



UNIDROIT Initiative on Close-out Netting (Update)

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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.
- UNIDROIT commissioned a study assessing the extent of legal risk arising out of situations involving cross-border netting and identifying the causes of legal obstacles to the proper operation of netting agreements.
- The study and the related preliminary report was prepared by Philipp Peach, London School of Economics and Political Science.
- Additionally, the study explores possible solutions and appropriate steps to take, if any.
- In 2011 the Secretary General of UNIDROIT (José Angelo Estrella Faria) set up a Study Group of renowned experts in the law of international financial markets. Chairman of the Study Group is Stanislaw Softysiński, A. Mickiewicz University Warsaw.
- The meetings of the UNIDROIT Study Group were held in Rome 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*“ (Study LXXVIII V – Doc 13 and Study LXXVIII V – Doc 14).



III. Main Content

1. Scope

- The new instrument should cover bilateral arrangements on close-out netting.
- The coverage of multilateral arrangements and other types of netting (settlement netting or netting by novation) was discussed but finally postponed.
- The protected products should include all derivative transactions as well as security financing transactions (i.e., repurchase agreements, securities lending transactions and margin lending).
- It was discussed whether close-out netting of loans and deposits should be covered and if yes, whether the protection should be limited to arrangements between financial institutions. The draft Principles do not cover them yet, but States may protect them.
- The protected counterparties or “**Eligible Parties**” (Principle 2) will include all legal entities as well as partnerships and unincorporated associations.
- Natural persons, including merchants, other professionals, sophisticated high net-worth individuals and consumers are not covered yet, but States may protect them.
- As far as the relevant laws are concerned, there is consensus that most legal uncertainty is with respect to the insolvency laws.
- It was disputed whether the new instrument should also aim at harmonization of administrative proceedings like regulatory measures for the recovery and resolution of ailing credit institutions.
- Conflict of law issues will be dealt with. However, consensus exists that any solution in this area should be reconciled with the Hague Conference on Private International Law (HCCH).



2. Definitions

- The key term of the instrument will be the definition of „**Close-out Netting Provision**“ (Principle 1) .
- Consensus is given to apply a functional approach rather than a existing legal concept.
- Key elements are:
 - Termination of transactions
 - Calculation of values in respect of the terminated transactions
 - Aggregation of the values to a net amount.
- The definition should be broad enough to cover cross product master agreements.
- The protection includes netting arrangements that provide for automatic early termination.
- The term „**Insolvency Proceeding**“ will likely be the same as in the Geneva Convention on Substantive Rules for Intermediated Securities, but this is not yet decided.
- Whether the term „**Restructuring Proceeding**“ is introduced is still open and depends on the Basel Committee on Banking Supervision’s work on cross-border crisis management and the proposed stay of close-out netting rights.
- The term „**Eligible Obligation**“ (Principle 3) will include derivative transactions as well as security financing transactions.
- It will also cover financial collateral.
- Other claims like loans and deposits are covered only if designated to that effect by the States.



3. Formal Requirements

- The instrument will establish the principle that the validity, enforceability or the admissibility in evidence of a netting arrangement should not be dependent on the performance of any formal act (except the requirement of being in “writing”) (Principle 4).
- The use of a specified market standard documentation (like the ISDA Master Agreements) should not be required (Principle 5).
- Registration, notification or reporting requirements (as under EMIR or MiFIR) should not impact on the enforceability (Principle 6).

4. Enforceability of Netting Arrangements

- The main principle will be that the enforceability of netting arrangements should be solely governed by the substantive domestic law agreed between the parties (Principle 7).
- National insolvency laws should not impose additional enforcement requirements (Principle 7 (b)).
- It should be ensured that, upon the occurrence of insolvency proceeding the netting arrangement should come into effect and should be enforceable as provided in the terms agreed therein. The receiver’s right to request performance of individual trades (“cherry picking”), a potential suspension or stay of termination rights, the principle of equal treatment of creditors or potential suspect periods should not impact on the enforceability (Principle 7 (c) (i) to (iv)).

5. Bank Resolution Measures

- Bank resolution measures are not covered by Principle 7 if and to the extent they provide for a temporary stay of termination rights and do not affect the enforceability of termination rights not related to the entry into resolution (Principle 8).



6. Conflict of Laws

- The principle that the enforceability of netting arrangements should be solely governed by the governing law of the agreement should also apply in situations involving cross-border netting.
- Exemptions are provided for the
 - avoidance of close-out netting provisions as a preference or a contract in fraud, and
 - voidening or temporary stay of a close-out netting provision as a consequence of the commencement of the insolvency proceeding.



IV. Next Steps

- On its 91st session on 7 to 9 May UNIDROIT's Governing Council endorsed the proposal to convening a Committee of governmental experts to consider and finalize the draft Principles.
- The first session of that Committee will be held from 1 to 5 October 2012.
- The Secretary General's proposal would be to have a second session in February 2013 and to approve the finalized Principles in the regular Governing Council meeting in 2013.