany and the Netherlands, the Third Country insurer's lack of local authorisation does not to give rise to a right to avoid the contract by either party. A claim by the insurer or broker (for example, for unpaid premiums), however, might well be unenforceable if it would have to brought in the courts of the relevant Member State.

Contractual consequences

4.14. Many existing contracts will provide for events of default and/or termination events that give one or both of the parties the right to terminate the contract upon the occurrence of the event, and provide for the consequences of any such termination. The termination events that are of particular relevance in this context are illegality and *force majeure* termination events. For example, both the 1992 ISDA Master Agreement and the ISDA 2002 Master Agreement include an illegality termination event, and the ISDA 2002 Master Agreement includes a *force majeure* termination event.

4.15. Broadly, the illegality termination event will occur if, after the date on which a transaction is entered into, it becomes unlawful under the applicable law for a party to perform one or more obligations in relation to making or receiving payments or deliveries in relation to that transaction or complying with any other material provision of the agreement in relation to that transaction.[40] Again, broadly, the *force majeure* termination event will occur if as a result of *force majeure* or an act of state, a party is prevented from performing one or more obligations in relation to making or receiving payments or deliveries in relation to that transaction or complying with any other material provision of the agreement in relation to that transaction or it becomes impossible or impracticable for a party so to perform. Both events comprise two main limbs: first, an event that occurs after the date on which the transaction is entered into, and second, as a consequence of such event a party is unable to perform in relation to that transaction. It will, of course, depend on the relevant obligation and the jurisdiction in which it is to be performed, but it seems unlikely that the mere

[40] '... under any applicable law (including without limitation the laws of any country in which payment, delivery or compliance is required by either party or any Credit Support Provider, as the case may be)...'. An alternative possibility, depending on the wording of the relevant clause, is that the clause would be triggered if and when a transaction results in one of the relevant countries' authorities imposing a regulatory or criminal sanction on the one of the parties.

performance of an existing transaction after "passporting" rights have been lost will trigger either the illegality or the *force majeure* termination event under the ISDA Master Agreement.[41] For further agreements or activities, however, the clauses may be relevant.

4.16. If the contract has in fact become illegal (for example, because it has to be performed in an E.U. Member State which regards performance as illegal),[42] it is possible that an illegality termination event clause may not be fully effective for a different reason, at least when the contract is governed by English law. If the contract can be "saved" by the sort of adjustment discussed earlier, so that the "adjusted" contract can be carried out lawfully, this would be considered acceptable.[43] On the other hand, if a clause were to require a party to undertake a further action which requires an authorisation no longer possessed by the party, the supervening illegality means the contract would be frustrated. The fact that the contract makes provision for the payment is arguably irrelevant; unlike in other cases of impossibility, in which the parties may make provision in the contract for supervening events and so in effect exclude application of the doctrine of frustration, with supervening illegality it is generally said that the parties cannot determine the consequences of supervening illegality by express provision.[44] It is true that the precedent on which this view rests involved trading with an enemy,[45] and the principle might not be applied to the less serious case of contracting without authorisation, but it is hard to be sure.

4.17. It also possible that, although the loss of authorisation does not render the contract illegal under English law, it will trigger an illegality termination event clause, because the concept of "illegality" in the clause is wider than the illegality which renders a contract unenforceable. For example, the clause might be interpreted as being triggered because the operation is "illegal" in the sense that it is forbidden in the relevant Member State, even though the illegality does not render the contract "illegal" in the sense of

41 See ISDA, *Brexit FAQs* (2018), Question 1 ('the performance of pre-existing contractual obligations (not involving a dealing type activity that in effect involves entry into a new trade in a "financial instrument")' is unlikely to be an Illegality Termination Event.

42 The *Ralli Bros* principle, see above, n 28.

43 Compare the cases involving prohibitions on export, where provisions allowing a party to pay a sum of money instead of performing the illegal act have been held to be effective, e.g. *Johnson Matthey Bankers Ltd v State Trading Corp of India* [1984] 1 Lloyd's Rep 427 (invoicing back clause): see Treitel, *Frustration and Force Majeure* (3rd edn, 2014), para 8-058.

44 See *Ertel Bieber & Co v Rio Tinto Co Ltd* [1918] AC 260 (clause providing for suspension of some obligations in event of war; held that its operation would still contravene the public policy against giving aid to the enemy).

45 See Treitel, *Frustration and Force Majeure* (3rd edn, 2014), paras 8-057-8-058.

being unenforceable. The interpretation of each clause in its context will determine the outcome.

4.18. As another possible example, under the ISDA Master Agreement, the "Misrepresentation" clause might be triggered. Representations are made under Sections 3(a)(iii) and 3(a)(iv) of the ISDA Master Agreement that performance does not violate applicable law and that all consents have been obtained, respectively. Breach of these representations would constitute a Misrepresentation Event of Default under Section 5(a)(iv) of the Agreement. At the time of the original contract there would have been no misrepresentation, and mere performance after loss of authorisation is unlikely to trigger the clause, but to the extent that the occurrence of any of the events discussed above could be construed as entry into a "new" OTC derivative transaction (namely rolling an option position, novations, "material" amendments and unwinds or portfolio compression exercises carried out by way of entering into an offsetting or replacement transaction, as the case may be), it may be that such representations will then be deemed to be repeated—at which point they will no longer be true.[46]

4.19. Therefore, the loss of "passporting" rights—and the consequence that future operations required by the contract or contemplated by the parties will be unauthorised—might trigger some unexpected contractual consequences, even if they do not result in the contract becoming illegal and being frustrated under the general law.

Penal or administrative sanctions

4.20. If the relevant authority in an E.U. Member State regards a U.K. firm as carrying on business in its territory without the necessary authorisation, which, given the complexity of local regulation that is currently masked by the E.U. "passporting" system, may not be easy to predict, there is also a risk that the authority will impose regulatory or even criminal sanctions on the U.K. firm or its employees.[47] This would have adverse reputational and financial consequences for the firm and/or the employees concerned as it may, in turn, act as a trigger in other financial contracts of the U.K. firm (such as loans, collateral management agreements and others).

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46 See ISDA, *Brexit FAQs* (2018), question 3, available at: https://www.isda.org/2018/04/10/brexit-faqs/.

47 For example, in Germany, section 32 of the Banking Act stipulates that any person who performs regulated banking activities or financial services requires prior authorisation by the Federal Financial Supervisory Authority. Were a firm to be found to be providing regulated services or products to customers in Germany in a manner determined to be prohibited by German law, this may constitute a criminal offence (Section 54(1) of the German Banking Act) punishable on indictment by a term of up to five years of imprisonment and/or a fine. In addition, non-compliance with regulatory duties is potentially subject to administrative fines. Under German law, a bank can be held liable to administrative fines, but not for criminal violations (which would instead potentially apply to relevant staff or management).

5. SOLUTIONS WHICH HAVE BEEN SUGGESTED

5.1. As noted above there are risks for parties to contracts concluded by U.K. firms with E.U. clients or counterparties before the U.K.'s departure from the E.U., where these contracts remain to be performed or otherwise operated after the U.K. departs. There are significant legal uncertainties in respect of whether U.K. firms may require E.U. or local (Member State) regulatory authorisations for the performance or operation of those contracts after the U.K.'s exit, authorisations which cannot practically be obtained and the absence of which might mean that a U.K. firm is exposed to criminal or administrative sanctions or other adverse regulatory consequences and/or that the contracts may be found to be illegal or unenforceable.[48]

5.2. The FMLC is aware that market participants have been considering reverse solicitation arrangements and human rights provisions as means by which contractual continuity can be secured—the FMLC intends to analyse these in a forthcoming publication. Two other paths are among those receiving consideration: (1) transfer contracts to an appropriately authorised entity in the E.U.; and (2) depend on contractual arrangements as a remediation strategy. Another way by which long-term legal certainty might be provided is through the successful negotiation of an agreement between the U.K. and E.U. to grandfather existing contracts. Each of these three options is explored below.

<u>Transfer to an E.E.A. entity</u>

5.3. Statutory mechanisms such as those mentioned above are unlikely to be available in all cases and guidance from the E.U. has suggested that European authorities expect U.K. firms to address such issues through private law measures such as transferring business to appropriately authorised entities in the E.U.[49] Perhaps the most obvious way in which firms can work around the authorisation requirement would be by establishing a subsidiary in the E.U. and apply for authorisation to provide services through that subsidiary or apply to a local regulator for authorisation. The contracts could then be novated to the entity in the E.E.A. The FMLC has considered previously the difficulties in subsidiarisation in the context of Brexit.[50] In some cases, it may be

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48 Similar issues potentially also arise for E.U. firms which have concluded contracts with U.K. clients and counterparties before Brexit. As stated above, HM Government has published a draft statutory instrument establishing a "temporary permissions regime" under which E.U. firms and funds operating in the U.K. may obtain a "temporary permission" to continue their activities in the U.K. for a limited period after withdrawal.

49 See, for example, European Insurance and Occupational Pensions Authority, Opinion on service continuity in insurance in light of the withdrawal of the United Kingdom from the European Union (21 December 2017) available at: https://eiopa.europa.eu/Publications/Opinions/2017-12-21%20EIOPA-BoS-17-389_Opinion_on_service_continuity.pdf.

50 See *supra* n. 7

possible to carry out a novation without obtaining the specific consent of the E.U. client or counterparty by availing of provisions in the contract which might permit such a transfer without the consent of the client or counterparty (as discussed further, below) or by using available statutory mechanisms.[51] Many categories of contracts do not, however, contain permissive clauses and in those cases, firms' ability to transfer existing contracts will depend upon obtaining the consent of the client or counterparty to the transfer. Even if firms are able to surmount the practical obstacles of engaging with a large number of clients and counterparties, potentially in a compressed period, there may be countervailing reasons for the client or counterparty to refuse consent, including adverse tax consequences or because a transfer of the contract will trigger clearing or margin requirements under EMIR.

5.4. The scale and complexity of this process is undeniable. Large market participants have several thousand relationships, clients and counterparties to manage. The implications of such restructuring may involve not only significant demands upon time and resource, including reorganisation, capital and human resources costs, there is also the danger of ongoing expense and uncertainty where it is not possible to restructure the affected contract on a like-for-like basis. Further, the transfers will have to be synchronised with other related changes—such as, operational adjustments required to amend collateral arrangements or to address new clearing procedures. In the case of derivative contracts, often a transaction will be linked to another transaction or other services—for example, with a prime brokerage or a clearing arrangement—and it will therefore be necessary to carry out any novation as a package. Another challenge arises in the case of insurance contracts where novation is not available and insurers have to apply for a transfer of business under Part VII of the FSMA 2000.

5.5. Another option, if the contracts so provide (as for example with loan agreements which contain illegality provisions) would be for the U.K. firm to terminate its continuing obligations under the contract. This scenario may be unattractive from the point of view of the E.U. client or counterparty and the firm may be compelled to agree to a requested transfer of the contracts notwithstanding any adverse consequences it may suffer as a result.

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51 For example, using a cross-border merger under the E.U. cross-border mergers directive, a statutory banking or insurance business transfer scheme under Part VII of the Financial Services on Markets Act 2000 (reflecting Article 39 (Transfer of Portfolio) of the Solvency II Directive on the transfers of portfolios of insurance contracts) or conversion of a U.K. company into a Societas Europea (SE) and the relocation of its head office to the E.U. under the E.U. regulation on SEs.

Contracts as a remediation strategy

5.6. One possibility which market participants have been exploring is the insertion of a "Brexit clause" into contracts entered into after the referendum. A "Brexit clause" is a contractual provision which triggers some change in rights/obligations as a result of a defined Brexit-related event. The clause therefore sets out two basic things: (a) the specific Brexit related event triggering the clause; and (b) the contractual consequences of that event. These clauses have been compared to Material Adverse Change clauses.[52]

5.7. In some cases, identifying the provisions under part (a) of the clause (the specific Brexit related trigger) might be relatively straightforward—for example: a change in laws such that a party is no longer entitled by law to operate in the E.U.; there are, however, other circumstances, such as in relation to insurance contracts, where the lack of clarity as to what constitutes "carrying on" business would lend further complexity to identifying such a trigger. It is likely that the actions under part (b) will prove substantially more difficult to agree. The potential consequences could range from the allocation of responsibility for ensuring authorisation (through any of the means described in section 3 above) or to the subsequent transfer of business to an authorised entity (more on which, below). This solution will, however, require a significant repapering exercise and will involve substantial cost to market participants.

Public sector solution

5.8. In acknowledgment of the limitations of the private sector solutions, market participants have suggested that legal and regulatory action by authorities in the U.K. and E.U. might better mitigate these risks.[53] Such action, whether included in the Withdrawal Agreement, undertaken by the E.U. or initiated by individual Member States, would apply similarly to business conducted in the E.U. as that proposed by U.K. authorities in relation to business conducted in the U.K., and would involve legislative provisions continuing, after the U.K.'s exit from the E.U. (likely to be at the end of the transition period), the E.U. regulatory authorisations of U.K. firms which formerly benefitted from the "passport", to the limited extent necessary to enable an orderly wind down of their business with E.U. clients and counterparties. Such provisions could be further

52 In the insurance section, the Aviation Insurance Group has published a new model E.U. contract continuation clause (see: http://www.iua.co.uk/IUA_Member/Press/Press_Releases_2017/Publication_of_EU_Contract_Continuation_Clause.aspx) as has XL Catlin (see: https://www.insurancetimes.co.uk/xl-catlin-outlines-innovative-brexit-continuity-clause/1426657.article).

53 The broader implications for financial stability that such legal uncertainties can produce have been acknowledged in the establishment, in April 2018, of a joint technical working group of the Bank of England and the European Central Bank to study risk management around the departure of the U.K. from the E.U. and its implications for the financial services industry.

enhanced to allow for continued performance and enforcement of rights under contracts in existence on the date of exit (or the end of the transition period) and also for any amendments and new contractual arrangements necessitated by the existing contracts (examples include the facilitation of advances under revolving credit facilities and the operation of collateral arrangements and portfolio compression exercises, etc.). For such a solution to function efficiently, decisions would need to be made as to how long these authorisations might continue—whether they would last until the final maturity of the contract or they might impose a suitable-but-unrelated cut-off date.

5.9. Such continued authorisation would require related provisions to ensure that changes in law do not negate the benefit of the continuing authorisations as well as safeguards to ensure that regulators are able to take enforcement action against firms contravening local law requirements as well as have precautionary powers to take action against firms that clearly put clients' interests, market integrity or financial stability at risk during the wind-down period. It would also be desirable to put in place co-operation arrangements between the E.U. and U.K. authorities for the supervision of these activities. A first step might have been taken through the establishment of the joint technical working group of the Bank of England and European Central Bank. Three ways by which such legislative provisions can be made are discussed below.

Withdrawal Agreement

5.10. Since the result of the 2016 referendum was announced, market participants have highlighted the successful negotiation of a bespoke treaty between the U.K. and E.U. as the most efficient model for a future relationship. Such a treaty would provide for future and continued equivalency or mutual recognition of U.K. firms in the E.U., and *vice versa*, and provide certainty to market participants. The Withdrawal Agreement could, therefore, provide an opportunity for the relevant provisions continuing the ability of firms to provide services in the E.U. and the U.K. after the end of the transition period to the extent necessary to allow the wind down of existing contracts. Any deal on mutual access would address illegality issues, since the continued cross border provision of services between U.K. and E.U. persons would then be legal in all relevant countries. These provisions could be similar to the provisions in the draft Withdrawal Agreement continuing certain privileges, immunities and other rights of the European Central Bank and the European Investment Bank in the U.K. after the end of the transition period to enable them to wind down their existing U.K. operations.[54] The

[54] See Articles 112, 113, 118 and 119 of the draft Withdrawal Agreement between the EU and the UK.

inclusion of such provisions in the Withdrawal Agreement would substantially increase legal certainty as it would provide an E.U.-wide solution, avoiding the need for any individual Member State legislation, and secure consistency and reciprocal provisions for U.K. and E.U. firms conducting cross-border business. This approach would be consistent with the E.U. negotiating directives which envisage that negotiations should, to the extent possible, address uncertainties affecting those that have entered into contracts on the assumption of continued U.K. membership of the E.U.[55] It would also be consistent with the E.U. position, published in Summer 2017, regarding governing law and jurisdiction clause in contracts entered into prior to the date of the U.K.'s departure from the E.U.[56]

5.11. There might be concerns as to whether this is a subject that can be properly addressed within the scope of a Withdrawal Agreement under Article 50. It could be argued, however, that the subject matter is closely linked to the withdrawal process and the envisaged provisions are similar in concept to other provisions already included in the Withdrawal Agreement providing for the continued application of specific rights under E.U. law in relation to transactions started before the end of the transition period. It would also be important to agree these provisions as part of the Withdrawal Agreement concluded before the U.K.'s exit from the E.U. Uncertainty might be exacerbated if the U.K. and E.U. would defer the discussion of this approach to a later stage with a view to using the mechanisms in Article 50 to amend the Withdrawal Agreement to include such provisions.

Action by individual Member States

5.12. Individual Member States could legislate to address the continuity issues for existing contracts, in a way similar to that proposed by U.K. authorities. This would have the advantage of overcoming any residual concerns about the ability of the parties properly to include such provisions in the Withdrawal Agreement and would mitigate the risk that the Withdrawal Agreement is not agreed, ratified or concluded for any reason so that there is no transition period. There are, however, significant and possibly overwhelming challenges in putting appropriate legislation in place in all E.U. and E.E.A. Member States, even by 31 December 2020 when the transition period is supposed to end, let alone by March 2019. Further, the likely possibility of variations in

55 European Council (Art. 50) guidelines for Brexit negotiations (29 April 2017), Part III paragraph 9. (Available at: http://www.consilium.europa.eu/en/press/press-releases/2017/04/29/euco-brexit-guidelines/).

56 European Commission, Position paper on Judicial Cooperation in Civil and Commercial matters, (13 July 2017), available at: https://ec.europa.eu/commission/publications/position-paper-judicial-cooperation-civil-and-commercial-matters_en.

approach across the Member States would also create additional concerns relating to fragmentation and uncertainty.

E.U. legislative action

5.13. The E.U. could adopt an E.U. regulation to address the continuity issues for existing contracts, again in a similar way to that proposed by U.K. authorities. This would have similar advantages to the action by individual Member States discussed above. It is more credible that E.U. legislation could be put in place relatively quickly and this would ensure that the E.U. takes a harmonised approach. Nevertheless, there would still be formidable timing challenges if the E.U. is to legislate before March 2019. Additionally, where the E.U. has made commitments on its WTO schedule of commitments to provide other Third Countries with access to its market, the WTO most-favoured nation obligation prevents the E.U. from treating the U.K. more favourably than it would any other Third Country.[57]

6. CONCLUSION

6.1. In this paper, the FMLC has highlighted the questions which will be faced by market participants in relation to the continuity of contracts following a hard Brexit. The FMLC has found that, for the most part, it is in agreement with the European Commission's Communication of July 2018 (mentioned in paragraph 1.12 above) and considers it unlikely that Brexit will give rise to issues of contractual continuity in a general sense and so far as it is a matter of English law and jurisdiction. Nevertheless, the FMLC has explored the potential consequences to all concerned, including clients and markets, where authorisations are lost without adequate alternatives. Finally, the FMLC has examined some of the ways by which these issues might be mitigated, both by firms themselves and through legislative action, including within an agreement between the U.K. and E.U.

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[57] For a more in-depth exploration of the impact of the WTO rules on the U.K.-E.U. future relation, see the FMLC paper mentioned in footnote 8 above.

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