

FIA ADVISORY¹
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ARRANGEMENTS NECESSARY TO SUPPORT A POSITIVE BANKRUPTCY REMOTENESS
CONCLUSION UNDER THE CLEARED TRANSACTION RULES OF US BASEL III
WITH RESPECT TO COLLATERAL POSTED BY A CLEARING MEMBER
TO A CENTRAL COUNTERPARTY

We describe below arrangements that would be needed to be implemented by a central counterparty (a “**CCP**”) in order for a member of the CCP (a “**CM**”)² to conclude that initial margin it posts to the CCP is “bankruptcy remote”³ for purposes of the US Basel III cleared transaction rules.⁴

The US Basel III rules define “bankruptcy remote” to mean, with respect to an asset, that the asset would be “excluded” from an insolvent entity’s “estate” in a receivership, insolvency, liquidation or similar proceeding (“**insolvency**”). We believe that this definition should be construed to mean that margin posted by a CM could be considered bankruptcy remote if the CM can conclude that the margin is subject to arrangements that would prevent the margin from being subject to (1) competing claims of (and, thus, distribution to) a CCP’s creditors generally or (2) loss due to the CCP’s default, including insolvency (e.g., as a result of the CCP’s exercise of re-use, repledge, rehypothecation or other transfer rights), such that, in either case, the margin (or its liquidation value) would be unavailable for return to the CM in the CCP’s insolvency.⁵

¹ This advisory was prepared by the FIA in consultation with the FIA Netting Committee in order to provide general guidance to a member of a CCP in analyzing whether the initial margin it posts to the CCP is “bankruptcy remote” for purposes of the US Basel III rules. Nothing herein is intended as legal, regulatory or other advice, and firms should consult with their own counsel and draw their own conclusions as to whether the arrangements implemented by any CCP would support a positive bankruptcy remoteness conclusion.

² We discuss herein the arrangements that would be necessary to support a positive bankruptcy remoteness conclusion by a banking organization that is a “clearing member” under the US Basel III rules. We do not discuss arrangements that would be necessary to support a positive bankruptcy remoteness conclusion by a “clearing member client” with respect to initial margin posted by it to its CM or a CCP (including margin posted to a CCP by a CM on behalf of a clearing member client).

³ If a CM’s collateral is bankruptcy remote from the CCP, its fair value is excluded from the calculation of the CM’s trade exposure amount to the CCP.

⁴ We would note the US Basel III rules do not require a CM to also conclude that its margin is bankruptcy remote from a CCP’s custodian in order for the CM to exclude the fair value of the margin from the calculation of its trade exposure amount to the CCP. Thus, arrangements that would impose such a requirement are not necessary.

⁵ A literal construction of the definition is not appropriate if it would lead to conclusions that are inconsistent with the clear regulatory intent that margin can be considered bankruptcy remote only if it (or its liquidation value) would be available for return to the CM in the CCP’s insolvency. For example, under the commodity broker liquidation provisions of the US Bankruptcy Code and the Part 190 rules of the Commodity Futures Trading Commission (collectively, the “**US commodity broker liquidation provisions**”) applicable to a CCP that is a derivatives clearing organization (a “**DCO**”), a CM’s margin, to the extent it is “member property,” would be **included** in an insolvent CCP’s estate (although subject to special distributional rules). Under a literal reading of the definition, such margin would not be bankruptcy remote, even though it (or its liquidation value) could be

Whether any arrangements implemented by a CCP would satisfy these standards may require complex legal analysis. Accordingly, we believe that a CCP should obtain from external counsel a written, reasoned legal opinion, upon which its CMs are entitled to rely,⁶ that such arrangements satisfy these standards and would be enforceable under the laws of the relevant jurisdiction in the event of a legal challenge, including one in insolvency.

More specifically, we believe that the arrangements necessary to support a positive bankruptcy remoteness conclusion would include, at minimum, the following:

Posting and holding method. Margin should be posted in a way such that the CM is not merely an unsecured creditor of the CCP with regard to such margin.

As a general matter, in most jurisdictions, this would mean that margin should be:

- (1) posted by pledge or grant of a security interest (rather than by title transfer) so that the CCP obtains only a security interest, and not an ownership interest, in the margin; and
- (2) held by a third-party custodian in a manner that supports the conclusion that it is held in a custodial capacity or for the benefit of the CM(s) and does not constitute property of the CCP available for distribution to its creditors generally in the event of its insolvency.⁷

While it is preferable for a CM's margin to be individually segregated, it is acceptable if its margin is commingled with other CMs' margin; provided that, as described in further detail

available for return to the CM. However, if the CCP rehypothecated a CM's margin, the margin could be **excluded** from the CCP's estate and, thus, could be bankruptcy remote even though it could very well be unavailable for return to the CM. It would be nonsensical to assume that the definition of bankruptcy remoteness calls for these conclusions. Additionally, we do not believe that CMs' margin being subject to a ratable distribution scheme (whereunder it would be "member property" subject to ratable distribution among all CMs, but not otherwise available to cover losses on the CCP's balance sheet) would be antithetical to the concept of bankruptcy remoteness, even if the margin was first liquidated and the resulting proceeds ratably distributed – hence, our references herein to the return of a CM's margin or "its liquidation value."

⁶ Language to the effect that the opinion is furnished to the CCP for the benefit and use of its CMs and their affiliates is acceptable to satisfy this criterion. Other customary and reasonable qualifications would also be acceptable.

⁷ To be clear, we do not believe that it is necessarily the case that margin must always be posted by means of pledge or the grant of a security interest in order to be bankruptcy remote. Whether margin posted by title transfer could be bankruptcy remote depends on the terms and structure of the arrangements relating to the margin and applicable law and regulation. For example, we believe that it is possible for a CM's cash margin posted to a DCO by means of title transfer to be considered bankruptcy remote if the cash is "member property" under the US commodity broker liquidation provisions and is maintained in a segregated account that holds cash margin of only one or more CMs (and not any cash of the CCP) and is designated in a manner that clearly reflects that the CCP holds the cash in a custodial capacity or for the benefit of the CM(s).

below, the CCP and its CMs are restricted from taking action that would result in a CM's margin being applied to satisfy the obligations of any other CM or of the CCP.

Any custodian holding a CM's margin should also acknowledge to the CCP that the margin in its custody is not subject to any right, charge, security interest, lien or claim of any kind in favor of the custodian or any person claiming through the custodian other than in respect of custodial fees relating to the relevant securities and cash account held by the CCP on behalf of the CMs.

Use of margin. A CCP's rules or bylaws should expressly limit the use of the margin in a way that would impair a CM's right to return of the margin (or its liquidation value).

As a general matter, in most jurisdictions, this would mean that the CCP should not have the right to repledge, rehypothecate, transfer or use a CM's margin, unless an event of default or potential event of default (i.e., an event that, with the giving of notice or the passage of time or both, would constitute an event of default) has occurred with respect to the CM; provided, that:

- (1) The value of the margin repledged, rehypothecated, transferred or used by a CCP in connection with an event of default or potential event of default with respect to a CM may not exceed the value of the margin posted by the CM (stated differently, a CM's margin may not be applied to satisfy the obligations of any other CM or of the CCP).
- (2) A CCP may repledge, rehypothecate or transfer a CM's securities margin absent the occurrence of an event of default or potential event of default with respect to the CM so long as the resulting cash proceeds are maintained in a manner consistent with the other provisions hereof.
- (3) A CCP may instruct a third-party custodian to invest cash margin it receives so long as any such investment is held in a manner that reflects the ownership interest of the CM(s) and is otherwise held by the third-party custodian in a manner consistent with the provisions hereof.

If under applicable law or regulation, CMs' margin constitutes "member property" (or a similar concept) that is subject to a ratable distribution scheme, no CM of a CCP should be permitted to agree that limitations on the CCP's re-use, repledge, rehypothecation or other transfer rights do not apply to its margin, unless counsel is able to conclude with a well-founded basis that the CCP's right to repledge, rehypothecate, transfer or use the CM's margin could not result in a decrease in the total pool of member property available for distribution to non-defaulting CMs in the CCP's insolvency.