

BREXIT'S IMPACT ON ISDA DOCUMENTATION

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Investment Management Alert

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As previously noted in the client alert "Brexit: A First Look at the Impact on Asset Managers That Trade Derivatives," Brexit is not anticipated to have an immediate impact on ISDA Documentation or derivatives contracts. Until further details of the post-Brexit regime have unfolded, it will also be difficult to determine the future impact of Brexit on the 1992 and 2002 ISDA Master Agreements. This alert summarizes some of the key issues that counterparties to ISDAs will need to consider with respect to agreements that are already in place and those that are currently being negotiated.

- 1. Event of Default or Early Termination Event.** Under both versions of the ISDA Master Agreement, Brexit is unlikely to trigger a standard event of default or early termination event such as a breach of representation, illegality, force majeure event, or any of the standard disruption events applicable to plain-vanilla interest rate and FX derivatives under relevant ISDA Definitions. ISDA counterparties should consider reviewing Part 5 provisions in individual Schedules, especially for an ISDA subject to EU regulation, to see if they include any bespoke terms that anticipate Brexit or a similar scenario, cross-default provisions to a related loan agreement that would be impacted by Brexit, or references to the continued accuracy of representations regarding EU-specific regulation (such as EMIR) or applicable tax jurisdiction. However, in light of the uncertainty regarding the ultimate UK regulatory landscape and consequent impact that Brexit will have on ISDA documentation, it is likely best for ISDA counterparties to take a "wait and see" approach before repapering any specific terms.
- 2. Counterparty Creditworthiness and Collateral Issues.** Businesses with significant exposure to the UK economy and/or impacted EU economies may find their credit rating (or their counterparties' view of their creditworthiness) adversely affected by Brexit. ISDA counterparties should be attentive to the presence of any Additional Termination Events in their contracts that may occur as the result of a decline in their credit rating, or in the credit rating of an affiliate, custodian, or other party. A decline in creditworthiness may also lead to changes in the collateral obligations of an ISDA counterparty, which in turn could lead to operational difficulties and collateral-related defaults. Finally, although financial asset markets have stabilized after an initially violent reaction to Brexit, volatility in the value of UK securities collateral could also result in margin calls on affected parties.
- 3. Tax Considerations.** As the regulatory consequences of Brexit regulatory consequences unfold, ISDA Counterparties should keep a keen eye on any potential tax issues, such as unanticipated gains on assets that are marked to market (that would result in taxable gains) or any changes to the treatment of withholding tax that could trigger a "Tax Event" Termination Event.
- 4. Applicable Law and Jurisdiction.** ISDA counterparties select the applicable law governing an ISDA Master Agreement in Section 13 of the Schedule. English law has long been a popular choice of governing law, both for UK-domiciled counterparties and parties in other global jurisdictions. ISDA

counterparties also frequently agree to submit to the jurisdiction of the English courts to resolve any disputes, even for contracts that are not subject to the substantive provisions of English law.

English courts presently determine the applicable law governing a dispute in accordance with the Rome I Regulation (for contractual obligations) and the Rome II Regulation (for non-contractual obligations) (collectively, "Rome Regulations"). If the UK ultimately becomes a European Free Trade Association member state as a result of Brexit, the Rome Regulations would likely still apply. Even if this does not occur, we consider it highly unlikely that Brexit would substantively impact the enforceability in the UK or in the EU of contracts (such as ISDAs) with explicit governing law clauses in relation to the parties' contractual obligations. Although the EU courts will continue to uphold agreements as to the governing law of non-contractual obligations, the position in the UK may be less clear in this respect.

The future enforceability in the EU of judgments of the English courts is less certain. Depending on the ultimate terms of Brexit and/or any future agreements between the UK and the EU, the current 'passporting' of English judgments may continue. However, this outcome is far from certain, and parties seeking to avoid uncertainty may consider incorporating into their ISDA Master Agreements one of ISDA's model arbitration clauses in lieu of submission to the jurisdiction of English courts. Brexit is not expected to impact the enforceability of foreign arbitral awards. For additional information, see "Brexit: Governing Law, Jurisdiction, and Arbitration Clauses".

Finally, upon implementation in due course of further EU regulation of markets in financial instruments, i.e. MiFID II and MiFIR, scheduled to come into effect on 3 January 2018, subject ISDA Master Agreements may need to incorporate a clause providing for the jurisdiction of a court or arbitral tribunal in an EU Member State. If this requirement materializes, it is possible that English courts will not be considered a valid forum.

5. **ISDA's Response to Brexit.** ISDA released a statement that, in its view, Brexit "will not have an immediate impact on the legal certainty of existing derivatives contracts, nor will it require any immediate contractual change or action from counterparties. Once the UK government serves formal notice of its intention to withdraw, the UK will continue to remain a member of the EU for at least two years. During that time, existing European treaties, directives and regulations will remain in force." ISDA has published a web page on the impact of Brexit on the ISDA Master Agreement that addresses several issues including: the choice of English law; the choice of English courts/arbitral tribunals as dispute forum; bank resolution issues; insolvency issues; and collateral issues.

NEXT STEPS

Although it is difficult at this time to forecast precisely which provisions of the ISDA Master Agreement will need to be amended as a result of Brexit, counterparties can take steps now to identify current and future risks. An appropriate due diligence review of existing ISDA documentation will ensure that counterparties are aware of their potential exposure and in the best position to assess and respond to Brexit-related developments in the coming years.

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