

Allen & Overy LLP

MEMORANDUM

To Peter Werner
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International Swaps and Derivatives
Association, Inc.

From Richard Tredgett

Our ref RPT/0030047-0001105 ICM:27517080.4

Date 19 September, 2017

Subject **Brexit and ISDA's Standard Form Documentation for EU Emissions Allowance Trading**

Scope and Purpose

We have been asked to consider the likely effect of the UK's withdrawal from the European Union (**Brexit**) on EU emissions allowance transactions governed by standard form documentation published by ISDA.

This memorandum has been prepared on the basis that it will be used to aid discussion within ISDA's working groups. It is not intended to be an exhaustive analysis of all relevant issues. It is not intended to constitute definitive legal advice and should not be relied on as such.

Assumptions

We have been asked to assume that:

- as a result of Brexit, the UK will cease to participate in the EU Emissions Trading Scheme (the **EU ETS**);
- Brexit will not coincide with the end of a specific phase of the EU ETS, so that Brexit will occur during an EU ETS phase, and specifically before the compliance deadline for the final compliance year of the third phase of the EU ETS, being 30 March 2019;
- the relevant transactions are documented pursuant to an ISDA Master Agreement (Multicurrency – Cross Border) (a **1992 ISDA**) or an ISDA 2002 Master Agreement (a **2002 ISDA**), in either case in the form published by ISDA, and that the Schedule to the 1992 ISDA or 2002 ISDA (as applicable) is supplemented by provisions in the form of the Form of Part [7] to the Schedule to an ISDA Master Agreement for EU Emissions Allowance Transactions (incorporating options) (Version 5: May 2012) (Modified for Phase 3 delivery) (the **ISDA Emissions Annex**); and

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- the 1992 ISDA or 2002 ISDA (as applicable) is governed by English law.

We note that the assumptions regarding the nature and timing of Brexit should be kept under review and that ISDA might consider refreshing this memorandum as we learn more about these matters.

For purposes of this memorandum, we also assume that:

- as a result of Brexit, and with effect from the date of Brexit, holders of accounts within the Union Registry, which accounts are under the administration of the UK (**UK Account Holders**) will be unable to transfer Allowances from those accounts or to receive Allowances into those accounts; and
- as they relate to the terms of any relevant transaction, none of the provisions of the 1992 ISDA, the 2002 ISDA or the ISDA Emissions Annex which we consider in this memorandum have been materially amended, whether directly or indirectly.

Interpretation

Terms used and not defined in this memorandum have the meanings given in the 1992 ISDA, the 2002 ISDA or the ISDA Emissions Annex, as applicable.

Background

When used together with a 1992 ISDA or a 2002 ISDA, the ISDA Emissions Annex is designed to provide a standardised contractual basis for bilateral transactions involving the forward sale and purchase of Allowances (referred to as Allowance Forward Transactions) and for related option transactions (referred to as Allowance Option Transactions).

The key terms of an Allowance Forward Transaction and (upon exercise) of an Allowance Option Transaction provide for the Buyer/Receiving Party to pay an amount in cash to the Seller/Delivering Party on a defined Payment Date and for the Seller/Delivering Party to deliver Allowances of the specified type and relating to the specified Compliance Period to the Buyer/Receiving Party on the specified Delivery Date.

The ISDA Emissions Annex expands on the nature of a party's obligation to deliver Allowances in paragraph (d)(i)(2) (Delivery):

- Paragraph (d)(i)(2)(A) recites that the Delivering Party's obligation to deliver Allowances shall be discharged by the completed transfer of the Allowances from a Holding Account of the Delivering Party and that such a transfer shall be considered to be completed when the relevant Allowances are received at the relevant Specified Holding Account of the Receiving Party.
- Paragraph (d)(i)(2)(B) provides that if the Delivering Party has one or more Specified Holding Accounts for a relevant transaction, then the Delivering Party's obligation is limited to an obligation to deliver from any such Specified Holding Account to the relevant Specified Holding Account of the Receiving Party.
- Paragraph (d)(i)(2)(C) provides that if the Receiving Party has more than one Specified Holding Account for a relevant transaction, then the Delivering Party's obligation is to deliver to the first listed Specified Holding Account unless prevented by a Settlement Disruption Event or Suspension Event, in which case the obligation is to deliver to the next listed Specified Holding Account (if any), and so on.

Failure to Deliver

Unless "excused" by the existence of an Illegality, a Settlement Disruption Event or a Suspension Event, or by an abandonment of the Scheme, the ISDA Emissions Annex provides that a failure by the Delivering Party to deliver the required Allowances on the agreed Delivery Date which is not remedied within a short period (at most two business days) following notice from the Receiving Party will (in certain cases only upon

subsequent notice by the Receiving Party) result in termination of the relevant transaction and, in certain cases, payment by the Delivering Party of replacement costs.¹

The excuses for non-delivery referred to above can be summarised as follows:

- **Illegality.** Illegality is defined in the master agreement governing the relevant transaction. The term is defined differently in the 1992 ISDA and the 2002 ISDA, but, broadly, an Illegality would exist if it became unlawful for the Delivering Party to perform its delivery obligation.
- **Settlement Disruption Event.** Settlement Disruption Event is defined in the ISDA Emissions Annex as “an event or circumstance beyond the control of the party affected that cannot, after the use of all reasonable efforts, be overcome and which makes it impossible for that party to perform its obligations either to deliver or to accept Allowances in accordance with the terms of [a transaction]”.
- **Suspension Event.** Suspension Event is defined as “any date a party to the Agreement is unable to perform its delivery or acceptance obligations under and in accordance with [a transaction] and the Scheme through a Relevant Registry as a result of... the absence of Registry Operation... or... the occurrence of an Administrator Event”.
 - In the context of Brexit, the absence of Registry Operation might apply if the Relevant Registry is the UK Registry, but we do not need to consider this aspect in detail because we think it is likely that, where the Relevant Registry is the UK Registry, Brexit would lead to the occurrence of an Administrator Event on the basis that there will have been “a suspension of some or all of the processes of the Relevant Registry... in accordance with the registries Regulation by the relevant National Administrator or the Central Administrator (as applicable)... where that Relevant Registry is not operated and maintained in accordance with the provisions of the registries Regulation”.

Note that an event or circumstance that constitutes or gives rise to a Settlement Disruption Event and also constitutes a Suspension Event will be treated as a Suspension Event and not a Settlement Disruption Event.

We do not think it is necessary to consider the Force Majeure Event provisions of the 2002 ISDA because those provisions only apply after giving effect to applicable provisions or remedies pursuant to the relevant Confirmation or elsewhere in the Agreement. In our view, and as described below, the provisions of the ISDA Emissions Annex should provide a remedy for a Brexit-driven problem with making or accepting delivery of Allowances, even if that remedy involves termination and payment of replacement costs.

We go on to consider the potential impact of Brexit on Allowance Forward Transactions where the Delivering Party is a UK Account Holder and, separately, where the Receiving Party is a UK Account Holder.

UK Account Holder as Delivering Party

We need to consider two scenarios in which the Delivering Party is a UK Account Holder:

- Where there are no Specified Holding Accounts for the Delivering Party; and
- Where the only Specified Holding Account for the Delivering Party is an account within the Union Registry which is administered by the UK.

In both cases, we assume that the Receiving Party’s Specified Holding Account is not administered by the UK.

No Specified Holding Account

¹ See paragraph (d)(ii)(1) of the ISDA Emissions Annex

If there are no Specified Holding Accounts for the Delivering Party (or such Specified Holding Accounts do not include a UK account), then the UK registry is not the Relevant Registry for purposes of considering the Suspension Event and Settlement Disruption Event provisions of the ISDA Emissions Annex.

On the basis solely of the assumptions above, we have no reason to believe that performance by the Delivering Party of its delivery obligations would be unlawful, so it is unlikely that an Illegality would exist.

In the absence of an excuse for a failure to deliver, the consequences would be as summarised above: depending on elections made and notices being given, the Delivering Party might be required to pay replacement costs to the Receiving Party.

UK Registry Account as Specified Holding Account

If the only Specified Holding Account for the Delivering Party is an account in the Union Registry administered by the UK, then the UK registry is the Relevant Registry for purposes of considering the Suspension Event and Settlement Disruption Event provisions of the ISDA Emissions Annex.

It follows from our analysis above that we think it is likely that the failure by a Delivering Party to deliver Allowances out of its UK registry account would be potentially excused on the basis of it being both a Settlement Disruption Event and a Suspension Event and, because it is the same event or circumstance giving rise to both excuses, the event would be treated as a Suspension Event.

Broadly, the effect of a Suspension Event would be that both parties' obligations are deferred. Assuming the circumstances persist until a relevant Long-Stop Date (which varies depending upon the scheduled delivery date), then at that point the transaction would terminate with a refund of payments (including option premia) and payment of any amounts due in respect of delivery obligations already settled. ISDA and its members might want to consider whether parties affected in this way would prefer to bring forward the Long-Stop Date (for example, so that it corresponds with the Brexit date).

UK Account Holder as Receiving Party

We assume here that the Receiving Party is a UK Account Holder and that its account at the UK Registry is the only Specified Holding Account to which the Delivering Party is required to deliver Allowances.

We assume that the Delivering Party's Specified Holding Account is not administered by the UK.

The Delivering Party will be unable to deliver Allowances to the Receiving Party's Specified Holding Account. Subject to the discussion below the same analysis considered above in respect of a UK Account Holder as Delivering Party would apply.

The one difference here is that the ISDA Emissions Annex contemplates a situation in which the Receiving Party fails to comply with the Requirements under the Scheme².

The Requirements under the Scheme are a series of agreements made by the parties. Of particular relevance here is an agreement by each party to ensure that on a Delivery Date it has one or more Holding Accounts validly registered in accordance with the Registries Regulation and where it has one or more Specified Holding Accounts, ensure that on a Delivery Date it has all such Specified Holding Accounts validly registered in accordance with the Registries Regulation.

It is arguable that, as a result of Brexit, a Receiving Party with a single Specified Holding Account which is at the UK registry would not be in compliance with these Requirements under the Scheme. If that were the case, then the Receiving Party could take steps to comply (which would inevitably involve opening another account in the Union Registry or designating an existing account as a Specified Holding Account and

² See paragraphs (d)(ii)(2) and (d)(v) of the ISDA Emissions Annex

therefore allowing the Delivering Party to deliver). Failure by the Receiving Party to comply would result in termination at the option of the Delivering Party and payment of replacement costs.