NOTE TO MEMBERS - CRR Article 305(2)(c) Opinions

BACKGROUND

ISDA has published a number of clearing related legal opinions to assist ISDA members apply the risk weightings under CRR Article 305 (Article 305).

One of the conditions to apply the reduced risk weightings under Article 305 is that the client of a clearing member (“CM”) has an independent, written and reasoned legal opinion that concludes that, in the event of legal challenge, the relevant courts and administrative authorities would find that the client would bear “no losses” on account of the insolvency of its CM or any of that CM’s clients under the laws of the jurisdiction of: (a) the client; (b) its CM; (c) the central counterparty (“CCP”); (d) the law governing the transactions and contracts the client clears through the CCP; and (e) the law governing the collateral and the law governing any contract or agreement necessary to meet the porting condition (see Article 305(2)(c)).

OPINION APPROACH

The legal opinions are prepared using a modular architecture that allows an opinion to be provided through a combination of three modules. Each module covers an element of the relevant analysis under Article 305(2)(c).

SCOPE OF OPINIONS

Module 1 covers the core analysis in relation to the requirements of Article 305(2). Modules 2 and 3 draw down on that core analysis. Module 2 constitutes an insolvency analysis in respect of the jurisdiction of the relevant CM and Module 3 constitutes an analysis of the relevant CCP. For each of Modules 2 and 3, counsel confirms and, where necessary, expands the core analysis from Module 1.

Within the modular structure institutions would require Module 1 and at least one of each of the Modules 2 and 3, depending on their CM(s) and the CCPs that they use for clearing. Currently, the conclusions in respect of the three chosen modules for a given client-CM-CCP relationship are set out in the relevant Module 3.

The insolvency analysis in the Modules focusses solely on the requirement for an opinion as to “no loss” under Article 305(2)(c) of CRR. The package of modules should, for the avoidance of doubt, not be read as being all a regulated client needs in order to take advantage of the preferential risk weightings of its exposures under Articles 305(2) or 305(3) of CRR. A client will generally also need other legal opinions and analyses, which cover some or all of the following areas:

- netting between the client and the CM, under the insolvency law of the CM;
- netting between the CM and the CCP, under the insolvency law of the CM;
- the client being able to access (by direct payment, security or otherwise) the CM’s claim against the CCP, under the insolvency law of the CM;
porting being upheld in the CM’s insolvency, under the insolvency law of the CM;

- factual analyses as to the particular arrangements between the client and the CM; and

- once any transitional relief has expired, the relevant CCP is a QCCP (Qualifying Central Counterparty) for the purposes of CRR. This means the CCP has been either “authorised” under Article 14 EMIR or “recognised” under Article 25 EMIR.

Article 305(2)(a) requires that the positions and assets of an institution are distinguished and segregated, at the level of the CM and the CCP, from the positions and assets of both the CM and the other clients of that CM and as result of that distinction and segregation those positions and assets are bankruptcy remote in the event of the default or insolvency of the CM or one or more of its other clients. The modules do not consider this insolvency-related requirement (read together with the definition of bankruptcy remoteness in Article 300) that the CM’s claims on the relevant CCP (being “client assets” for the purposes of Article 300) are not available to the creditors of that CM or available to the CM to meet losses incurred following the default of other clients. Whilst there is no express obligation to obtain an opinion on such requirements of Article 305(2)(a), clients may wish to obtain formal advice thereon.

Module 1
Core Opinion

- Reasoned interpretation of “losses” (Article 305(2)(c))
- Description of client clearing account types – individually segregated and gross omnibus accounts – and identifying key features of these
- Analysis of key features of these accounts on the “no loss” requirement with reference to both the 2% and 4% risk weightings (Article 305(4)) and drawing on the reasoned interpretation of “losses” more generally
- A reasoned interpretation of the meaning of joint losses (Article 305(3))

Module 2
Insolvency Opinion

For each jurisdiction:
- Undertaking a regulatory characterization on the clearing member and any applicable client asset regime
- Preparing a drawdown legal opinion to Module 1 in relation to the insolvency regime applicable to a clearing member

Module 3
Opinion on CCP

For each CCP:
- Diligently the role set for the CCP to confirm the existence of the key features of accounts identified in Module 1 and to identify any other features that would impact the core analysis in Module 1
- Preparing the drawdown legal opinion to Modules 1 and 2 for the CCP which will contain and, where necessary, comment on the analysis in Modules 1 and 2 as applied to the CCP and the legal regime in which it operates

These opinions are available to ISDA members as a membership benefit, as with all ISDA’s opinions, and so there is no additional charge for these opinions.