Legal Bulletin
February 2014

Insolvency of exchanges in Brazil: consequences for investors

The vagaries of Brazilian and international economy often give rise to analysis by professional investors of insolvency scenarios regarding the entities that intermediate such investments in local capital markets.

Brazilian futures exchange (BMF) and stock exchange (Bovespa) have been merged in 2008 and operate as a single entity, BM&FBovespa. Operations therein are cleared through special clearing systems destined to stock, fixed rate financial investments and their derivatives (from time to time known as Companhia Brasileira de Liquidação, CBLC, and lately as "*Câmara de Ações*"), derivatives in general, foreign currency and other assets. Such clearing houses are part of the exchange, and references in this text to the exchange cover them. Access to the exchange system is in general terms limited to clearing members. Other intermediaries, brokers or final clients should act through them.

Such exchanges may be suspended from activities or have their authorization to carry business revoked in case of serious violations of laws or regulations, what would interfere with their operation and ability to meet obligations. Further to that, Brazilian securities authority (*Comissão de Valores Mobiliários* – CVM) may determine the cancellation of trades or prevent the liquidation of trades in case of operations that violate existing laws or regulations.

Except for these extreme scenarios, the basic rule is that the imposition of insolvency or bankruptcy regime does not interfere with the effectiveness of the obligations of such exchanges.

Clearly, this does not prevent such entities from being unable to meet their obligations. The exchanges are under existing regulation parties to the transactions that take place in them, rather than simply intermediaries or negotiation systems. Thus, two parties wishing to trade in derivatives in opposing positions (A and B) will not directly enter the trade among themselves. Rather, Part A will enter into a trade with the clearing house, which will subsequently enter into a trade in the inverse position with Part B.

In fact both Party A and Party B have to relate to the exchange through at least two intermediaries, their own brokerage houses and typically another brokerage house or entity serving as a clearing member of the exchange. Moreover, and typically, under the rules in place, the brokerage houses serve as co-debtors of their client's obligations, and the clearing members serve as co-debtors of the brokerage houses dealing through them, thus providing the exchange with a string of liability to stave off default.

If Party A posts collateral with the clearing house, such collateral must be used in favor of the clearing even though Party A has become insolvent. Typically, in a derivatives transaction the clearing house would enter into a countervailing transaction with Party B. In such case the collateral posted in favor of the clearing house by Party A would be free from any lien in case of insolvency or any kind of foreclosure of assets of Party A or the clearing house.

After collateral is exhausted and in case Party A, its brokerage house or the respective clearing member defaults in replenishing it, liquidity and special asset funds under the control of the exchange may be used to cover the shortfall.

An additional guaranty in case of insolvency of Party A would be the rule contained in section 171 of the operational rules of BM&FBovespa clearing system. Under this provision, whenever BM&Fbovespa has used all margins, liquidity fund and other financial reserves

São Paulo
Av. Brig. Faria Lima, 2601
12th floor - 01452-924
São Paulo, SP - Brazil
Phone. +55 11 3555 5000

Rio de Janeiro
Praia de Botafogo, 440
15th floor - 22250-908
Rio de Janeiro, RJ - Brazil
Phone. + 55 21 3503 2000

Brasília
SBN Q 1, Bl B, n. 14, Ed. CNC
2th floor - 70714-900
Brasília, DF - Brazil
Phone. + 55 61 2109 6070

contato@levysalomao.com.br

and still does not have sufficient funds to meet its market obligations, it may unilaterally cancel the countervailing trade with Party B, that cease to be mandatory. If valid and put into effectiveness, this provision would avoid financial insolvency ever from reaching BM&FBovespa in relation to cleared trades involving most financial instruments.

An important qualification to that is however the fact that Brazilian law does not recognize clauses in agreements or similar instruments that leave their effectiveness subject to the arbitrary decision of one of the parties only (article 122 of the Brazilian Civil Code). The protective provision in the previous paragraph would in our opinion incur in such prohibition, and may be considered invalid.

Given this structure, most likely the insolvency of the exchange would reflect the insolvency of either Party A, Party B or their intermediaries in an amount of sufficient value to compromise the financial position of the exchange. Such insolvency would typically: i) be limited to the specific trade or trades in relation to which default occurred, ii) be decreased by margin deposits previously made with the exchange in relation to the specific trade defaulted and iii) would not be communicated to other trades. Unless, of course, economic factors of general scope (such as sharp variations in the indexes pursuant to which margins are to be posted) produce as a result default in relation to all or a substantial number of trades.

Eduardo Salomão Neto
esalomao@levysalomao.com.br

Luis Eduardo Al-Contar
lalcontar@levysalomao.com.br