



UNIDROIT Initiative on Close-out Netting (Update)

EFMLG in Frankfurt, 30 November 2012

Holger Hartenfels



I. Introduction

- The International Institute for the Unification of Private Law (UNIDROIT) is an independent intergovernmental organization.
- Its purpose is to study needs and methods for modernizing, harmonizing and coordinating private and in particular commercial law as between States and groups of States and to formulate uniform law instruments, principles and rules to achieve those objectives.
- UNIDROIT has 63 members from all five continents
- UNIDROIT's seat is in Rome.
- Instruments used by UNIDROIT are conventions, model laws and principles. Examples:
 - Convention relating to a Uniform Law on the International Sale of Goods (The Hague, 1964)
 - Convention on International Financial Leasing (Ottawa, 1988)
 - Convention on International Factoring (Ottawa, 1988)
 - Convention on International Interests in Mobile Equipment (Cape Town, 2001)
 - Model Law on Leasing (Rome, 2008)
 - Convention on Substantive Rules for Intermediated Securities (Geneva, 2009)



II. Initiative on Close-out Netting

- At its 67th session on 1 December 2010, UNIDROIT's General Assembly approved the Triennial Working Program for the years 2011 to 2013.
- The General Assembly also endorsed the recommendation of its Governing Councils concerning the development of a new instrument on netting on financial instruments; it was decided to assign the highest level of priority to this subject.
- In 2011 the Secretary General of UNIDROIT (José Angelo Estrella Faria) set up a Study Group, which met three times from 18 to 21 April 2011, 13 to 15 September 2011 and 7 to 9 February 2012 respectively.
- The results of the Study Group work is reflected in new draft „*Principles regarding the enforceability of Close-out Netting Provisions*“.
- Shortly after the publication of the draft Principles, the Secretary General of UNIDROIT invited its members to designate national experts for a new Committee of Governmental Experts.
- The first meeting of the Committee of Governmental Experts was held in Rome from 1 to 5 October 2012.
- The EFMLG is invited as observer.
- The second and last meeting will be held from 4 to 8 March 2013.
- The Governing Council of UNIDROIT aims at publishing the final Principles in the course of the next year.



III. Main Content

Principle 1 – “close-out netting provision”

- The Principles will cover bilateral arrangements on close-out netting only.
- The Principles will also cover master netting or cross product netting agreements.
- The coverage of multilateral arrangements and other types of netting (settlement netting or netting by novation) was discussed but not supported.
- The functional approach taken by the Study Group was supported, but some Governmental Experts felt that the definition should reflect the three-step mechanism of close-out netting provisions (i.e., termination, valuation and aggregation).
- The Secretariat will provide new drafting for next meeting.



III. Main Content

Principle 2 – “eligible party”

- The Study Group proposed to cover all legal entities as well as partnerships and unincorporated associations.
- Natural persons, including merchants, other professionals, sophisticated high net-worth individuals and consumers have not be included by the Study Group, but the proposal was that States may protect them, if they want to.
- Some Governmental Experts (including France) proposed to reconsider the scope of eligible parties. Protection should be given only to systemically important financial institutions and only to regulated products. The granting of preferences to other entities would need specific justification.
- A small group of Governmental Experts (France, United Kingdom, U.S.A. and Germany) tried to find a compromise that would at least reflect the coverage of counterparties under the European Financial Collateral Directive.
- The interim solution includes all financial institutions (banks, investment firms, insurance companies, funds, central counterparties) as well as certain public authorities (government, central banks, BIS and multilateral development banks).
- However, it was not clear whether other counterparties should be subject to an opt-in or opt-out approach.
- The small working group will continue its discussion between the meetings and will present a new compromise for March 2013.



III. Main Content

Principle 3 – “eligible obligation”

- The Study Group proposed to cover financial derivatives, security financing transactions (repurchase agreements and securities lending transactions); it was supposed to also cover title transfer collateral and guarantees (which would support certain cross-entity netting arrangements).
- Other transactions like loans and deposits have not be included by the Study Group, but the proposal was that States may protect them, if they want to.
- As indicated above, some Governmental Experts (including France) proposed to reconsider the scope of eligible obligations and cover only regulated financial transactions as listed in the Annex to the MiFID.
- The interim compromise negotiated amongst the above mentioned Governmental Experts proposes to protect all products (as specified by the Study Group), but only if both parties are eligible parties.
- Spots and physically settled forwards on currencies, precious metals and commodities are not in scope if one of the counterparty is not a financial institution.
- Again, the small working group will present a new compromise for the second meeting.



III. Main Content

Principle 4 – formal requirements

- The validity and enforceability of close-out netting provisions should not depend on any formal act.
- The only exemption (as in the European Financial Collateral Directive) is the a requirement that the close-out netting provision is evidenced in writing.

Principle 5 – market standard documentation

- The use of a specific market standard documentation (e.g., ISDA Master Agreements) should not be precondition for the validity and enforceability of a close-out netting provision.

Principle 6 – reporting and registration requirements

- The recognition of close-out netting should not depend on any reporting or registration requirement (e.g. under EMIR or the Dodd Frank Act).
- Some Governmental Experts (e.g., Russia) raised concerns about Principle 6.



III. Main Content

Principle 7 – enforceability especially upon bankruptcy

- Close-out netting provisions should be enforceable in accordance with its terms before and after the commencement of insolvency proceedings.
- The Governmental Experts discussed the recognition of close-out netting prior to insolvency. The prevailing view was that Principle 7 does not constitute a choice of law rule: Whether the choice of law made by the parties in the netting agreement is to be recognized and whether it conflicts with mandatory provisions of the otherwise applicable law is a question outside the proposed Principles.
- As far as close-out netting upon insolvency is concerned, the Governmental Experts supported the partial derogation of insolvency law as outlined paragraphs (a) to (c).
- The Study Group's proposal to define the term „insolvency proceeding“ by reference to Article 1(h) of Geneva Convention on Substantive Rules for Intermediated Securities was not challenged. This reference would include administrative proceedings initiated by competent authorities for the purpose of reorganization (see exemptions in Principle 8).
- As far as Principle 7(b) is concerned (rotten apple in the barrel principle) it was clarified that such principle should not cure a transaction or collateral transfer that otherwise would be unenforceable; it would only protect the netting of the remaining transactions.
- Principle 7(c) (no cherry picking, stay or suspect periods) was broadly supported, but subject to technical redrafting.



III. Main Content

Principle 8 – bank resolution

- The safeguards for certain bank resolution measures was broadly appreciated.

Principle 9 – conflict of law rules

- The conflict of law rule was supported, especially by the observer of the Hague Conference on Private International Law.
- There was, however, a strong view to redraft Article 9 (in accordance with a specific drafting proposal submitted by the U.S.A) and to further align the language used in paragraph 4 to Principles 7 and 8.
- There was also a strong position (presented by France) to determine the eligibility of parties and obligations based on the law of the insolvency proceeding.
- The Secretariat will provide new drafting for the second meeting.