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**UNIDROIT Committee of governmental  
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netting provisions  
Second session  
Rome, 4 – 8 March 2013**

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**REPORT**

*(prepared by the UNIDROIT Secretariat)*

**Opening of the session**

1. Mr J. A. Estrella-Faria, Secretary-General of UNIDROIT, opened the second session of the Committee of Governmental Experts on the enforceability of close-out netting provisions (hereinafter referred to as the *Committee*), held at the Headquarters of the Food and Agriculture Organization of the United Nations in Rome, at 9.45 a.m. on 4 March 2013 and welcomed all participants.

**Agenda Item No. 1 on the annotated draft agenda: Election of the Chairman**

2. The Secretary-General explained that Mrs M. Vermaas, head of the delegation of South Africa, who had been elected Chair at the first session of the Committee, could not be present at this session of the Committee by reason of being involved in consultations and hearings concerning the adoption and implementation of legislation in South Africa. The Secretary-General expressed his gratitude for Mrs Vermaas' work as Chair at the first session of the Committee.

3. On the proposal of the South African delegation, Mr Alexandre Pinheiro dos Santos, head of the delegation of Brazil, was elected Chairman for the second session of the Committee.

**Agenda Item No. 2 on the annotated draft agenda: Adoption of the agenda and organisation of the session**

4. The annotated draft Agenda (C.G.E./Netting/2/W.P. 1) was adopted by the Committee as proposed.

5. It was also agreed that there would not be a need for setting up a drafting committee. At the proposal of the Japanese delegation, Mr Philipp Paech, member of the delegation of the United Kingdom, was elected Rapporteur for the second session of the Committee.

**Agenda Item No. 3: Consideration of the Draft Principles regarding the enforceability of close-out netting provisions (UNIDROIT 2012 C.G.E./Netting/2/W.P. 2)****Discussion of Draft Principle 1**

6. The Secretariat described the changes made to Draft Principle 1 and its commentary. On this point, the Committee was reminded of the changes agreed to and incorporated in the present revised draft, including suggestions: to split the former Draft Principle 1 (C.G.E./Netting/1/W.P. 2) into two separate provisions on scope (present Draft Principle 1) and definitions (present Draft Principle 2); to describe the relationship between set-off and close-out netting in greater detail; to introduce minimum harmonisation (paras. 11 s. of the commentary), including adding criteria for implementing States which desire to extend the scope of the Principles beyond the level of minimum harmonisation.

7. The Chairman proceeded to invite the delegations to comment on revised Principle 1. It was agreed that these changes reflected previous consensus, but it was further mentioned that the commentary should make clear that the flexibility to provide a greater level of harmonisation did not require special legislation and that the implementing States could achieve a broader effect also simply by not restricting safe-harbour provisions to certain obligations and parties or by applying general rules giving effect to close-out netting provisions in general.

**Discussion of Draft Principle 2**

8. The Secretariat introduced the changes previously agreed to Draft Principle 2 and its commentary and highlighted comments presented in writing by Delegations. In this respect, it was pointed out that, like the former draft Principle 1, also the current Principle 2 would provide general, broad and functional definitions of close-out netting. It was also mentioned that the words "... or replaced by..." had been added to the phrase "obligations ... are reduced to...", and the words "... whether by novation, agreement or otherwise..." had been added at the end of the principle in order to help ensure that all legal techniques used under national legislation for close-out netting are incorporated into the Principles.

9. It was also explained that the former second sentence of the definition regarding the extension to both automatic close-out and to netting at the election of one party had been deleted since it was felt that it was not strictly necessary to refer to this distinction in the definition.

10. Another point referred to by the Secretariat was that that paragraph 14 of the commentary added the concept of "operation of a close-out netting provision", as a shortened reference to a single term intended to cover all phases of netting operations. Such term allows shortened references in all other provisions. Further additional content in paragraph 19 of the commentary clarified that the Principles extended to master-master agreements. Finally, it was pointed out that additional content had been added to the commentary dealing with walk-away-clauses, wait-and-see-periods and requirements of commercial reasonableness, arguing that these Principles applied only to close-out netting provisions in the strict sense of the definition in Draft Principle 2, while the implementing States were free to decide whether or not to enforce walk-away-clauses or wait-and-see-periods or close-out netting provisions under which the calculation of the aggregate value did not comply with standards of commercial reasonableness.

11. Delegations felt that correlation between netting and set-off could be dealt with in greater detail in the explanatory notes, particularly to explain that set-off in general is not affected by the Principles, while some instances of set-off, when occurring within the context of a close-out netting provision, might be covered. It was agreed that some more content should be added to the commentary concerning this issue.

12. There was also some discussion on the issue of valuation, particularly to determine whether a commercial reasonableness standard will apply to the determination of the resulting net amount under the close-out netting provision. Although some delegations felt that further wording in the text could help clarify the issue, at a minimum, it was agreed that further detail in the commentary could be useful to acknowledge that countries which use a requirement of commercially reasonable valuation may continue to do so, while these Draft Principles should not generally prescribe such a requirement as a condition for the enforceability of close-out netting provisions.

13. With regard to specific wording, it was agreed that the terms "whether or not at that time they are due and payable", should be added to replace the words "due and undue", and that the word "aggregate" should be added before the word "value". It was also agreed that the wording of the former second sentence of the definition would be restored in the text.

#### **Discussion of Draft Principles 3 and 4**

(i) *Introduction to Draft Principles 3 and 4 (C.G.E./Netting/2/W.P. 2) and to the Joint Proposal (C.G.E./Netting/2/W.P. 4)*

14. The Secretary-General explained that the discussion of Draft Principles 3 and 4 should take place on the basis of the Joint Proposal of the Delegations of France, United Kingdom and the United States of America contained in Working Paper C.G.E./Netting/2/W.P. 4. He reminded the Committee that in its first session in October, a draft presented by the same delegations as an alternative to the Secretariat's draft version of the principles on eligible parties and obligations did not find sufficient support, so that it was agreed that for the time being, the Secretariat's version should be retained, while the delegations were invited to re-work their draft in inter-session consultations. Since at the time of the publication of the Secretariat's revised version of the Draft Principles in C.G.E./Netting/2/W.P. 2, these inter-session consultations had not yet come to a final result, the Secretariat had included in document C.G.E./Netting/2/W.P. 2 an only slightly reworked version of its original draft. However, now that the Joint Proposal of the Delegations of France, United Kingdom and the United States of America contained in Working Paper C.G.E./Netting/2/W.P. 4 had been presented to the Committee, the Secretariat regarded this draft as a useful basis for the discussion at the second session of the Committee.

15. The delegations supporting the Joint Proposal explained that their proposal was based upon the idea of systemic risk being a core rationale for the enforceability of close-out netting provisions. While there might also be other reasons for supporting close-out netting, the rationale of systemic risk was generally accepted and therefore could be used as a criterion underlying the delimitation of a minimum core where close-out netting should be enforceable. This would translate into the limitation of this minimum core to transactions involving financial institutions and public authorities undertaking traditional financial market transactions, while not precluding any recognition of the enforceability of close-out netting beyond this minimum core by the implementing State.

(ii) *Issues raised in relation to individual aspects of the Joint Proposal*

16. While some delegations expressly declared their support for the Secretariat's version of the principles on eligible parties and obligations, the debate generally focussed upon the Joint Proposal. In the discussion, a number of issues were raised in relation to different aspects of the Joint Proposal:

17. There was some discussion concerning the question whether the term "eligible party" should be defined with reference to the term "consumer" as the outer limit. Some delegations argued that this term could only be used if there was a special definition of this term in the Draft Principles, a proposition which other delegations regarded as unrealistic.

18. Other delegations argued that natural persons in general, whether consumers or not, should be excluded from the scope of eligible parties. It was argued that implementing States could still decide to extend the scope of application of the protection under these Draft Principles to certain natural persons if they so wished.

19. As a matter of drafting, it was also suggested that the definition of the term "eligible party" in Draft Principle 3 also refer to the categories of financial institutions and public authorities, since the latter type of parties, even though separately defined under these Draft Principles, at the same time also constituted eligible parties under the Draft Principles.

20. Concerning the use of the term "financial institutions" it was suggested that this term should rather be replaced by terms such as "important market participant" or similar, because in letter (f) this definition clearly goes beyond what could reasonably be understood as financial institutions. Moreover, if the general term "financial institution" were to be retained, letter (a) of this definition would have to be changed because it contained the same term.

21. One delegate argued that the term "market maker" under letter (a) of the definition of the term "financial institutions" was probably a very complicated concept that had better not be used in a definition.

22. The question was raised whether the definition would extend to hedge funds.

23. It was suggested by several delegations that letter (e) in the definition of the term "financial institutions" should be changed so as to refer to "an operator of a clearing and/or settlement system".

24. Some delegations expressed their view that the wording in letter (e) in the definition of the term "financial institutions" (Principle 3) and in letter (c) of No. 4 under Part I of the list of contracts (Principle 4) should be harmonised. Generally, it was said to be too EU-centric a terminology to refer to undertakings for collective investments in transferable securities.

25. Some comments were made in relation to the provision extending the scope of application of the principles to suretyships (Draft Principle 4(b)). The question was raised whether there was intentionally no limitation of the scope of eligible parties that could act as a surety, i.e., no restriction to financial institutions or public authorities. One of the delegations supporting the joint proposal explained that suretyships could only be covered if also the obligation of the original debtor was an eligible obligation.

26. As concerned Part I of the list of contracts in Draft Principle 4, one delegation suggested that the inherent volatility of the obligations concerned should be emphasised as a reason justifying the enforceability of close-out netting provisions covering such obligations.

27. In relation to No. 3 of Part I of the list of contracts in Draft Principle 4, several delegates argued that the term "title transfer" should be understood as covering cash transfers as well. However, it was argued by others that some legal systems would rather regard a title transfer arrangement concerning cash as a security agreement which should then not be covered under No. 3 of Part I of the list of contracts in Draft Principle 4.

28. The fact was criticised that neither Part I nor Part II of the list of contracts in Draft Principle 4 appeared to cover master-master agreements, i.e., netting agreements covering the resulting net amount under other master agreements.

29. Additionally, it was argued that Part I of list of contracts in Draft Principle 4 should be extended so as to cover deposit and loan contracts between two professional parties.

30. In relation to Part II of the list of contracts in Draft Principle 4, several delegations argued that an open-ended list would be preferable, which would also allow to deal with new arrangements that might be developed in the financial markets. It would therefore be possible to state in Draft Principle 4 under No. 2 that the implementing States could provide that these principles might

extend to any kind of contract so designated by the implementing State. The contracts listed in Part II could then be used as mere examples in the commentary.

31. Some delegations raised criticism concerning elements of Part II of the list of contracts in Draft Principle 4. It was said that No. 6 would not cover cash collateral and that it would be necessary to allow an implementing State to provide for the extension of close-out netting to obligations arising from the provision of this type of collateral.

*(iii) Amendments agreed by the Committee in relation to the Joint Proposal*

32. After consideration of those matters, the Committee agreed to see the following amendments:

Draft Principle 4 under No. 2 could be redrafted so as to provide that the implementing States could provide that these principles might be extended to obligations arising "under other contracts of such kind as the implementing State may specify". The contracts listed in Part II could then be used as mere examples in the commentary and the commentary might also refer to some policy arguments why States might wish to extend the scope of application of these Draft Principles.

As a consequence of the foregoing amendment, Part I of the list of contracts could be included in Draft Principle 4(a) without any further need for a separate list at the end of the Draft Principle.

The term "consumer" in Draft Principle 3 could be defined along the following lines "a natural person acting primarily for personal, family or household purposes", as in the Hague Convention on Choice of Court Agreements.

The term "financial institution" should be replaced by "qualifying financial market participant".

There was general agreement as to these suggestions and it was agreed that a redraft of Draft Principles 3 and 4, taking into account the results of this discussion, should be presented to the Committee during the remaining days of the session.

33. As an additional issue, one delegation asked whether implementing States should be free to apply certain parts of the Draft Principles to consumers, even if primarily acting for personal, family or household purposes. It was suggested that it should be taken into consideration that in the financial sector, consumers should often be regarded as investors and investors would generally fall within the scope of application of these Principles.

### **Discussion of Draft Principle 5**

34. The Secretariat gave a short introduction to Draft Principle 5. It was explained that Draft Principle 5 combined the content of the former Draft Principles 4 to 6 (C.G.E./Netting/1/W.P. 2) and that the Secretariat was of the opinion that the new drafting of this provision allowed an easier understanding of its content, without including major changes as to the substance. Specific reference was made to paragraph (3) and it was said that this provision contained rules formerly dealt with only in the commentary to the Draft Principles, which were, however, felt to be too important not to be included in the text of the Black Letter Rules.

*(i) Issues arising in relation to Draft Principle 5(3)*

35. Some delegations expressed their view that paragraph (3) should be deleted as it was thought that this provision gave rise to uncertainties. The text of this paragraph could instead be included in the commentary, where it could be clarified that there could be reporting requirements,

but that a failure to comply with them should not affect the enforceability of the close-out netting provision.

36. One delegate argued that it could also be stated in the commentary that only non-compliance with reporting requirements could justify criminal sanctions, whereas failure to fulfil other formal requirements should not have such consequences.

37. As another addition to the commentary, it was suggested that the commentary should give further examples of formal requirements that should not affect the enforceability of the close-out netting provision, such as mandatory notice periods or a requirement of prior approval by the courts before the operation of a close-out netting provision.

38. The view was expressed that it was unclear whether the meaning of the terms "law or regulations" in paragraph (3) should be understood as having a general meaning or as referring to some specific concept. It was agreed that the commentary should provide appropriate clarification.

*(ii) Other drafting issues*

39. Concerning the title of the Draft Principle, it was argued by one delegation that "Formal Acts and Reporting Requirements" would be more precise.

40. It was observed that the opening phrase of Draft Principle 5 "The law should not..." was unclear as concerned the issue which law exactly was meant there. It was therefore agreed that the opening phrase should be reworded as follows: "The law of the implementing State should not...". The commentary could then refer to the fact that the issue of whether the law of the implementing State was applicable would be decided on the basis of the principles laid down in Draft Principle 9.

41. Concerning the alternative texts in square brackets in paragraphs (1) and (2), it was agreed that only the term "operation" should be kept. The same term should also be introduced in Draft Principle 1, which should now read "These Principles deal with the effects and the operation of close-out netting provisions...". The term "operation" should then be defined in the commentary to Draft Principle 1.

### **Discussion of Draft Principle 6**

42. Draft Principle 6 was introduced by the Secretariat, highlighting that the former Draft Principle 7 (C.G.E./Netting/1/W.P. 2) had been split into two provisions following the first session of the Committee in October 2012 in order to present the content of the rule in a more accessible manner. It was explained that the new Draft Principle 6 was to cover the operation of close-out netting provisions in general, while Draft Principle 7 contained additional rules for insolvency-related situations. It was pointed out that paragraph (1) of Draft Principle 6 contained only minor amendments to the former text, letters (a) and (b) having been adopted from the former Draft Principle 7(1)(a) and (b), respectively, subject only to minor drafting changes, but no changes as to the substance. Paragraph (2) was explained to be a new addition, intended to reflect a view expressed at the last session of the Committee that the restrictions to the enforceability of close-out netting provisions under laws and regulations concerning fraud and the conditions governing the validity of contracts should not only be referred to in the commentary, as was the case under the previous version of Draft Principle 7.

43. Some delegations criticised the inclusion of paragraph (2) in Draft Principle 6 and argued that it would be better to regard the issues dealt with in paragraph (2) as being excluded from the content of the rule in paragraph (1) as a matter of course, without any need for an express provision to this effect in the black letter rules. Such an inherent limitation of the scope of the rule in paragraph (1) sentence 1 would then cover not only the limitations currently expressly referred

to in paragraph (2), but all such general rules of contract law that were likely to restrict the enforceability of close-out netting provisions as opposed to restrictions specifically directed against close-out netting provisions. The issues of fraud and the conditions for validity of contracts as currently mentioned in paragraph (2) would then only be examples for the application of this general rule. It was said that this approach would also be in line with the reasoning in the commentary under paragraph 94.

44. Other delegations, however, argued that while it was true that the issues mentioned in paragraph (2) were only examples of the application of a broader rule, this broader rule which allowed the restriction of the enforceability of close-out netting provisions on the basis of general rules of law nevertheless should be expressly mentioned in the text of the black letter rules.

45. At this junction, it was suggested that Draft Principle 6(2) could be redrafted so as to provide that the Principles were not intended to render enforceable close-out netting provisions that would otherwise be unenforceable for reasons of fraud or the non-fulfilment of other requirements for the validity of contracts. It was agreed by the Committee that the Secretariat should undertake to redraft the paragraph (2) following these broad lines.

46. The Committee agreed that the text at the end of Draft Principle 6(1)(b), where there was currently a text in square brackets, should be redrafted as follows: "... in relation to those obligations, which are valid, enforceable and eligible.", thereby avoiding the unclear term "other" and the slight redundancy that existed in the present version of the text.

### **Discussion of Draft Principle 7<sup>1</sup>**

47. The Secretariat gave a short introduction to Draft Principle 7, pointing out that this provision was to deal with matters of enforceability of close-out netting provisions that were specific to insolvency situations and contained the insolvency-related content of the former Draft Principle 7 (C.G.E./Netting/1/W.P. 2).

#### *(i) Extension of Draft Principle 7 to resolution proceedings*

48. One issue that was intensively debated was the desirability of maintaining the current approach of the Draft Principles according to which the insolvency-related rules in Draft Principle 7 also covered resolution proceedings. Several delegations argued that such proceedings should not be covered by Draft Principle 7, but only by the general rule in Draft Principle 6 and the specific provision in Draft Principle 8. It was recommended that the definition of the term "insolvency proceedings" as applied in the Draft Principles should not extend to resolution proceedings since they were said to be different in character. Even if substantively the same principles concerning the enforceability of close-out netting provisions applied in both types of proceedings, it was said to be preferable to deal with them separately. Also the references in paragraph 98 of the commentary concerning the scope of the term 'insolvency proceedings' were said not necessarily to support an extension of the scope of this term to cover resolution proceedings as well.

49. Other delegations expressed the contrary view and argued that the specific provision in Draft Principle 8 was based upon the assumption that resolution proceedings would be covered by Draft Principle 7 as well. It was also questioned whether, due to the fact that close-out netting provisions would be generally enforceable under both types of proceedings, subject to the exceptions dealt with in Draft Principle 8, there would be any need for a separate treatment of these types of proceedings in Draft Principle 7.

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<sup>1</sup> Please note that the discussion of Draft Principle 7 took place over two days and was therefore split up in the daily reports C.G.E./Netting/2/W.P. 12 and C.G.E./Netting/2/W.P. 13. For purposes of a coherent presentation of this discussion in this report, the order of paragraphs concerning the discussion of Draft Principle 7 in the daily reports C.G.E./Netting/2/W.P. 12 and C.G.E./Netting/2/W.P. 13 has been rearranged, without any changes to the text of the individual paragraphs having been made.

50. The Committee concluded the discussion concerning the extension of Draft Principle 7 to resolution proceedings and agreeing on the need to distinguish two issues: (a) whether the terminology applied in Draft Principle 7, based upon the meaning given to the term "insolvency proceedings", for instance, in the Geneva Securities Convention, could be understood as covering resolution proceedings; and (b) whether it was preferable from a policy point of view to have a broad scope of application for Draft Principle 7, including resolution proceedings.

51. Resuming the discussion of the scope of Draft Principle 7 as regards resolution proceedings, it was pointed out that, even if the principles did not define the term "insolvency proceedings" paragraph 98 of the commentary to the draft principles assumed an understanding at least as broad as the corresponding definition in Article 1(h) of the Geneva Securities Convention, which in turn derived from the definition used in Article 29(a) of the 1997 UNCITRAL Model Law on Cross-Border Insolvency. However, it was noted that since the adoption of that definition, some doubt had arisen as to whether the definition extended to resolution proceedings. In some jurisdictions, such proceedings would be regarded as insolvency proceedings in the strict sense, while in other jurisdictions, resolution proceedings might or might not lead to the opening of insolvency proceedings. If a distinction between insolvency proceedings and resolution proceedings was made, typically issues such as cherry-picking, stays and insolvency avoidance did not arise in the context of the latter proceedings, but might arise once those resolution proceedings ended up in the commencement of insolvency proceedings.

52. Noting that the question of terminology was still uncertain, and that the policy implications varied according to the jurisdiction concerned, some delegates argued that resolution proceedings should be strictly distinguished from insolvency proceedings, while a larger number of delegations held the view that resolution proceedings should be dealt with in Draft Principle 7. However, those delegations favouring the application of Draft Principle 7 to resolution proceedings also argued in favour of including an express reference to this effect in the text of the black letter rules, since they felt that the mere reference in the commentary to the definition of the term "insolvency proceedings" as presently understood under these Principles would not constitute a sufficiently certain or desirable basis for this result.

53. The argument was raised that some of the uncertainties concerning the scope of application of the current Draft Principle 7 seemed to stem from the division of the original Draft Principle 7 into two separate provisions, but a proposal to revert to the original drafting with a single Draft Principle covering all issues of the enforceability of close-out netting provisions did not find support.

54. While one delegate argued that the Draft Principles should also attempt to include a definition of the term "restructuring", other delegations expressed the view that this concept was often used in very specific contexts, so that the attempt to provide a definition of these term would be rather bold. The view prevailed that such proceedings would already be covered by the present concept of "insolvency proceedings" as applied in Draft Principle 7.

55. The proposal was then agreed that Draft Principle 7 should expressly refer to "resolution regimes", a term that was preferred because some delegations argued that the alternative terms "resolution measures/powers" would primarily cover the exercise of such powers, not the general framework that was the source of such measures/powers. Moreover, the term "resolution regime" was also used by the Financial Stability Board in its Key Attributes. It was also agreed that the commentary to the draft Principles should clarify that the term "reorganisation proceedings" would already be covered by the definition of the term "insolvency proceedings", and include an additional definition of the term "resolution regime", based upon international standards developed, amongst others, in the work of the Financial Stability Board.



56. Additionally, it was agreed that Draft Principle 6 was intended to apply in the context of both insolvency proceedings and resolution regimes and that this should be clarified in the text of the black letter rules.

(ii) *Substantive content of Draft Principle 7(1)(d)*

57. There was some discussion as to whether and to what extent Draft Principle 7(1)(d) should offer protection against an insolvency avoidance action based upon the occurrence of a juridical act in a suspect period before the commencement of insolvency proceedings:

58. No objection was raised in the Committee against the reasoning that the mere fact that a close-out netting provision took effect in a suspect period before the opening of insolvency proceedings should not give rise to an avoidance action.

59. Some delegations expressed doubts as to whether Draft Principle 7(1)(d) should have the consequence that a close-out netting provision undertaken during a suspect period would not constitute sufficient grounds for the avoidance of the close-out netting provision. However, a larger number of delegations voiced their support for the understanding that under the current draft of this provision, the mere fact that a close-out netting provision was concluded in a suspect period should not have as a consequence that the close-out netting provision could be avoided.

60. Some delegations expressed concerns in relation to the redrafting of Draft Principle 7(1)(d) and argued that the reasons set out in the commentary under paras. 121 and following would justify giving the underlying obligation the same protection as that afforded the close-out netting provision itself.

61. Several delegations argued, in favour of a broad scope of the principles, that the underlying obligations should not be subject to avoidance solely on the grounds that the obligations concerned were concluded or had arisen in the suspect period, more closely following the previous draft of this provision in C.G.E./Netting/1/W.P. 2. The same protection was also argued to be necessary in relation to additional margin provided in the period immediately preceding the insolvency. However, several delegations also expressed the view that these Draft Principles should not validate transactions that were not themselves actually included in the calculation of the single net sum under the netting mechanism.

62. It was agreed that Draft Principle 7(1)(d) should be amended in order also expressly to cover the protection of the underlying obligations, while a qualification should be added that this protection should be provided by Draft Principle 7(1)(d) only to the extent that the obligations concerned were actually themselves included in the calculation of the single net sum under the netting mechanism, i.e., the enforceability of the underlying obligation outside the close-out netting mechanism was not to be affected by these Principles. Additionally, it was agreed that it should be clarified that the provision of additional margin should also be protected against avoidance under Draft Principle 7(1)(d).

(iii) *Draft Principle 7(1)(a)*

63. Concerning Draft Principle 7(1)(a), it was argued that it might be preferable to draft the principle in more precise terms, indicating more clearly in which respect a stay should be prohibited, since the present general formula could be understood as being too broad. It was also said that the use of the term "operation" in the current version of Draft Principle 7(1)(a) argued against the broad definition of this term as suggested by the Secretariat, since a stay would, for instance, never affect the creation of a close-out netting provision.

64. One delegation suggested that the wording of Draft Principle 7(1)(a) could be improved by stating "should not be stayed" instead of "is not stayed".

(iv) *Draft Principle 7(2)*

65. Much as in the discussion concerning Draft Principle 6, there was also discussion in relation to Draft Principle 7 as to whether or not to maintain the exceptions in paragraph (2). Some delegations argued that the issues dealt with in paragraph (2) could be regarded as a specific application of a general principle already flowing from paragraph (1), namely that the general principle on the enforceability of close-out netting provisions despite the commencement of insolvency proceedings should not affect the applicability of general restrictions such as those concerning fraudulent transactions or detrimental preferences. It was argued that this principle would extend to other issues as well, such as a requirement of mutuality for the claims to be netted out in insolvency and a restriction concerning the operation of the close-out netting provision in relation to transactions entered into at a time when the counterparty of the insolvent debtor already had notice of the impending insolvency.

66. On the basis of this reasoning, some delegations argued in favour of the deletion of paragraph (2) and argued that it added little to the content of Draft Principle 7(1), especially since the list in Draft Principle 7(1) was understood to be an exhaustive one.

67. Other delegations, however, preferred to retain paragraph (2) in the text. In this context, some delegations referred to the fact that some of the rules in Draft Principle 7(1), specifically letters (a) and (b), seemed to be very broad and could be in need of restriction in certain situations. Specifically as regards letter (a), however, another delegation held the view that this provision should only apply to the automatic stay at the commencement of an insolvency proceeding and would therefore not be overly broad.

68. Concerning the question of the scope of paragraph (2), there was a suggestion to limit this provision to cases of actual fraud. However, this proposal did not find widespread support.

69. Instead, a number of delegations argued that the scope of paragraph (2) should be extended to cover issues such as the afore-mentioned requirement of mutuality for the claims to be netted out in insolvency and a restriction concerning the operation of the close-out netting provision in relation to transactions entered into at a time when the counterparty of the insolvent debtor already had notice of the impending insolvency. Other delegations, however, expressed their concern as regards a broader exception in paragraph (2).

70. Concerning specific issues to be covered in paragraph (2), one delegation expressed the view that references to the principle of equal treatment of creditors should only be included with some caution, arguing that the conclusion of a close-out netting provision inherently included some unequal treatment of creditors. It was suggested that the threshold for the application of paragraph (2) should be kept at a rather high level.

71. One delegate suggested that it should be clarified that even a transaction concluded at a moment when the counterparty of the party who subsequently became insolvent already had notice of the latter party's financial difficulties should not be subject to an avoidance action if this transaction was concluded with legitimate intentions. Other delegations argued that this issue could be dealt with under the general rules of the national insolvency law to which Draft Principle 7(2) referred, which should allow for distinction between cases in which there were legitimate intentions from cases in which there were not.

72. It was then agreed that the Secretariat, in its effort to redraft Draft Principle 7, should keep paragraph (2), taking into account the considerations specifically concerning the possible extension of this provision to other general aspects of insolvency law which could justify a restriction of the operation of a close-out netting provision.

(v) *Additional drafting issues concerning Draft Principle 7*

73. One delegation asked whether it might be necessary to include in the provision some reference stating that the consequences spelled out here would apply only in relation to eligible obligations and eligible parties.

74. Several delegations criticised the wording of the title and of the chapeau of Draft Principle 7, stating that for such an important provision a stronger title than "Additional Rules on the Operation of Close-out Netting Provisions in Insolvency" might be necessary. Moreover, it was said that the chapeau of this provision (as opposed to the title) did not clearly indicate that this provision was intended to be applied in addition to the general rules in Draft Principle 6, which continued to apply also in insolvency situations.

75. Some criticism was also raised in relation to the treatment of "zero-hour" rules in the commentary in paragraph 123, and it was argued that the black letter rules did not actually address this issue. It was also asked whether the words "or on the day of but before" in Draft Principle 7(1)(d) actually added to the content of the rule. Others, however, argued that these words could be understood as covering legal fictions such as the afore-mentioned zero-hour rules, where an insolvency proceeding was declared to have been opened at 00.00 hrs, even though in fact the order had been issued only later on the same day.

76. It was also suggested that the language in the commentary should not use expressions such as "inside/outside insolvency", but should employ a more precise language, such as "before/after the commencement of insolvency proceedings".

77. The Secretariat was asked to consider whether for the sake of clarity, the first words of the chapeau should be changed to "The law of the implementing State...", as had been previously suggested for other Draft Principles.

78. In relation to Draft Principle 7(1)(b), it was suggested that the phrases "even if these obligations are otherwise enforceable" and "and otherwise enforceable" could be deleted, since they did not seem to be necessary for the understanding of the rule.

79. Concerning the language used in Draft Principle 7(1)(c) and 7(1)(d), the Secretariat was asked to consider whether the terminology applied in these two provisions ("avoidance" and "restriction", respectively) could be harmonised.

### **Discussion of Draft Principle 8**

80. Draft Principle 8 was introduced by the Secretariat, highlighting that as compared to the former version of this Principle (C.G.E./Netting/1/W.P. 2), the new draft had been simplified and was strictly intended to be interpreted in light of the international standards on resolution regimes developed under the Financial Stability Board's Key Attributes.

81. Some delegations, however, expressed the concern that the current draft appeared to revert to lesser standards than those set under the Financial Stability Board's Key Attributes. It was argued that the Financial Stability Board's Key Attributes set stricter standards for the exercise of resolution powers than would follow from the current draft of Draft Principle 8.

82. It was argued that by referring exclusively to the term "stay", the current version of Draft Principle 8 failed to encompass the full scope of resolution measures which included also permanent restrictions of the operation of close-out netting provisions and rules which provided that the entering into resolution proceedings as such, as well as the exercise of resolution powers by the competent authorities, should not trigger the operation of a close-out netting provision.

83. Concerning the issue whether reference should be made to other international standards, besides those set by the Financial Stability Board's Key Attributes, some delegates pointed out that

the European Union is developing proposals for secondary legislation, which should also be taken into consideration.

84. Other delegates argued that Draft Principle 8 should elaborate more extensively on the appropriate safeguards that would restrict the exercise of resolution powers.

85. Several delegations, however, emphasised the need not to deviate from the standards set by the Financial Stability Board's Key Attributes, specifically also because it appeared that this Committee would not be the appropriate forum for the discussion of policy issues relating to resolution regimes. Instead, it was suggested that the draft Principle or the commentary should refer to the policy concerning the resolution of financial institutions as an evolving policy.

86. Concerning the personal scope of application of Draft Principle 8, some delegates argued that it would be preferable to extend the rule in Draft Principle 8 to entities other than financial institutions. However, while the point was raised that the Financial Stability Board's Key Attributes presently cover some non-bank institutions, such as bank holding companies, others argued that it was rather unclear at this juncture how the Financial Stability Board would address the issue of the resolution of non-banks in general in the future.

87. While several alternative drafting proposals were suggested (see C.G.E./Netting/2/W.P. 6, at page 3 and W.P. 9, at page 1), the view prevailed that Draft Principle 8 should be redrafted on the basis of the following wording: "These Principles are without prejudice to any provision which the law of the implementing State, subject to appropriate safeguards, may provide for in the course of resolution regimes for financial institutions".

### **Discussion of Draft Principle 9**

88. The Secretariat presented a summary of the changes to Draft Principle 9 as agreed at the first session of the Committee, describing the organisation of the Principle in five paragraphs: (1) containing the principle that the governing law of the close-out netting provision is to be determined on the basis of the private international law rules of the implementing State, with a specific reference to the relevance of choice-of-law clauses if these are recognised under the law of the implementing State; (2) extending the scope of application of the governing law to the determination of the scope of eligible parties and obligations, subject to the rule in paragraph (5)(a); (3) regulating the relationship between conflicting choice-of-law clauses; (4) establishing the principle that the determination of the applicable law on the basis of the rules in paragraphs (1)-(3) is not affected by the commencement of insolvency proceedings; and (5) establishing an exception to the preceding rule which allows an implementing State to provide that instead of the governing law according to the paragraphs (1) to (4), the law of the insolvency proceedings should govern (a) the scope of eligible parties and obligations for purposes of the enforcement of the close-out netting provision in insolvency proceedings in a local court, and (b) the application of rules on the avoidance of fraudulent transactions and detrimental preferences.

89. Several delegations criticised the reference to choice-of-law clauses in paragraph (1) and argued that if these Principles intended to be neutral as to the determination of the governing law in general, there should likewise not be such a specific reference which could be understood as an endorsement of the principle of freedom of choice of law in relation to close-out netting provisions. One delegate recommended that the whole paragraph (1) could be deleted as it appeared to add nothing to the present state of the law. Another delegation, however, argued that paragraph (1) would at least be useful in so far as it made clear that the governing law should be determined on the basis of the implementing State's private international law rules concerning contracts in general, while in some jurisdictions there were said to be uncertainties whether there might be an application of the private international law rules concerning secured transactions.

90. Some delegates suggested that paragraph (3) should also be deleted, since the provision interfered with general rules of private international law on contractual matters, and its possible implications might not be entirely anticipated at the present time. Another delegation, however, regarded the rule in paragraph (3) as useful.

91. Concerning general policies to be followed in Draft Principle 9, it was argued that it should generally be made clear to which extent the parties should not be allowed to contract out of the application of the appropriate law to their close-out netting provision, i.e., in some situations especially the determination of the eligible parties and obligations should be governed by the proper law of a State without there being any possibility for the parties to choose the application of another regime. On the other hand, implementing States should be prevented from circumventing the protection afforded to close-out netting provisions under these Principles by laying down specific private international law rules for close-out netting provisions which would be distinct from the private international law rules for contracts in general.

92. There was some discussion in relation to the extension of Draft Principle 9(5) to resolution regimes. Some delegates advocated that this provision should be specifically declared to apply to resolution regimes as well, echoing the discussion in Draft Principle 7. The effect of acts undertaken in the course of resolution regimes on close-out netting provisions should be governed by the law applicable to these regimes, not by the governing law of the close-out netting provision. Other delegations, however, expressed concerns, arguing that the status of foreign law in resolution regimes was a complicated issue, often calling for international co-operation of the competent authorities. They argued that at the very least, it should be ensured that the extension of Draft Principle 9(5) to resolution regimes should not have as a consequence that the effects of resolution measures under their own law would have to be accepted under any other legal regime as well, specifically in the State whose law otherwise governed the close-out netting provision.

93. In response to a question as to whether Draft Principle 9(5)(b) went beyond the current Draft Principle 7(2), it was noted that Draft Principle 9(5)(b) dealt only with the avoidance of fraudulent transactions and detrimental preferences, which corresponded to the scope of the issues dealt with in Draft Principle 7(2).

94. Several alternative drafting proposals were suggested to the Committee. One was a proposal by the Government of United Kingdom (C.G.E./Netting/2/W.P. 10) to restructure Draft Principle 9 and to limit it to three basic elements: (1) referring to the application of the implementing State's normal private international law rules relating to contractual obligations to close-out netting provisions; (2) containing a rule of recognition in insolvency proceedings, corresponding to the existing Draft Principle 9(4); and (3) a confirmation regarding the possible overriding application of insolvency rules applying the Principles in accordance with the law governing the relevant insolvency proceedings, corresponding to the existing Draft Principle 9(5). A second proposal was made by the Government of France (C.G.E./Netting/2/W.P. 6), referring to the text of Draft Principle 9(5) and suggesting to redraft this provision with the following wording:

(5) Notwithstanding the above, if insolvency **or resolution** proceedings have been commenced in respect of a party to the close-out netting provision [or a branch of that party] and under a law other than the law determined in accordance with paragraph (1), the implementing State may provide that the law ~~governing the insolvency of the opening of~~ proceedings governs also

(a) the determination of the scope of parties and obligations that are eligible for close-out netting ~~for the purposes of~~

**(b)** the **conditions of** enforcement of the close-out netting provision in the context of insolvency **or resolution** proceedings before the courts of the relevant implementing State; and

(bc) the avoidance of a close-out netting provision as a fraudulent transaction or as a preference that is detrimental to other creditors of the insolvent party.

95. It was agreed that the Secretariat should undertake to redraft Draft Principle 9 and submit the revised draft to the Committee, working along the lines of the proposal by the Government of United Kingdom (C.G.E./Netting/2/W.P. 10) and including in square brackets the additional content suggested by the Government of France (C.G.E./Netting/2/W.P. 6).

#### **Discussion of the revised Draft Principles (C.G.E./Netting/2/W.P. 11)**

96. Having concluded its second reading of the Principles, the Committee proceeded to consider a revised version of the Draft Principles prepared by the Secretariat to reflect the comments and decisions by the Committee so far (C.G.E./Netting/2/W.P. 11).

#### **Discussion of revised Draft Principle 1 (C.G.E./Netting/2/W.P. 11)**

97. The Committee agreed to the redrafting of Draft Principle 1(1) in the document C.G.E./Netting/1/W.P. 11.

#### **Discussion of revised Draft Principle 2 (C.G.E./Netting/2/W.P. 11)**

98. While there was some discussion concerning the possible replacement of the phrase "owed by the parties to each other" by the words "owed by and to that party", it was agreed that this phrase, as contained in the version of Draft Principle 2 in document C.G.E./Netting/2/W.P. 11, should be maintained since it was thought to be useful to highlight the restriction of the scope of application of these Principles to close-out netting between two parties.

99. One delegation suggested to delete the phrase "by one party to the other" at the end of the provision. It was agreed, however, that this phrase could help the understanding of the Principles as it emphasised the replacement of all the underlying obligations by a single net obligation under the close-out netting provision.

100. A suggestion to delete the words "due and" in the fourth line of the redrafted Draft Principle 2 did not find general support. For the sake of consistency, it was agreed that the concluding words of Draft Principle 2 should be reformulated as follows: "..., which is thereupon due and payable by one party to the other".

#### **Discussion of revised Draft Principle 3 (C.G.E./Netting/2/W.P. 11)**

##### *(i) Definition of "consumer" in Draft Principle 3(1)*

101. While one delegation suggested that the Draft Principle should include a definition of "consumer", referring to a person acting for purposes which can be regarded as outside its trade or profession, it was agreed that the approach of the redrafted Draft Principle 3(1) should be maintained.

102. It was also agreed that it should be clarified in the commentary that this definition of the notion of a consumer was used for the purposes of the delimitation of the scope of these Principles only and that implementing States would be free to apply their own national definitions of the term "consumer" in their national legislation.

- (ii) *Whether the definition of "eligible party" in Draft Principle 3(1) should be extended to cover the categories of parties in Draft Principle 3(2) and (3)*

103. One delegation asked whether the definition of "eligible party" in Draft Principle 3(1) should be extended to cover the categories of parties in Draft Principle 3(2) and (3). Others, however, argued that the present draft of Draft Principle 3(1) was already broad enough to achieve this result.

- (iii) *"Qualifying financial market participant" in Draft Principle 3(2)*

104. While there was some discussion concerning the issue whether, in Draft Principle 3(2), the term "qualifying financial market participant" should be replaced by terms such as "qualifying party" or "financial party", it was agreed to keep the wording "qualifying financial market participant".

- (iv) *Reference to "financial institution" in Draft Principle 3(2)(a)*

105. It was suggested that Draft Principle 3(2)(a) should use terms such as "other financial market participant" or "financial entity" instead of "financial institution", bearing in mind that the enumeration of different types of parties in Draft Principle 3(2)(a) to (f) could imply that parties covered in other sub-paragraphs of this provision could not be regarded as "financial institutions" in the sense of these Principles, an interpretation which was said to be at odds with the use of the term "financial institution" in Draft Principle 8.

106. Since a number of delegations held the view, however, that the scope of Draft Principle 8 would be primarily determined by reference to the scope of the Financial Stability Board's Key Attributes, it was agreed that it was not necessary to change the wording of Draft Principle 3(2)(a) in this respect.

- (v) *Terminology used in Draft Principle 3(2)(c) and Draft Principle 4(1)(a)(ii) and 4(1)(a)(iv)*

107. It was agreed that the wording in Draft Principle 3(2)(c) and Draft Principle 4(1)(a)(ii) and 4(1)(a)(iv) should be harmonised, referring in all cases, with appropriate adaptations, to "an undertaking for collective investment or an investment fund".

- (vi) *Draft Principle 3(2)(d)*

108. While some delegates argued that the reference in Draft Principle 3(2)(d) to a requirement of "regulation or prudential supervision" could be deleted, this proposal did not find broad support. Instead, it was agreed that the wording of the provision should be amended as follows "subject to regulation, supervision or oversight".

109. It was also agreed that the provision should be merged with Draft Principle 3(2)(e).

- (vii) *Draft Principle 3(2)(e)*

110. It was agreed that the wording of Draft Principle 3(2)(e) should be extended by adding a reference to a "payment system".

111. The issue arose whether also in Draft Principle 3(2)(e), there should be a reference to requirements of regulation, supervision or oversight. It was agreed to solve this question on the basis of the merger of this provision with Draft Principle 3(2)(d).

(viii) *Draft Principle 3(3)*

112. The view was expressed that, in order to avoid tautology, in the definition of “public authority” in the chapeau of Draft Principle 3(3), the term to be defined should be changed from “public authority” to “qualifying public authority”.

113. Another suggestion was to change the wording in Draft Principle 3(3)(a) and refer to an “other public body/entity” instead of an “other public authority”. It was argued that this suggestion would provide for a wider scope of application of the term “public authority” at the end of Draft Principle 3(3)(a), which was favoured by several delegations. An alternative suggestion to replace the word “public authority” at the end of Draft Principle 3(3)(a) with “public-sector entity”, however, was regarded by several delegations as going too far as concerns the scope of application of these Principles.

114. It was agreed to keep the wording of the chapeau and to replace the words “public authority” at the end of Draft Principle 3(3)(a) with a reference to a “public entity” and to include some clarifications in the commentary stating that some private entities providing public services would be included, depending upon the local framework, while on the other hand a merely minor public involvement in an entity would not necessarily qualify the latter for the application of Draft Principle 3(3)(a).

**Discussion of revised Draft Principle 4 (C.G.E./Netting/2/W.P. 11)<sup>2</sup>**

(i) *Whether Draft Principle 4(1)(a)(i) should be a definition or merely give examples*

115. Some delegations argued that the term “meaning” should be replaced by terms like “including” or “such as”, not only for linguistic reasons, but also in order to indicate that the enumeration in Draft Principle 4(1)(a)(i) should be understood as a list of examples rather than a definition. Other delegations, however, expressed the view that the Draft Principles should rather be based upon a precise understanding of the term “derivatives”, which is central to their scope of application, which was said to argue against an open-ended category and in favour of a definition. The Committee, therefore, agreed to maintain “meaning” or an equivalent phrase.

(ii) *Whether Draft Principle 4(1)(a)(i) should refer to assets or values presently being or in the future becoming the subject of recurrent contracts*

116. One delegation suggested that in Draft Principle 4(1)(a)(i), the entire wording after “reference value” should be deleted. It was argued that those criteria gave rise to uncertainties and could rarely be established with reasonable certainty.

117. Other delegations, however, preferred to keep the reference to assets or values being the subject of recurrent contracts, arguing that this criterion allowed an important restriction of the scope of application of the Principles, allowing a distinction to be made from one-of-a-kind transactions. Therefore, it was agreed to keep this reference in the text.

118. Arguments were also put forward in favour of maintaining the reference to future developments which was said to allow the Principles to be applied to new and evolving types of financial transaction.

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<sup>2</sup> Please note that the discussion of revised Draft Principle 4 took place over two days and was therefore split up in the daily reports C.G.E./Netting/2/W.P. 14 and C.G.E./Netting/2/W.P. 15. For purposes of a coherent presentation of this discussion in this report, the order of paragraphs concerning the discussion of revised Draft Principle 4 in the daily reports C.G.E./Netting/2/W.P. 14 and C.G.E./Netting/2/W.P. 15 has been rearranged, without any changes to the text of the individual paragraphs having been made.



(iii) *Reference to any other transactions on financial instruments in Draft Principle 4(1)(a)(ii)*

119. Some delegates argued that the reference to “any other transactions on financial instruments” in Draft Principle 4(1)(a)(ii) was too wide and could not be defined with sufficient certainty. It was therefore suggested to replace this term with the phrase “any securities financing transactions” and this was so agreed by the Committee.

(iv) *Extension of Draft Principle 4(1)(a)(iv) to contracts relating to fungible commodities*

120. It was suggested to extend Draft Principle 4(1)(a) to include transactions concerning fungible commodities. Some delegates suggested that Draft Principle 4(1)(a)(iv) should include contracts relating to fungible commodities, arguing that banks and other financial institutions would often conclude such transactions, and also referred to their understanding of the views expressed in the October session of the Committee, that under the joint alternative drafting proposal discussed at that session, which formed the basis for the current draft version of Draft Principles 3 and 4, obligations arising under such transactions would always be included where both of the parties were banks or public authorities. However, while the market relevance of fungible commodities transactions was recognised, there was not sufficient support for the proposed addition within the Committee.

(v) *Extension of Draft Principle 4(1) to master-master agreements*

121. Some delegations supported the view that Draft Principle 4(1) should be extended to cover master-master agreements. The reasoning was brought forward that the extension of Draft Principle 4 to such agreements could also be regarded as a matter of course that did not require express mention in the text.

122. There was support for the extension of Draft Principle 4(1) to master-master agreements, provided that the component master agreements themselves covered eligible obligations. The Committee agreed that a new sub-paragraph (c) should be introduced in Draft Principle 4(1) with the following wording:

“(c) a single net obligation determined under a close-out netting provision entered into by the same parties in respect of obligations under sub-paragraph (a) or (b).”

(vi) *Deleting the restriction to “eligible” parties in Draft Principle 4(2)(a)*

123. Several delegations were in favour of allowing implementing States to extend the personal scope of application of the Draft Principles to consumers. The fact was criticised that the present wording of Draft Principle 4(2)(a), as understood by several delegations, appeared to prevent the implementing States from doing so.

124. It was agreed that the word “eligible” in Draft Principle 4(2)(a) should be deleted, allowing the implementing State to extend the personal scope of application of the Principles beyond the scope of eligible parties as defined in Draft Principle 3(1), especially having in mind individuals acting as investors, each implementing State remaining free to define this notion more or less narrowly.

(vii) *Whether Draft Principle 4(2)(b) should refer to “contracts of such kind as the implementing State may specify”*

125. It was agreed that the reference at the end of Draft Principle 4(2)(b) to “obligations arising under contracts of such kind as the implementing State may specify” should be replaced by the simpler formula “obligations not limited to those listed in paragraph (1)” or equivalent wording.

126. It was suggested that the commentary should specifically mention the possibility of extending the scope of application under Draft Principle 4(2)(b) to the provision of cash collateral.

*(viii) Suretyships under Draft Principle 4(1)(b)*

127. Concerning suretyships (Draft Principle 4(1)(b)), the view was expressed that the eligibility of an obligation under a guarantee would follow the question of the eligibility of the secured obligation.

**Discussion of revised Draft Principle 5 (C.G.E./Netting/2/W.P. 11)**

128. It was agreed that Draft Principle 5(3) should be deleted.

**Discussion of revised Draft Principle 6 (C.G.E./Netting/2/W.P. 11)**

*(i) Whether Draft Principle 6 should refer to "operation" or "enforceability"*

129. Several delegates suggested that the title of Draft Principle 6 should refer to "enforceability" instead of "operation". This proposal, however, did not find broader support and it was therefore decided to maintain the reference to "operation" in the title of Draft Principle 6. There was also no decision as to whether to change the wording of the text on the basis of the suggestion to use the word "operation" in Draft Principle 6(2).

*(ii) Whether Draft Principle 6(2) would cause concerns in relation to central counterparty netting*

130. One delegation expressed the view that Draft Principle 6(2) could hinder the efficient operation of central counterparty netting as it was feared that this provision could mean that the invalidity of the individual transactions would extend to the close-out netting mechanism involving the central counterparty. Other delegates, however, pointed out that implementing States would not be prevented by the Draft Principles in their ability to insulate the close-out netting mechanism involving the central counterparty from the effects of an invalidity of the individual transactions.

*(iii) Whether to extend the scope of Draft Principle 6(2)*

131. It was agreed that the wording of Draft Principle 6(2) should be extended as follows:

"These Principles do not render enforceable a close-out netting provision and an eligible obligation that would otherwise be unenforceable in whole or in part on grounds of fraud or conflict with other requirements of general application affecting the validity and enforceability of contracts."

**Discussion of revised Draft Principle 7 (C.G.E./Netting/2/W.P. 11)**

*(i) Reference to the provision of additional collateral in Draft Principle 7(1)(d)*

132. It was agreed that the references to the provision of additional collateral in the revised version of Draft Principle 7(1)(d) should be deleted. One delegate expressed his view that at least as the safe harbour needed for obligations to re-transfer collateral provided in the suspect period, some protection was offered under the remaining revised version of Draft Principle 7(1)(d), notably its extension to the protection of the inclusion of eligible obligations in the calculation of the single net obligation.

(ii) *Whether Draft Principle 7 should extend to resolution regimes*

133. While some delegates argued that the decision taken by the Committee concerning the extension of Draft Principle 7 to resolution regimes should be revised, it was agreed that resolution regimes should be kept within the scope of Draft Principle 7. In order to emphasise that resolution regimes are also dealt with in Draft Principle 8, it was agreed that the beginning of Draft Principle 7(1) should be reformulated as follows: "Subject to Principle 8, in addition to Principle 6, ...".

(iii) *Whether the insolvency administrator's right to trigger close-out netting should be expressly acknowledged*

134. One delegate asked whether Draft Principle 7 should expressly acknowledge the insolvency administrator's right to trigger close-out netting. See, for the current treatment of this issue, the commentary to Draft Principle 7, paragraph 111 in C.G.E./Netting/2/W.P. 2.

(iv) *Whether Draft Principle 7(1)(b) should refer to obligations concluded in a suspect period*

135. It was suggested that an additional qualification should be added to Draft Principle 7(1)(b), effectively allowing an insolvency administrator to reject the performance of such obligations whose inclusion in the calculation of the single net obligation, due to these obligations having been concluded in a suspect period, would not be restricted under Draft Principle 7(1)(d) (see the drafting suggestions presented to the Committee in footnote 3). This proposal, however, did not find sufficient support and it was instead agreed that the issue could be dealt with in the commentary, referring also to the general rule in Draft Principle 6(1)(b), which was understood as allowing the exclusion of unenforceable obligations from the close-out netting set.

(v) *Whether Draft Principle 7(1)(c) should refer to "entering into and operation"*

136. One delegate suggested that in Draft Principle 7(1)(c), the words "entering into" could be deleted, since this would be encompassed by the notion of "operation". However, this proposal did not attract further support and the Committee decided to maintain the clarifying reference to "entering into".

(vi) *Whether Draft Principle 7(1)(d) should be extended to protect the triggering of the close-out netting provision against time-based avoidance*

137. Some delegates suggested that Draft Principle 7(1)(d) should be extended to protect not only the entering into, but also the triggering of the close-out netting provision against time-based

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<sup>3</sup> Drafting suggestions presented to the Committee for Draft Principle 7

(b) add ....

" (other than an obligation arising during a period prior to the commencement of insolvency proceedings the inclusion of which in the calculation of the single net obligation is restricted on a ground not prohibited by sub-paragraph (d) below;"

(d) add...

"or the operation of the close-out netting provision has the effect of placing the [solvent party] in a better position in the insolvency proceedings than it would otherwise have been in;"

(2) These principles do not affect a partial or total restriction of the operation of a close-out netting provision under the insolvency law of the implementing State on grounds which include factors other than or additional to those referred to in sub-paragraphs (c) and (d) above.

[Note: examples in the commentary should include fraud, intention to prefer, knowledge of pending insolvency proceedings...]

avoidance. Others, however, felt that this was to be regarded as a matter of course within the context of these Principles and would not require express mention in Draft Principle 7(1)(d). In the course of the discussion, the view that eventually prevailed favoured the following amended wording: "...because the close-out netting provision was entered into, an obligation covered by the provision arose or the single net obligation under the close-out netting provision became due and payable." The Committee agreed to align the wording of Draft Principle 7(2) with the amended text of Draft Principle 7(1)(d).

*(vii) Whether there should in Draft Principle 7(1)(d) be an additional reference to the exclusion of avoidance of a close-out netting provision as a preference and whether Draft Principle 7(1)(c) and Draft Principle 7(1)(d) could be merged*

138. It was suggested that Draft Principle 7(1)(d) should clarify that close-out netting provisions concluded in a suspect period should not only not be subject to time-based avoidance, but should also not be subject to an avoidance action on the grounds that they placed the solvent party in a better position in the insolvency proceedings than it would otherwise have been in (see the drafting suggestions presented to the Committee in the footnote to paragraph 135).

139. There was some discussion as to whether this would create an overlap with Draft Principle 7(1)(c) and some delegates advocated an merger of Draft Principles 7(1)(c) and 7(1)(d). However, the majority felt that such an approach would not help to clarify the issues dealt with in the two provisions and that these provisions should be kept separate because the protection under Draft Principle 7(1)(c) should not be extended to the obligations covered by the close-out netting provision.

140. Concluding this discussion, it was agreed that Draft Principle 7(1)(c) and Draft Principle 7(1)(d) should be kept as separate provisions. The suggested additional clarification in Draft Principle 7(1)(d) (see the drafting suggestions presented to the Committee in the footnote to paragraph 135) was rejected.

*(viii) Draft Principle 7(2)*

141. There was some discussion as to the question whether Draft Principle 7(2) should be drafted as a closed list or should merely contain a general reference to insolvency law restrictions in general. The alternative drafting suggestions presented to the Committee (see footnote to paragraph 135) envisaged Draft Principle 7(2) as being redrafted in terms of a general reference. This proposal found support with several delegations, who argued that the commentary could indicate that there should nevertheless be a high threshold for intervention by the relevant insolvency law.

142. Other delegations, however, preferred a closed list, arguing that an open-ended exception would be overly broad.

143. As a compromise, it was suggested that Draft Principle 7(2) could be based upon the drafting suggestions presented to the Committee (see footnote to paragraph 135) and that – using words like "such as" – a list of examples could be added.

144. The precise content of these examples was the object of some discussion. It was argued that the term "fraud" or "fraudulent transactions" alone would give rise to difficulties, owing to the fact that this concept was defined differently in various jurisdictions. It was pointed out that some jurisdictions applied a rather narrow understanding of this concept, while at the same time using other insolvency law restrictions alien to other jurisdictions, which would argue in favour of an open-list approach for Draft Principle 7(2).

145. While it was suggested that the list of insolvency law restrictions in Article 14(2) of the Geneva Convention on Intermediated Securities could be used as a general guideline, several

delegates pointed out that this list would have to be adapted for the present purposes. There was some discussion concerning the item "ranking of categories of claims", since some delegates held the view that this should not constitute an obstacle to the operation of close-out netting provisions, a view which was not generally shared by the other delegates.

146. Also the suggestion to refer to the character of the provision as a "preference" as a factor justifying the restriction of a close-out netting provision was criticised by some delegates, as it was felt that to some extent a close-out netting provision would always contain an element of preferential treatment of one particular creditor.

147. Another suggestion was to use the list of examples provided in the drafting suggestions presented to the Committee (see the footnote to paragraph 135) as examples that could be expressly mentioned in Draft Principle 7(2). It was pointed out, however, that at least the item "knowledge of pending insolvency proceedings" could be problematic in this regard, given the fact that close-out netting mechanisms would often be triggered at a moment when the counterparty actually had such knowledge. As regards other situations, however, such as the incurring of further obligations, this factor was regarded as possibly justifying the restriction of a close-out netting provision.

148. Several delegates also argued that Draft Principle 7(2) should be extended so as to deal also with the restrictions of the operation of the obligations covered by the close-out netting provision.

149. Concerning the use of the term "operation" in Draft Principle 7(2), it was suggested to extend the term to "entering into or operation".

150. Summing up the discussion, the Committee agreed to a redrafting of Draft Principle 7(2) along the following lines. Beginning with the drafting suggestions presented to the Committee (see the footnote to paragraph 135), the wording would then continue as follows: "such as knowledge of pending insolvency proceedings at the time the close-out netting provision or the obligation was entered into, the ranking of categories of claims, or the avoidance of a transaction as a fraud of creditors."

#### **Discussion of revised Draft Principle 8 (C.G.E./Netting/2/W.P. 11)**

151. Suggestions to delete the restriction of the scope of application of this Draft Principle by deleting the words "for financial institutions" and to explain the term "appropriate safeguards" by references in the black letter text to the standards set by the Financial Stability Board's Key Attributes did not find broad support and it was agreed to keep the provision as it stood in the revised version of the Draft Principles in C.G.E./Netting/2/W.P. 11, subject to the replacement of the word "any measure" in the first line by the phrase "a stay or any other measure".

152. Concerning the commentary, it was agreed that there should be further reference to the fact that the Financial Stability Board's Key Attributes were subject to development.

#### **Discussion of revised Draft Principle 9**

153. It was agreed that this provision should be deleted.

#### **Discussion of the commentary in C.G.E./Netting/2/W.P. 2**

154. The following amendments of the commentary were agreed:

155. In paragraph 11 of C.G.E./Netting/2/W.P. 2, it should be clarified that no express implementing measures would be necessary where the general legal framework of a State already

ensured the enforcement of close-out netting provisions in a broader scope of situations as envisaged under the core pillar of these Principles.

156. In the commentary to Draft Principle 1, there should be a more nuanced treatment of the risks and benefits of close-out netting, referring also to criticism of close-out netting in connection with its possible crisis-acerbating effects, as had been dealt with in earlier UNIDROIT documents.

157. In the commentary to Draft Principle 1, there should also be an additional reference to the need of achieving legal certainty in commercial transactions.

158. Paragraphs 98 and 99 of the commentary should be revised so as to make it clear that the breadth of resolution measures was a continuously evolving matter and that, depending on the jurisdictions concerned, such measures might or might not be covered by the definition of insolvency proceedings under the Geneva Securities Convention. The commentary should point out that, by using both expressions in tandem, the Principles acknowledged the current diversity of situations and refrained from offering a strict classification.

159. In paragraph 106, there should be some reference to the restrictions under Draft Principle 7(2), clarifying that these exceptions should not be understood as giving an implementing State a general discretion to stay the operation of insolvency proceedings as would be prohibited under Draft Principle 7(1)(a).

160. In the commentary to Draft Principle 8 (see paragraph 129), there should be a reference to national resolution regimes implementing the standards set by the Financial Stability Board's Key Attributes. Moreover, the commentary should also refer to the evolving nature of the Financial Stability Board's standards.

#### **Approval of the summary reports for 4 to 7 March 2013 and of the revised version of the Draft Principles in W.P. 16**

161. The summary reports for the discussions that had taken place on 4, 5, 6 and 7 March 2013 (documents C.G.E./Netting/2/W.P. 12 to 15) and which covered the discussions reported above were approved, subject to amendments taken into account in this Report.

162. The Committee also approved the revised version of the Draft Principles, which the Secretariat had prepared on the basis of the comments and decisions by the Committee (document C.G.E./Netting/2/W.P. 16), subject to amendments taken into account in this Report (see Annex III).

#### **Agenda Items No. 4 and 5: Future work and any other business**

163. No other business being raised, *the Chairman* indicated that he was pleased to be able, on behalf of the Committee, to recommend to the Governing Council that it adopt the revised draft Principles and authorise the Secretariat to publish and disseminate them widely, and declared the session closed at 16.16 p.m. on 8 March 2013.

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**ANNEX II****AGENDA**

(prepared by the UNIDROIT Secretariat)

1. Opening of the session and election of the Chairman
2. Adoption of the annotated draft agenda and organisation of the session
3. Consideration of the draft Principles regarding the enforceability of close-out netting provisions (UNIDROIT 2012 – C.G.E./Netting/2/W.P. 2)
4. Future work
5. Any other business.

**ANNEX III****Draft Principles on the  
Operation of Close-out Netting Provisions**

*(version approved by the Committee)*

**Principle 1: Scope of the Principles**

(1) These Principles deal with the operation of close-out netting provisions that are entered into by eligible parties in respect of eligible obligations.

(2) Except as otherwise expressly indicated in these Principles, the term 'operation' encompasses the creation, validity, enforceability, effectiveness against third parties and admissibility in evidence of a close-out netting provision.

**Principle 2: Definition of 'close-out netting provision'**

'Close-out netting provision' means a contractual provision on the basis of which, upon the occurrence of an event predefined in the provision in relation to a party to the contract, the obligations owed by the parties to each other that are covered by the provision, whether or not they are at that time due and payable, are automatically or at the election of one of the parties reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other.

**Principle 3: Definition of 'eligible party' and related notions**

(1) 'Eligible party' means any person or entity, other than a natural person who is acting primarily for personal, family or household purposes, and includes a partnership, unincorporated association or other body of persons.

(2) 'Qualifying financial market participant' means any of the following:

(a) a bank, investment firm, professional market maker in financial instruments or other financial institution which (in each case) is subject to regulation or prudential supervision;

(b) an insurance or reinsurance company;

(c) an undertaking for collective investment or an investment fund;

(d) a central counterparty or a payment, clearing or settlement system, or the operator of such a system which (in each case) is subject to regulation, oversight or prudential supervision;

(e) a corporation or other entity that, according to criteria determined by the implementing State, is authorised or supervised as an important participant in the implementing State's markets in contracts giving rise to eligible obligations.

(3) 'Public authority' means any of the following:

(a) a governmental or other public entity;

(b) a central bank;

(c) the Bank for International Settlements, a multilateral development bank, the International Monetary Fund or any similar entity.

**Principle 4: Definition of 'eligible obligation'**

(1) 'Eligible obligation' means:

(a) an obligation arising under a contract of any of the following kinds between eligible parties at least one of which is a public authority or a qualifying financial market participant:

(i) Derivative instruments, that is to say, options, forwards, futures, swaps, contracts for differences and any other transaction in respect of an underlying or reference asset or a reference value that is, or in future becomes, the subject of recurrent contracts in the derivatives markets;

(ii) Repurchase agreements, securities lending agreements and any securities financing transaction, in each case in respect of securities, money market instruments or units in an undertaking for collective investment or an investment fund;

(iii) Title transfer collateral arrangements related to eligible obligations;

(iv) Contracts for the sale, purchase or delivery of:

- securities;
- money market instruments;
- units in an undertaking for collective investment or an investment fund;
- currency of any country, territory or monetary union;
- gold, silver, platinum, palladium or other precious metals;

(b) an obligation of an eligible party (whether by way of surety or as principal debtor) to perform an obligation of another person which is an eligible obligation under sub-paragraph (a);

(c) a single net obligation determined under a close-out netting provision entered into by the same parties in respect of obligations under sub-paragraph (a) or (b).

(2) An implementing State may elect to broaden the scope of paragraph (1)(a) in one or both of the following ways:

(a) by providing that it is to extend to obligations arising under contracts between parties neither of whom is a public authority or a qualifying financial market participant;

(b) by providing that it is to extend to obligations not limited to those listed in paragraph (1);

subject, in either case, to such limitations or exceptions as the implementing State may specify.

**Principle 5: Formal acts and reporting requirements**

(1) The law of the implementing State should not make the operation of a close-out netting provision dependent on:

(a) the performance of any formal act other than a requirement that a close-out netting provision be evidenced in writing or any legally equivalent form;

(b) the use of standardised terms of specific trade associations.

(2) The law of the implementing State should not make the operation of a close-out netting provision and the obligations covered by the provision dependent on the compliance with any requirement to report data relating to those obligations to a trade repository or similar organisation for regulatory purposes.

**Principle 6: Operation of close-out netting provisions in general**

(1) The law of the implementing State should ensure that a close-out netting provision is enforceable in accordance with its terms. In particular, the law of the implementing State:

(a) should not impose enforcement requirements beyond those specified in the close-out netting provision itself;

(b) should ensure that, where one or more of the obligations covered by the close-out netting provision are, and remain, invalid, unenforceable or ineligible, the operation of the close-out netting provision is not affected in relation to those covered obligations which are valid, enforceable and eligible.

(2) These Principles do not render enforceable a close-out netting provision or an eligible obligation that would otherwise be unenforceable in whole or in part on grounds of fraud or conflict with other requirements of general application affecting the validity or enforceability of contracts.

**Principle 7: Operation of close-out netting provisions in insolvency and resolution**

(1) Subject to Principle 8 and in addition to Principle 6, the law of the implementing State should ensure that upon the commencement of an insolvency proceeding or in the context of a resolution regime in relation to a party to a close-out netting provision:

(a) the operation of the close-out netting provision is not stayed;

(b) the insolvency administrator, court or resolution authority should not be allowed to demand from the other party performance of any of the obligations covered by the close-out netting provision while rejecting the performance of any obligation owed to the other party that is covered by the close-out netting provision;

(c) the mere entering into and operation of the close-out netting provision as such should not constitute grounds for the avoidance of the close-out netting provision on the basis that it is deemed inconsistent with the principle of equal treatment of creditors;

(d) the operation of the close-out netting provision, and the inclusion of any obligation in the calculation of the single net obligation under the close-out netting provision, should not be restricted merely because the close-out netting provision was entered into, an obligation covered by the provision arose or the single net obligation under the close-out netting provision became due and payable during a prescribed period before, or on the day of but before, the commencement of the proceeding.

(2) These Principles do not affect a partial or total restriction of the operation of a close-out netting provision under the insolvency law of the implementing State on grounds which include factors other than, or additional to, those referred to in sub-paragraphs (c) and (d) above, such as knowledge of a pending insolvency proceeding at the time the close out netting provision was entered into or the obligation arose, the ranking of categories of claims, or the avoidance of a transaction as a fraud of creditors.

**Principle 8: Resolution of financial institutions**

These Principles are without prejudice to a stay or any other measure which the law of the implementing State, subject to appropriate safeguards, may provide for in the context of resolution regimes for financial institutions.