INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

UNIDROIT Study Group on Draft Principles and rules on the netting of financial instruments

Third Meeting
Rome, 7 – 9 February 2012

UNIDROIT 2012
Study LXXVIII C - Doc. 12
February 2012

REPORT

(prepared by the UNIDROIT Secretariat)

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Abbreviated report

I. General Discussions

A. Interplay between close-out netting and new resolution frameworks, p. 6-7 [5-8]

The Study Group acknowledged the Key Attributes of Effective Resolution Regimes for Financial Institutions ('Key Attributes') issued by the Financial Stability Board (FSB) and considered different options to integrate this standard into the Principles. The participants agreed that the general provision of Draft Principle 7 should be broad enough to cover resolution measures of regulatory authorities. To achieve this, the notion of insolvency proceedings should be broadly defined in the commentary to Draft Principle 7. It should encompass all judicial, administrative or hybrid resolution proceedings for financial institutions. A new Draft Principle 8 should then be introduced which sets out the relationship between the resolution measures recommended in the Key Attributes of the FSB and Draft Principle 7.

B. Application to underlying transactions and ancillary provisions, p. 7-8 [9-11]

The participants chose as their general approach not to make any pronouncements on the validity of the underlying obligations. An exception to that approach should be made with respect to Draft Principles 6 and 7(c)(iv). The Study Group decided further not to address ancillary provisions of master agreements in the black letter text of the Principles. However, the functioning and implications of ancillary provisions that were very closely related with the close-out netting mechanism should be explained in the commentary. As such provisions the Study Group identified walkaway clauses/limited two-way payment clauses and powers to wait and see.

C. Netting in multilateral structures, p. 8-9 [12-14]

The Study Group reiterated the view that the Principles were to apply to all close-out netting mechanisms that created mutuality in a first step. Thus, close-out netting mechanisms in the rulebooks of central counterparties (CCPs) would be covered. The Study Group noted that the application of the Principles to cash-pooling systems and in multi-branch structures still needed to be analysed.

II. Consideration of the Preliminary Draft of Principles regarding the Enforceability of Close-out Netting Provisions (UNIDROIT Study LXXVIII C – Doc. 11)

A. The introduction, p. 9-10 [15-19]

The Study Group welcomed the Preliminary Draft of Principles as a mature text that addressed the most important issues and was crisp and accessible. Some minor editorial amendments should be made. In particular, the introduction should clarify the interplay of close-out netting with collateral, possibly also with insolvency laws. The introduction should further cite the number of jurisdictions that had already adopted particular netting legislation.

B. Draft Principle 1: Definition of 'Close-out Netting Provision', p. 10-13 [20-35]

The Study Group chose the new drafting proposal 'Alternative (c)' as a basis for its deliberations. It agreed upon some editorial changes with respect to particular formulations of the black letter text such as "*means a contractual agreement*", "*between Eligible Parties*", "*reduced, so as to result in a single net obligation representing the aggregate value of all combined obligations*" and "*which is then payable by the relevant party*". Relating to the commentary, the participants agreed to clarify in particular the section on netting in multilateral structures in paragraphs [19] and [20] of the Draft Principles. The commentary should further explain better to what extent the Principles applied to hybrid close-out netting mechanisms composed of statutory and contractual elements.

C. Draft Principle 2: Definition of 'eligible party', p. 13 [36]

The Study Group endorsed the proposed definition of eligible parties with one amendment: It should be clarified in paragraph [35] of the commentary that public law entities set up under public international law were covered by Draft Principle 3(a). A proposal to move unincorporated entrepreneurs (merchants) from Draft Principle 3(c) to subparagraph (b) was rejected.

D. Draft Principle 3: Definition of 'eligible [financial] contract', p. 14-17 [37-50]

The Study Group endorsed the proposed definition of 'eligible [financial] contracts' with some amendments. The Study Group decided to replace the term '*eligible [financial] contract*' by '*eligible obligation'.* Accordingly, the chapeau to Draft Principle 3 should be rephrased along the lines of "'*Eligible obligation' means an obligation arising under one of the following contracts […]*". Another modification concerned subparagraphs (d) and (e) dealing with deposits and loans. Since it could not find a common position regarding these contracts, the Study Group decided to delete subparagraphs (d) and (e). Instead, a new subparagraph should be added to the end of the list that referred to '*any other contract or transaction designated by the laws of the relevant state*'. A commentary to that paragraph should present arguments raised in favour and against the inclusion of deposits and loans. The Study Group agreed that the explanation in favour of including deposits and loans in paragraphs [60] to [71] should be rephrased. It felt that the arguments presented did not relate to systemic risk and were thus inconsistent with the justification for the instrument given in the introduction and in the commentary to Draft Principle 7. The Study Group further agreed to delete subparagraph (h) on claims based on the principle of unjust enrichment. It came to the conclusion that the Principles should not be burdened with the additional layer of complexity brought about by the law of unjust enrichment.

E. Draft Principles 4-6 on formal requirements for close-out netting provisions, p. 17-19 [51-60]

The Study Group agreed that the delimitation of principles 4 and 6 should be clarified. **Draft Principle 4** should cover any formal act with respect to the formation of close-out netting provisions. Thus it would apply also to registration requirements regarding the close-out netting provision. It should, however, be limited to formal acts of private law. By contrast, **Draft Principle 6** was drafted to address the new reporting obligations with respect to the underlying obligations that had gained importance under the new regulatory framework for financial markets.

F. Draft Principle 7: Enforceability of close-out netting, p. 19-24 [61-78]

The Study Group considered the delimitation between **Draft Principle 7(a)** on the one hand and Draft Principles 4 and 5 on the other. It concluded that Draft Principle 7(a) referred to enforcement obstacles whereas Draft Principles 4 and 5 focussed on formation issues. Some participants pointed to the fact that the requirements addressed in both sections were in fact broadly the same. To avoid misunderstandings and mismatches, they suggested that it would be better to replace the enumeration in paragraph [96] with an explicit reference to Draft Principles 4 to 6.

The participants further agreed that the "bad apple provision" of **Draft Principle 7(b)** should be rephrased. First, it should be extended to apply also to underlying obligations that were enforceable but ineligible for netting. Second, it should be clarified that the provision protected only the operation of the close-out netting provision from contamination of an unenforceable or ineligible obligation as regards the remaining obligations. It was not destined to render otherwise unenforceable obligations enforceable. To clarify the focus on the close-out of the remaining obligations, one participant proposed to introduce the concept of severability: unenforceable or ineligible obligations needed to be severed from the netting set and disregarded for the calculation of the net sum.

Draft Principle 7(c)(iii) should receive a proper commentary explaining its function with respect to anti-deprivation cases and delineating the interplay with Draft Principle 7(c)(iv).

Draft Principle 7(c)(iv) dealing with suspect periods and zero-hour rules should be expanded to apply also to the underlying obligations. A majority of participants advocated for restoring the

previous broader formulation which had encompassed the entering into the underlying obligations. Some participants proposed that the Principle should also apply to the conclusion of collateral arrangements entered into under a master agreement.

One participant proposed to expand Draft Principle 7(c)(iv) or to introduce a new subparagraph to protect also contracts made on market terms from the general insolvency law.

The **commentary to Draft Principle 7** should be amended to present the notion of insolvency proceedings based on the broad definition of the UNIDROIT Geneva Convention.

The Study Group further discussed the nature of amicable creditor settlement proceedings cited in paragraph [89] of the commentary. It contemplated different proceedings to better understand their functioning and their implications for the application of the Principles. The participants discerned different types of amicable proceedings – purely contractual agreements, voluntary arrangements concluded under a statutory regime and regimes that were subject to some judicial or administrative intervention. They concluded that there was room for the application of the Principles if the reorganisation proceedings were of an official nature.

The Study Group also addressed the transposition of the principles into the national laws. One participant pointed to the fact that jurisdictions without particular netting legislation might characterise close-out netting as set-off. He suggested to express clearly for such situations that the national set-off regime would have to be amended to prevent that traditional set-off limitations applied to close-out netting.

The Study Group discussed briefly the application of the Principles in Sharia Law jurisdictions but came to the conclusion that it should not focus on those aspects. It felt however that the commentary should be expanded to address also the issue of master-master agreements. Furthermore, the interaction between cherry-picking rights and the operation of the close-out netting agreement should be explained in the commentary.

G. Draft Principle 8 on resolution measures by regulatory authorities, p. 24 [79]

The Study Group decided to introduce a new Draft Principle 8 which sets out the relationship between the resolution measures recommended in the Key Attributes of the FSB and Draft Principle 7.

III. Finalisation of the instrument, p. 24 [80-82]

The substantive laws section of the Principles will be amended on behalf of the UNIDROIT Secretariat in accordance with the decisions and proposals made during the meeting. The final draft of the Principles will then be sent to the participants of the Study Group.

The Secretariat announced to provide a revised paper on conflict of laws issues at a later stage. As a next step, the Secretariat will seek the approval of the UNIDROIT Governing Council to convene of a Committee of Governmental Experts.

Introduction

1. The Study Group on principles and rules on the netting of financial instruments met in Rome at the seat of UNIDROIT from 7 to 9 February 2012.

2. Before opening the discussions, Ms Hansen from the Federal Reserve Bank of New York gave a short overview of the *'Key Attributives of Effective Resolution Regimes for Financial Institutions'* (Key Attributes) published by the Financial Stability Board (FSB) on 4 November 2011. [1] The Key Attributes reflected and elaborated the recommendations of the Cross-Border Bank Resolution Group of the Bank for International Settlements (CBRG) of March 2010. [2] In the Key Attributes, the G20 and the FSB called on national legislators to implement the new standard with respect to all financial institutions that could be systemically significant, thus not only to banks but also holding companies of financial institutions and non-regulated entities of financial groups. [3] In addition, the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the International Organisation of Securities Commissions (IOSCO) jointly analysed the extent to which the Key Attributes should apply to Financial Market Infrastructures. [4]

3. The Key Attributes set forth a core of resolution powers destined to preserve the continuity of critical operations. [5] Amongst these powers it listed

- the establishment of temporary bridge institutions or of separate asset management vehicles,
- transfers and sales of assets, liabilities, legal rights and obligations without consent,
- bail-ins and
- temporary stays of early termination rights or moratoria on payments to unsecured creditors.

Ms Hansen drew the Study Group's attention in particular to key attribute 4 of the document, which laid down the requirements for a legal framework governing set-off and netting. [6] In key attribute 4 and in the related Annex IV, the FSB elaborated on the conditions and safeguards for imposing a temporary stay on the execution of early termination rights that might otherwise be triggered upon the application of or in connection with resolution powers. The Study Group welcomed the clarifications brought about by the FSB. It came to the conclusion that its previous assumptions regarding resolution powers were still valid since they were based on the CBRG Recommendations.

4. With regards to the proceedings at EU level, the Study Group noted that the Close-out Netting Initiative had neither been identified as a priority measure in the Work programme of the European Commission for the first half of 2012 [7] nor in the considerations surrounding the Danish presidency. [8] Considering that a sequence of important legal measures such as the European Market Infrastructure Regulation (EMIR) [9] were being pursued and the EC Regulation on central securities depositories was about to be proposed, [10] the Study Group did not expect proposals regarding the harmonisation of securities laws and the enforceability of close-out netting for the immediate months to come.

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[1] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions of October 2011 (available under http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

[2] Bank for International Settlements/Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, www.bis.org/publ/bcbs169.pdf.

[3] *Cf.* Key Attributes (fn. 1), Sect. 1.1, p. 5.

[4] *Cf*. Footnote 3 of the Key Attributes (fn. 1), p. 5.

[5] *Cf.* Key Attributes (fn. 1), Sect. 3 et seq., p. 7 et seq.

[6] *Cf.* Key Attributes (fn. 1), p. 10 et seq.

[7] Cf. http://ec.europa.eu/atwork/programmes/docs/cwp2012_en.pdf. The Close-out netting initiative figuring as item 90 of the Annex (http://ec.europa.eu/atwork/programmes/docs/cwp2012_annex_en.pdf) is not marked with an asterisks which indicates that Commission did not commit to deliver the initiative in the course of 2012.

[8] *Cf.* http://www.europarl.europa.eu/meetdocs/2009_2014/documentss/empl/dv/empl_programme_presidency_dk_/empl_programme_presidency_dk_en.pdf.

[9] *Cf.* The EU Commission's proposal Com(2010)484 of a Regulation on OTC derivatives, central counterparties and trade repositories (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF).

[10] *Cf*. The EU Commission's proposal COM(2012) 73/2 on improving securities settlement in the European Union and on central Securities depositories (CSDs) and amending Directive 98/26/EC (http://ec.europa.eu/internal_market/financial-markets/docs/COM_2012_73_en.pdf).
European Council on 21.02.2012 (http://register.consilium.europa.eu/pdf/en/11/pe00/pe00068.en11.pdf).

I. General discussions

A. Interplay between close-out netting and the new resolution framework

5. The Study Group acknowledged the pronouncements of the Key Attributes on the interplay between resolution powers of regulatory authorities and close-out netting and decided to incorporate the new standard into the Principles. [11] To this end, a new concise Draft Principle 8 on resolution powers should be inserted into the Principles, the commentary to which should reflect the findings of the Key Attributes. Several participants stressed the importance of following closely the terminology of the Key Attributes in both the black letter text and in the commentary. In order to explain the importance of the wording, they drew the Study Group's attention to the fact that the Key Attributes expressed that the stay should be imposed on acceleration and early termination rights only, thus on the right to initiate the close-out netting process. All other rights and obligations under the close-out netting provision should remain fully effective.

6. The participants noted that the language and structure of that new Draft Principle 8 depended on the notion of insolvency proceedings that had still to be developed under Draft Principle 7(c). The scope of that definition determined the interplay between the protection of close-out netting in insolvency proceedings under Draft Principle 7(c) and the priority of resolution measures recommended by the Key Attributes. The Study Group considered two models for the definition:

- The definition of insolvency proceedings proposed in the UNCITRAL Legislative Guide on Insolvency Law:

  > *"Insolvency proceedings: collective proceedings, subject to court supervision, either for reorganization or liquidation".* [12]

  The Study Group apprehended that administrative measures taken by a regulator did not fall under that definition. It concluded that the pronouncements on insolvency proceedings of Draft Principle 7(c) would not apply to most (administrative) resolution measures if it adopted the UNCITRAL definition. It followed that the new Draft Principle 8 would have to establish itself in a first step a protective regime for administrative measures – either by cross-reference to Draft Principle 7(c) or by making pronunciations similar to those in Draft Principle 7(c) for administrative resolution proceedings. In a second step, Draft Principle 8 could then exempt those resolution measures addressed in the Key Attributes from the previously established protection of the close-out netting provision.

- The UNIDROIT Geneva Convention, which employed a broader definition of insolvency proceedings covering all judicial, administrative and also interim proceedings:

  > *"(h) "insolvency proceeding" means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation".* [13]

The Study Group came to the conclusion that this definition encompassed all contemplated resolution measures and also all elements of the UNCITRAL definition. It inferred that Draft Principle 7(c) would apply to traditional court organised insolvency proceedings but also to administrative resolution measures if this broad definition was chosen. With regard to the document structure, this implied that Draft Principle 7(c) would set a single protection standard applicable to insolvency and resolution measures alike, irrespective of their administrative, judicial or hybrid nature. The role of Draft Principle 8 could then be to exempt the resolution powers proposed in the Key Attributes from the close-out netting protection of Draft Principle 7 (c).

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[11] *Cf*. Key Attribute 4, p. 10 and Annex 4, p. 41 of the Key Attributes (fn. 1).

[12] *Cf*. UNCITRAL Legislative Guide to Insolvency Law of 2005 (www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf), p. 5.

[13] *Cf*. Art. 1 (h) of the UNIDROIT Convention on Substantive Rules for Intermediated Securities of 9 October 2009 (http://www.unidroit.org/english/conventions/2009intermediatedsecurities/convention.pdf).

7. The Study Group decided to follow the broader definition of the Geneva Convention. The participants felt that this approach guaranteed a coherent treatment of resolution measures regardless of their judicial, administrative or hybrid nature. The notion of insolvency proceedings should be laid out in the first paragraphs of the commentary to Draft Principle 7. The new Draft Principle 8 should then provide a carve-out for the resolution measures addressed in the Key Attributes such as the short stay on early termination rights and transfers of rights and liabilities out of an ailing bank. It should further explain the corresponding safeguards.

8. Some participants drew attention to potential difficulties in drafting those provisions. They invited the Study Group to analyse Key Attributes 4.1, 4.2 and 4.3 carefully and to follow the debate on resolution measures closely. One participant pointed to the fact that the FSB was working on specific recommendations for systemically important financial institutions (SIFIs) and might issue specific considerations for financial market infrastructures (FMIs) and insurance companies. These developments should be taken into account. With regard to the requirement that close-out netting "*should not hamper the effective implementation of resolution measures*" set up by Key Attribute 4.1, another participant invited the Study Group to monitor also the national implementation of resolution measures. To specify his words of caution, the participant distinguished three types of resolution procedures in the Key Attributes: First, diagnostic proceedings in which an official interim manager stabilised a bank to analyse whether it could be returned to viability. A second type of measures were transfers of assets and liabilities to either a private sector acquirer or to a public sector bridge bank, which was often preceded by a temporary stay on early termination rights. The third type of measures consisted in reducing unsecured debt of the ailing bank or converting it into equity in order to restore the bank's viability within its original legal entity (bail-ins). The participant assumed that this third type of proceeding aiming at restructuring the bank itself might give rise to debates on the interplay with close-out netting during the national implementation. He gave the example of a haircut imposed upon unsecured loans, which might conflict with close-out netting of loans. To fully encompass all those elements, he advised the Study Group to exchange views with the key contributors of the FSB working groups and to analyse how Draft Principle 7 related to the resolution measures that took shape in national legislations. The participant concluded by stating that the Study Group should be attentive not to create the impression that the broad language in Draft Principle 7 might conflict with resolution measures.

B. Application of the Principles to underlying transaction and ancillary provisions

9. The Study Group further considered whether the Principles

- should be extended to protect also the underlying contracts and obligations against certain typical obstacles to the enforcement of netting, [14] and/or
- should address certain ancillary provisions of master agreements that were so closely related with the close-out netting mechanism that they would be mainly included in master agreements. [15]

It came to the conclusion that those aspects were highly political and not strictly necessary to ensure the protection of the close-out netting mechanism. Though it might be desirable to come to a common understanding on those issues, the Study Group estimated that the project should not be loaded with elements that might endanger the timely finalisation of the project.

10. The participants agreed therefore that it would **not make any pronouncements on the validity of the underlying obligations** other than those in Draft Principle 6, which addressed the

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[14] *Cf.* Doc. 9, paras. [38]-[43], p. 14-16.
[15] *Cf*. Doc. 9, paras. [44]-[46], p. 16.

reporting obligations under the new regulatory frameworks [16] and in Draft Principle 7(c)(iv) which disapplied suspect periods and zero-hour rules. [17] As for the remaining provisions, the protection should be limited to the close-out netting provision itself. Principle 7(b) was sufficient to ensure that the unenforceability of certain underlying obligations or their ineligibility for netting did not affect the operation of the close-out netting provision as regards the remaining obligations.

11. The Study Group further discussed provisions of master agreements which did not refer directly to the close-out netting mechanism as defined in Draft Principle 1 (by termination/ acceleration, valuation and determination of the net sum) but were closely related to that mechanism. As such ancillary provisions the Study Group identified **walkaway clauses**/limited two-way payment clauses allowing a non-defaulting party not to make payments in the event of default of their counterparty or **wait and see-powers** that allowed a party to withhold payments upon the default of its counterparty while not forcing it to close-out. The Study Group agreed that it was not necessary to address these issues in a black letter rule. However, those provisions had occupied the minds of policy makers for some time and should therefore be addressed in the commentary to Draft Principle 1. The Study Group committed to a neutral position on these provisions explaining basically their functioning and implications. The commentary should also lay out that these provisions were addressed by the Basel Framework and in certain insolvency schemes and explain the underlying policy consideration.

C. Netting in multilateral structures

12. The Study Group reiterated the view that the Principles were drafted to apply to all close-out netting mechanisms that created mutuality in a first step. That implied close-out netting provisions in the rulebooks of central counterparties (CCPs). [18]

13. Several participants pointed to some aspects that still needed to be analysed and explained in the Principles. On the one hand, they pointed to the application of the Principles to cash-pooling systems of corporate groups, thus among distinct legal subsidiaries and their parent companies. On the other hand, they identified the problem of the enforceability of close out netting in multi-branch structures. They stressed that the enforceability of close-out netting provisions in companies that operated through branches in third countries gave rise to complex legal problems. They explained that some jurisdictions opened separate territorial insolvency proceedings for the liquidation of the branch even though the company and its branches formed one single legal entity. If in such a situation the company had derivative transactions on a branch book and the jurisdiction of the branch did not recognise the enforceability of close-out netting for transactions entered into by the branch, the question arose whether the unenforceability of the close-out netting in the branch's jurisdiction could contaminate the entire netting set of the company's head office. In that regard, the problem mirrored the difficulty of 'bad apple transactions' dealt with under Draft Principle 7(b).

14. The Study Group considered that the problem of multi-branch enforceability was strongly intertwined with the determination of the applicable law and with the question of jurisdiction in cross-border insolvencies. It noted that UNCITRAL was currently debating the notion of centre of main interest (COMI) [19] and that the Study on conflict of law issues was yet to be completed. [20] The participants concluded that it was wise to await some more clarifications of those parallel work strands and agreed to refer the multi-branch problems to the debate on the conflict of laws section.

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[16] E.g. provided for in the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law No. 111-203, available under http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf) or in the EU proposal Com(2010)484 of a Regulation on OTC derivatives, central counterparties and trade repositories (EMIR) (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF).

[17] *Cf.* infra, para. [68], p. 21.

[18] *Cf.* Doc. 4, paras. [8]-[10], p. 3 and Doc. 9, para. [58], p. 18 f.

[19] *Cf.* Working Group V: Insolvency Law in particular Docs. A/CN.9/WG.V/WP.95 and A/CN.9/WG.V/WP.93 (http://www.uncitral.org/uncitral/en/commission/working_groups/5Insolvency.html).

[20] *Cf.* infra, para. 81, p. 24 and also Doc. 9, para. [109], p. 30.

II. Consideration of the 'Preliminary Draft of Principles regarding the Enforceability of Close-out Netting Provisions' (UNIDROIT Study LXXVIII C – Doc. 11) [21]

A. The introduction

15. The Study Group welcomed the 'Preliminary Draft of Principles regarding the Enforceability of Close-out Netting Provisions' as a mature text which addressed the most important issues and was crisp and accessible.

16. The text of the introduction was endorsed with few amendments. The Study Group welcomed that the introduction placed the draft Principles into the context of other international instruments which recommended and regulated the enforceability of close-out netting provisions such as the Key Attributes of the FSB, [22] the Recommendations of the Cross-border Bank Resolution Group of the Bank for International Settlements, [23] the UNCITRAL Legislative Guide on Insolvency Law [24] and the UNIDROIT Geneva Convention. [25] One participant added that it might be wise to continue adding further cross-references when new documents appeared in the future.

17. Differing views were expressed as to whether the introduction should be amended to address the interaction with insolvency laws. One participant felt it was too difficult to justify the deviations to the general insolvency regime in a concise manner, whereas others stressed that this justification was a core element of the work that should be outlined in the introduction.

18. Some participants suggested that the first sentence of **paragraph** [**1**] should be clarified to avoid misunderstandings.

> *"Financial institutions and other financial market participants in their daily operations basically apply two types of mechanism designed to reduce their risk exposure."*

They noted that several risk-mitigation tools existed in the financial market besides collateral and close-out netting and cited segregation of assets, credit limits with counterparties or supervisory imperatives. One participant suggested that netting should be presented first, since it was the most important risk-mitigation mechanism. Some participants felt that the relationship between netting and collateral should be clarified. They noted that close-out netting was overwhelmingly applied first and collateral was given in a second step only as a means to secure the net amount. [26] Thus, a party would be undercollateralised if the close-out netting provision was not enforceable.

19. With regard to terminology, the Study Group decided that the term "*close-out netting arrangement*" used in paragraphs [3 et seq.] should be replaced by "*close-out netting provision"* to enhance the consistency of the instrument. In the same line of thought, one participant suggested that the terms "*transaction"* and "*financial transactions"* employed in paragraph [3] should be adapted to the terminology of draft Principle 3. The Study Group further agreed to amend the introduction by adding a reference to the number of jurisdictions that have enacted netting legislation today. [27]

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[21] *Cf.* Doc. 11 (http://www.unidroit.org/mm/s-78c-11-e.pdf)
[22] *Cf.* supra, fn. 1. The Key Attributes are mentioned in paragraph [4] of Doc. 11.
[23] *Cf.* Bank for International Settlements/Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, www.bis.org/publ/bcbs169.pdf, cited in paras. [6] and [7] of Doc. 11.
[24] UNCITRAL Legislative Guide on Insolvency Law of 2005 (available under http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf), cited in paragraph [9] of Doc. 11.
[25] Convention on Substantive Rules for Intermediated Securities (*cf. supra* fn. 13), cited in para. [8] of Doc 11.
[26] In the derivatives market, almost 85% of risk-mitigation is achieved through netting (cf. the Netting Benefit Statistics under http://www2.isda.org/functional-areas/research/data-sources/). The remaining risk-exposure is covered by other means such as collateral.
[27] *Cf.* the list under http://www.isda.org/docproj/stat_of_net_leg.html.

B. Draft Principle 1: Definition of 'Close-out Netting Provision'

1. The black letter rule

20. The Study Group welcomed the functional language of the new drafting proposal for a definition of close-out netting provisions (Alternative (c)) and chose it as a basis for its deliberations.

21. The Study Group made some drafting proposals to amend the first sentence.

> "*'Close-out Netting Provision'* ***means a contractual agreement*** *relating to Eligible Financial Contracts* ***between Eligible Parties*** *under which, on the occurrence of a predefined event in relation to one of the parties, the respective obligations of the parties under such Eligible Financial Contract are* ***reduced, so as to result in a single net obligation representing the aggregate value of all combined obligations,*** *which is then* ***payable by the relevant party.****"*

It agreed to revise the constituent "***"Close-out Netting Provision" means a contractual agreement"****.* Some participants felt that the term '*agreement'* might give the impression that the close-out netting provision needed to be a stand-alone agreement whereas in fact it could be a clause of a broader agreement or of the rules of an infrastructure. Other participants pointed to the pleonasm of the term "contractual agreement". The Study Group considered several alternatives such as replacing the term "*contractual agreement"* by either "*a clause"*, "*a mechanism"* or simply "*a provision"*. The Study Group opted for a formulation along the lines "*'Close-out Netting Provision' means a provision of an agreement or of the rules of a system'* or *'means a provision – be it in a contract or in the rules of a system",* which was inspired by the wording of both the UNIDROIT Geneva Convention [28] and the Financial Collateral Directive. [29]
Several participants stressed that the definition should not single out one particular type of financial infrastructure or service such as CCPs. One participant suggested that it might be wise to reflect in the definition itself that the instrument should apply to mechanisms that created mutuality in a first step [30] and suggested that the wording "*between eligible parties"* could be amended. In any event, the formulation should remain broad enough to cover clearing and multilateral arrangements that shared this feature. Another participant emphasised that the wording of the definition should itself be clear enough to determine whether certain usances among economic agencies, in particular banks, were covered and gave the example of *compte courant*/current account relationships, [31] which did not apply a Close-out Netting mechanism *strictu sensu* but a mechanism that shared several features.

22. Several participants suggested to rephrase the constituent "***reduced, so as to result in a single net obligation representing the aggregate value of all combined obligations***". Participants proposed to replace the words "*are reduced"* by "*are subtracted from each other"* or "*are discharged"* and to speak of "*the remaining value of obligations"* rather than of "*the aggregate value"*, which implied complex concepts. One participant stressed that when employing the term "*reduced"* or "*discharged"*, the second half of the phrase should begin with "*resulting in"* or "*replaced by"*; if the term "*subtracted"* was employed, the second part of the phrase could be maintained. Another participant stressed that a functional definition should be broad enough to encompass different legal techniques to establish the net sum, the first being that the underlying

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[28] *Cf.* fn. 13; Art. 31 (j) *"close-out netting provision" means a provision of a collateral agreement, […]"*

[29] Art. 1(n) of the Financial Collateral Directive 2002/47/EC of 6 June 2002 which reads *'close-out netting provision' means a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by which, […]"* (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF).

[30] *Cf.* infra para. [30], p. 12. For previous discussions *cf*. Doc. 9, para. [58], p. 18 and Doc. 4, paras. [8]-[10], p. 3.

[31] *Cf*. for instance the Austrian and German '*Kontokorrent'* under § 355 of their respective commercial codes.

'old' obligation continued to exist (set-off), the second being that those obligations were replaced by a 'new' obligation (novation). To that end, the participant proposed to refer to both alternatives explicitly by using the terms "*reduced or discharged*" and "*resulting in or replaced by*" cumulatively. With regard to the constituent "***payable by the relevant party***", one participant feared that "*payable*" might be misunderstood to indicate a mere faculty to pay and should therefore be replaced by the word "*is to be paid*".

23. With regard to the second sentence of the proposed definition, several participants drew attention to the fact that the last part of the sentence limited the instrument to termination events based on the default of a party.

> *"Depending on the contractual agreement and applicable law, close-out netting occurs automatically by operation of the contractual agreement or may occur at the election of the party **which is not the party to which the predefined event relates**."*

In non-default events, the party that was affected by the event often had the right to terminate and close out. The Study Group agreed that the second half of that sentence should be deleted or amended to encompass also non-default termination events such as illegality (fait du prince, capital controls) or tax events. [32] The Study Group agreed that the text should be amended in the light of these discussions.

2. Key Considerations and Commentary

24. The Study Group agreed to make some amendments to the key considerations and the commentary to the definition of 'close-out netting provision' in paragraphs [11]-[31].

25. Several participants proposed to further clarify the interplay between contractual and statutory close-out netting mechanisms addressed in the **third bullet point of the key considerations**, in **paragraph [13]** and in **paragraph [22]**: One participant proposed to state more clearly under what circumstances a hybrid close-out mechanism composed of statutory and contractual elements could be subsumed under the definition. He explained that paragraph [22] recognised that certain elements of the close-out netting mechanism might be determined by the relevant legislation, in particular the predefined event triggering the termination. Paragraph [13] laid down that the Principles should be applicable to the contractual elements of the mechanism only in such a situation. The participant suggested rephrasing the relevant sections to clarify that the Principles were applicable whenever a single contractual element remained and that only statutory close-out netting provisions covering conclusively all elements of the mechanism did not fall into the scope of the Principles. Another participant drew attention to the fact that the commentary did not explicitly address the problem of a contractual netting mechanism that deviated from a statutory provision. He suggested clarifying this interplay by a reference to draft Principle 7(a), which required a disapplication of statutory provisions that were in conflict with the contractual agreement. It should be mentioned expressly that Principle 7(a) would apply to legislation providing for automatic termination or methods to calculate the lump sum.

26. The Study Group further decided that sentences two and three of **paragraph [11]** should be rephrased.

> *"A bundle of financial contracts between the parties is contractually covered by a netting agreement. **Upon the occurrence of a predefined event**, all non-performed contracts covered by the netting provision cease to be treated individually"*.

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[32] *E.g.* Sect. 5(b) of the 1992 and 2002 ISDA Master Agreements.

The language should reflect more adequately the single agreement concept commonly underlying master agreements.[33] Several participants explained that the single agreement concept was implemented upon the entry into the trade and not at the later point when a default occurred. With the entry into the trade, the underlying contract ceased to be individual but was transformed into a cash-flow under the netting set. The netting set was from that moment on subject to particular protection through non-assignment clauses. The idea that the original 'contracts' or 'obligations' were transformed was also reflected by the language of the master agreements that spoke only of 'transactions'.

27. One participant proposed to amend **paragraph [15]** to reflect that close-out netting was not frequent in payment and settlement systems.

28. Regarding **paragraph [17]**, one participant proposed to rephrase the constituent "*between the parties themselves, or through a central entity"* by the formulation "*between the parties themselves, or bilaterally through a counterparty"* in the first sentence.

> *"Financial contracts concluded between two parties may be settled either bilaterally, **between the parties themselves, or through a central entity** interposed between the parties."*

Another participant suggested adding an introductory explanation to the beginning of the section "*between eligible parties".* It should introduce the distinction between

- purely bilateral relations which did not raise problems in the application of these principles,
- relations that were originally multilateral but created mutuality in a first step and were therefore covered by the principles and last
- truly multilateral mechanisms that did not create mutuality and were therefore excluded from the scope of the principles.

He considered that this would facilitate understanding of the section.

29. One participant drew attention to the problems of mutuality in trust structures. He felt that it would benefit the principles and its users to clarify whether the relations to trustees could be qualified as mutual and argued that everybody believed that netting should be enforceable in these relations. Yet, the mechanism raised several technical problems.

30. The Study Group agreed to rephrase **paragraphs [19] and [20]** dealing with netting in multilateral infrastructures. It should be clarified that close-out netting provisions in infrastructures fell under the Principles if the system created mutuality in a first step - regardless of the mechanisms employed to that end. Paragraph [19] should focus on infrastructures that created bilateral contractual relationships between parties *ab initio* through techniques such as 'novation'. It should give the example of certain central counterparties (CCPs) and avoid the appearance of extending to the whole collectivity of clearing and settlement systems. To avoid confusion, the reference to truly multilateral mechanisms made in the current draft should be deleted. One participant suggested to further explain the operation of close-out netting in the interaction between two CCPs and to clarify thereby that the Principles applied also to cooperation of two CCPs.

31. The following paragraph should present methods of creating mutuality without relying on a previously established bilateral contractual relationship between the parties of the close-out netting, such as cross-assignments and cross-guarantees.

32. With regard to the exclusion to truly multilateral close-out netting, the Study Group considered that it was difficult to exclude the mechanism without defining the term. However, it felt that the definition of truly multilateral close-out netting could be complicated. Attention needed to

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[33] E.g. Sect. 1(4) of the 2001 and 2004 multi-product European Master Agreement for Financial Transactions (EMA) of the European Banking Federation, Sect. 1(c) of the ISDA Master Agreements of 1992 and 2002, Sect. 13 of the 2000 and 2011 Global Master Repurchase Agreement of SIFMA/ICMA, Art. 17 of the 2010 ISLA Global Master Securities Lending Agreement.

be paid not to confuse truly multilateral close-out netting with netting in infrastructures that created mutuality in a first step, for instance through cross-assignments. Also, multilateral close-out netting needed to be distinguished from other forms of netting such as payment/settlement netting employed in many payment systems or such as novation netting that was used in some multilateral compression systems. The Study Group confirmed that truly multilateral close-out netting was rare in practice but that a number of payment infrastructures employed both, payment netting and on top a set of close-out netting. Some participants suggested that the reference to truly multilateral systems could be dropped from the commentary if it was too complicated to explain these mechanisms.

33. The Study Group further stressed that the discussion of multilateral infrastructures under paragraphs [19] and [20] should be distinguished from the issue of cross-affiliate netting. The reference to cross-affiliate/multi-branch problems in the second half of paragraph [20] should therefore be deleted. The issue would be discussed in the context of the conflict of laws section. [34]

34. One participant suggested that **paragraphs [27] and [28]** should be amended to refer more clearly to both legal techniques that were available to come to the net sum: by acceleration and subtraction of 'old' obligations (in set-off) or by creating a 'new obligation replacing those old obligations (novation). [35]

35. The participants further noted that the last sentence of **paragraph [30]** excluded the enforceability of walkaway clauses because it stated that the solvent party *"must pay the insolvency estate"*.

> *"Where the net amount is positive for the insolvent party,* ***the solvent party must pay the insolvency estate****."*

The Study Group decided to replace that formulation by a neutral one. The sentence should further be relocated to a new paragraph of the commentary, in which the concept and the policy considerations underlying walkaway clauses should be explained. [36]

C. Draft Principle 2: Definition of 'eligible party'

36. The Study Group welcomed the black letter definition of eligible parties and the associated comment. One participant proposed to remove unincorporated entrepreneurs (merchants) from Draft Principle 2(c) to subparagraph 2(b) of the black letter rule. Referring to previous discussions, [37] the Study Group rejected that proposal. With regard to the commentary, the Study Group agreed to insert into **paragraph [35]** entities under public international law to encompass also international financial institutions like regional and global development banks or the World Bank. Last, the Study Group decided to correct a drafting mistake in the second half of sentence one in **paragraph [40]**.

> '*Unincorporated entrepreneurs (merchants) are covered by paragraph (c)* ***even where they conduct themselves as incorporated companies***'.

The second half of the sentence should be rephrased along the lines of "*even where they engage in business usually conducted by incorporated companies"*. One participant raised concerns that such a broad definition of eligible parties might impede political support for instrument.

[34] *Cf*. supra para. [13 f.], p. 8 et seq.
[35] *Cf.* supra para. [22], p. 11.
[36] *Cf.* supra paras. [9] and [11], p. 7 et seq.
[37] *Cf.* Doc. 9, paras. [11], [14] and [16], p. 8 et seq.

D. Draft Principle 3: Definition of 'eligible [financial] contract'

1. The black letter rule

37. The Study Group endorsed the definition with a few amendments. First and foremost, it decided to replace term '***eligible [financial] contract***' by '*eligible obligation*' in the heading and in the chapeau of the draft Principle. Accordingly, the chapeau should be rephrased along the lines of "*'Eligible obligation' means an obligation arising under one of the following contracts"*. The participants felt that such a language would better reflect the theory that the master agreement was one single contract with several underlying obligations, not a bundle of contracts. The deletion of the qualifier `financial' allowed to include commodity transactions into the scope of the instrument.

38. With respect to the definition of derivative instruments in **paragraph (a)**, one participant advocated for deleting the constituent "*that is, or may in the future become, the subject of recurrent contracts in the derivatives markets"*.

> *"'derivative instrument' means an option, forward, future, swap, contract for differences or other transaction in respect of a reference value* ***that is, or may in the future become, the subject of recurrent contracts in the derivatives markets****."*

He felt that the constituent might cause obstacles for including unique obligations or first trades in new markets into the netting set. Those derivative transactions should however not be excluded from the close-out netting operation under the Principles.

39. One participant proposed to expand **paragraph (b)** to cover also repurchase, lending and other agreements relating to commodities and precious metals, possibly all elements that were enumerated under paragraph (f). He explained that gold lending in particular was a very old and established product which was subject to close-out netting.

40. The Study Group further decided to delete **paragraphs (d) and (e)** from the black letter text of Principle 3 because it could not agree on a common position regarding the inclusion of deposits and loans, which involved substantive policy considerations. The arguments raised in favour and against the inclusion of deposits and loans should be presented in the commentary.[38] To include these obligations, some participants suggested to add a new paragraph to the end of the list that referred to any other contract or transaction designated by the laws of the relevant state.

41. With regard to the enumeration of precious metals in **subparagraph (f)(5)**, one participant cautioned not to become too specific.

> *"5.- gold, silver, platinum, palladium, iridium, or any other precious metal".*

The Study Group agreed to delete iridium from the definition. The other four elements should however be maintained since these types of metals had traditionally been traded, were used for intra-central bank transactions and were sometimes subject to particular legal regimes.

42. The Study Group further decided to delete **paragraph (h)**. Some participants voiced the concern that the inclusion of claims based on the principle of unjust enrichment might negatively affect the public perception of the instrument and advocated for deleting that paragraph. Some of them saw a risk of conflicts with national laws sanctioning illegal transactions, others felt that the law of unjust enrichment itself was a rather hazy and fact-based branch of law and suggested that the instrument should not be loaded with this additional layer of complexity. Taking the contrary view, one participant stressed that the possibility to include claims based on unjust enrichment into the close-out netting mechanism was very important. He explained that Court decisions declaring a complex financial transaction invalid or void could sometimes come as a surprise for the parties

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[38] *Cf.* infra paras. [46]-[50], p. 16 et seq.

because the distinction between valid and invalid transactions could be very subtle. He gave the example of a Credit Default Swap (CDS) that would be qualified as an insurance contract under English law if it provided protection only upon the proof of an actual loss. Hence required an insurance license. Without that license, the contract would be void. The parties to the contract would have to recover the premium paid in execution of that contract on the basis of unjust enrichment. The Study Group concluded that even if there were theoretical or technical merits in including those claims, the perception of the instrument should not be burdened with complex ancillary issues that could endanger the success of the Principles.

2. Key considerations and Commentary

43. The Study Group decided to make some amendments to the commentary to Draft Principle 3. Some concerned sheer editorial choices: In the second sentence of **paragraph [44]**, the description of derivatives referring to "*paradigmatic high volatility transactions"* should be modulated to accommodate the fact that some derivatives had a low volatility in relation to relatively illiquid assets. It should further be clarified in **paragraph** [**46**] that all and not just certain types of derivatives were either physically and/or cash settled. One participant cautioned that the current wording could be understood to state that a third category of settlement existed.

44. In the section on 'Title transfer collateral arrangements', the meaning of "*The first ty*pe" in the first sentence of **paragraph [55]** should be clarified.

> "***The first type of collateral arrangement*** *involves traditional security agreements such as pledge or charge."*

One participant explained that the formulation could be misunderstood to refer to title-transfer collateral arrangements, which were cited first in the previous paragraph. In that reading, the first sentence would appear to be incorrect. The statement was however true for pledges or charges. In the middle of **paragraph [57]**, the redundant terms "*an identical or"* should be deleted. The term was synonym for "*the same*". To express the broader scope, the term "*equivalent*" was sufficient, in particular since it was the term normally employed for hypothecations.

> *"This is the case, in particular, where the agreement, sanctioned by the relevant law, permits the collateral taker to use the encumbered asset for its own purposes, in particular to 'rehypothecate' it, and subsequently to return not the same asset but* ***an identical or*** *equivalent one."*

Some participants feared that the doctrinal explanation given in paragraph [57] as to why certain claims under non-title transfer collateral arrangements should be covered by the instrument might raise problems in jurisdictions that were not build on these considerations. To prevent such problems, the explanation should be softened by adding 'in general' or 'in most cases' to indicate that a transfer or replacement of the proprietary claim was not necessary for the application of the principles. The Study Group further envisaged to expand the scope of Draft Principle 3(c) to strict foreclosure, respectively claims enforcing the pledge by appropriation.

45. The commentary to the new subparagraph of Draft Principle 3 referring to 'any other contract or transaction designated by the laws of the relevant state' should present the arguments in favour and against the inclusion of **deposits and loans**. The Study Group felt that the explanation presented in **paragraphs [60] to [71]** in favour of including deposits and loans should be rephrased. It noted that these arguments did not relate to systemic risk and were therefore inconsistent with the justification for the close-out netting protection expressed in the introduction and in draft Principle 7. One participant stated that the argument made in paragraphs [66] and [68] that deposit insurance schemes supported the bank's general creditors if the close-out netting was not enforceable was not entirely reflective of the way deposit insurance schemes worked in many countries. The participant explained that a majority of the G20 member states applied depositor preference. If the deposit insurance scheme had to pay the claim of a creditor,

the depositor preference ensured that the deposit insurance scheme was paid out of the insolvency estate before any other creditor.

46. One participant cautioned that the exclusion of loans and deposits might create risks for the enforceability of the other contracts listed. Since many of the transactions had a cash-leg which looked functionally as a loan, a Court might come to the conclusion that a derivative or other contract enumerated contained a loan element and was therefore not eligible for close-out netting. Other participants cited regulatory arbitrage as one argument in favour of including deposits and loans. They explained that a loan could be collateralised in different ways: as a derivative, as title-transfer arrangement (in particular as a repo) or by a pledge. Whereas the first options to structure the collateralised loan were eligible for netting and thus protected by the Principles, the pledged loan was not. Yet, margin loans in particular were economically very close to repos. Against this background several participants raised the question as to whether it was justified to exclude loans and deposits from the protective shield of the Principles. To illustrate why it might be desirable to include deposits and loans, one participant gave the example of a central bank that wanted close-out claims arising from its monetary policy considerations with its positions under deposits in the monetary reserves in case the collateral posted was not as good as it ought to be. Endorsing the view that the central bank should be entitled to close out their positions in the cited situation, one participant pointed to the fact that it was not possible to include proprietary claims into the close-out netting operation. Other participants maintained that it was important to include deposits and loans into the Principles to cover also cash pooling arrangements in corporate groups. The close-out netting mechanism provided for in those arrangements should be encompassed and adequately protected by the Principles.

47. Other participants took the view that the risk of regulatory arbitrage was not sufficient to extend the Principle's protection to deposits and loans. One participant cautioned that it would be difficult to make the argument that every transaction of bank should be subject to close-out netting. He wondered what parts of a bank's balance sheet was not eligible for close-out netting if deposits and loans were covered by the Principles. The participant drew attention to the fact that the ineligibility of deposits and loans for close-out netting did not exclude the application of traditional set-off principles or of other forms of netting. Deposits and loans would simply be subject to the ordinary insolvency regime in that case.

48. A majority of participants felt that deposits and loans should be covered if those contracts were concluded amongst financial institutions and central banks. Deposits and loans amongst these institutions were often expressed in different currencies and thus tended to have volatile notionals. They were thereby subject to the fluctuation of the currency market. That brought the contracts close to a currency swap. Some participants cautioned that the Study Group would have to define the term 'financial institution' if it suggested to cover loans and deposits between financial institutions only. Other participants pointed to the fact that defining the term 'financial institutions' was not necessary if the recommendation to cover those loans and deposits was made under the new provision of Draft Principle 3. Since it was supposed to refer to 'any other contract or transaction designated by the laws of the relevant state', the legislator electing to designate deposits and loans as eligible obligations could establish or refer to its own definition.

49. With regards to the explanation of cash pooling arrangements in **paragraph [64]** one participant wondered whether the statement made was true for all cash pooling arrangements.

> "*Legally, mutual payment obligations are not settled until the member in question exits the cash pool arrangement*"

The participant further suggested replacing the word "*incalculable*" at the end of the sixth sentence of that same paragraph [64] by a more moderate term.

> *"If the insolvency administrator were able to cherry pick those deposits/loans which were favourable to the insolvent estate, and if it could at the same time*

set aside those that were unfavourable, the risk to the solvent party would be ***incalculable****".*

E. Draft Principles 4-6: Formal requirements

50. The Study Group agreed that the delimitation of principles 4 and 6 should be clarified. Draft Principle 4 should cover any formal act with respect to the formation of a close-out netting provision, thus apply also to registration requirements with respect to the close-out netting provision itself. By contrast, Draft Principle 6 was drafted to address reporting obligations that had gained importance with recent legislatory activities, in particular with the Dodd-Franck Act in the U.S. and EMIR in the European Union. [39] Draft Principle 7(a) complemented the close-out netting protection by addressing requirements regarding the enforceability of a validly formed close-out netting agreement.

51. With respect to editorial choices, the Study Group decided to reintegrate the words 'effectiveness against third parties' into all three provisions of the section.

1. Specific comments on Draft Principle 4

52. The Study Group clarified that Draft Principle 4 applied to all formal acts with respect to the master agreement such as registration, notarisation and other requirements. Several participants stressed that the provision was very important to the resilience and robustness of trading. A strong majority supported the position that no registration requirements should be imposed for the conclusion of the close-out netting agreement, in particular none that affected the private law validity of a close-out netting provision. This fact should be clearly expressed in the Principles. One participant pointed to the fact that the conclusion of a close-out netting agreement would not be transparent to third parties without any publicity act. Comparing netting to its functional equivalent, security interests, he invited the Study Group to explain in the Commentary why an analogy to the problems of intransparent security interests/secret liens was not valid. Several participants replied that close-out netting did not constitute a security interest in legal terms. In particular, it did not create an effect *inter omnes*. In bilateral relationships, there was no publicity requirement like in transfers of movables. At most, if netting was to be compared to traditional securities interests, it could be compared to a situation where two counterparties bilaterally pledged their obligations to each other. Pledges of obligations required a notification only vis-à-vis a third party debtor and such a third party debtor did not exist in the bilateral scenario cited. Thus, there was no necessity for a notification even in comparable pledge cases. With regard to the broader question of transparency and of giving evidence of the agreement in a court proceeding, one participant drew attention to the fact that an entire toolbox of new instruments had been established to increase transparency in the financial market - not only with respect to the underlying obligations but also regarding the close-out netting agreement. He gave the example of disclosure requirements regarding a bank's balance sheet under Pillar III of the Basel II framework which obliged banks to show how intensively they used close-out netting and other risk-mitigation techniques. [40] The same data would also be published in the 20-F report for U.S. GAAP purposes. Those mechanisms were sufficient to ensure transparency. With the new regulatory framework, transparency and regulatory oversight in the markets would increase even further.

53. Another participant suggested that jurisdictions applying registration requirements might be convinced to abolish those requirements if close-out netting was eligible only to a small, well regulated group of parties - in particular to (financial) institutions that were under prudential

[39] *Cf*. supra fn. 16, p. 8.

[40] *Cf*. Bank for International Settlements/Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards of June 2006 (http://www.bis.org/publ/bcbs128.pdf) , para. 825, p. 232 and Table 8, p. 238.

supervision. He advised the Study Group therefore to either limit the personal scope of application of the Principles or to accept registration requirements. He stressed that the rationale behind registration requirements was the fear of fraudulent backdating. Registration was destined to prevent that a close-out netting agreement was entered into in or at the edge of insolvency and backdated to prefer one unsecured creditor to the detriment of the other unsecured general creditors. The participant invited the Study Group to address the problem of fraudulent backdating at least in the commentary. In reply to that concern, other participants stressed that nothing in the Principles, prevented a jurisdiction from denying the enforceability of fraudulent actions. In particular Draft Principle 7(c)(iv) disapplied only provisions relying solely on timing, not insolvency provisions relating to fraud, knowledge, undue preference or other additional elements.

54. One participant pointed out that draft Principle 4 needed to be limited to formal acts of private law. He gave the example of capital controls, which were a formal act of public law and still existed in many countries. Under those regimes, international contracts or transactions were subject to approval, typically of the central bank of that country. If the capital control had been approved by the International Monetary Fund (IMF), all exchange contracts in violation of those controls had to be unenforceable in every Member State of the IMF as a matter of public international law. [41] The participant conceded that the interplay of capital controls with close-out netting needed to be examined in more detail, but underlined that mandatory formal acts of public law needed to be exempted from Principle 4.

2. Specific comments on Draft Principle 5

55. Draft Principle 5 received general approval in the Study Group. A single remark concerned the last sentence of **paragraph** [**82**] of the commentary:

> *„Hence, the concept of only protecting the enforceability of netting agreements that are part of standard documentation is not suitable* ***in a cross-jurisdictional context****."*

One participant suggested deleting the limiting supplement "*in a cross-jurisdictional context".* He explained that the argument was valid also for sheer domestic relationships.

3. Specific comments on Draft Principle 6

56. The Study Group examined the impact of the developing legal framework governing financial transactions[42] to determine whether and how these new mechanisms should be addressed in the Principles. It identified two sorts of reporting obligations in the legislative framework:

- In centrally cleared transactions, real-time reporting was destined to make the essential terms and pricing of the transactions transparent to the market. This mechanism was intended to improve the functioning and competitiveness of the market and to create an audit trail for supervisory and regulatory purposes.
- The reporting obligation of non-centrally cleared transactions towards a trade repository served similar purposes. It ensured that supervisors determined whether large exposures were building up between counterparties and allowed them to evaluate the knock-on effect the failure or stress of one party would have on the counterparty. The supervisor could thus apprehend the implications of stress and disruptions in the market.

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[41] Art. VIII(2)(b) of the Articles of Agreement of the IMF (www.imf.org/external/pubs/ft/aa/pdf/aa.pdf), p. 23.

[42] *Cf*. The U.S. Dodd-Franck Act (available under http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf) and the proposed EMIR Regulation of the European Commission (Proposal Com(2010)484 of a Regulation on OTC derivatives, central counterparties and trade repositories (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF).

57. A majority of participants felt that the non-compliance with those reporting obligations should not be sanctioned by invalidity or unenforceability of the close-out netting provision nor of the underlying obligations. They stressed that the reporting obligations served supervisory and regulatory objectives and aimed at the well functioning of the market. Supervisors and regulators were provided with the information they needed to ensure that the market functioned well. A sanction based on invalidity or unenforceability of the close-out netting provision would be contrary to that purpose. If parties who relied on the effectiveness of a transaction discovered retroactively that their position was invalid - possibly through no fault of their own – this could have strong negative repercussions for their hedging and for the entire market functioning. The Study Group confirmed therefore that the validity of a contract should not be put into question if a party did not comply with reporting obligations.

58. The Study Group further decided to amend the wording of the first sentence of Draft Principle 6 to better reflect its purpose.

> *„**The law may require** the **registration** of **financial contracts** covered by a close-out netting provision **[and of the provision itself]** with a trade repository or similar organisation for regulatory purposes."*

The introductory passage "*The law may require*" should be rephrased along the lines of "*To the extent that a country requires the reporting of data […], a failure to comply […]*" to avoid making pronouncements on regulatory aspects. Some participants added that the current language was not consistent with the soft law nature of the instrument and might be misunderstood as an initiation to introduce new requirements.

59. Moreover, the term "*registration*" should be replaced by "*reporting*" or "*data reporting*". The Study Group felt that the term "reporting" reflected better that the parties were only requested to provide information on the key data of a transaction such as the object and the price of the transaction and the name of the parties. The term 'registration' could give the impression of a much more elaborate procedure like notarisation, review or at least a filing of the entire contract.
The Study Group further decided that the term "financial contracts" should be replaced to enhance consistency of the terminology. It clarified that Principle 6 applied to the underlying obligations. For this very purpose, also the reference to the close-out netting provision in square brackets should be deleted. It should be clarified in the commentary to Draft Principle 6 that it applied only to reporting obligations relating to the underlying obligations.

F. Draft Principle 7: Enforceability of close-out netting

60. The Study Group agreed that Draft Principle 7 was the key provision of the Principles. It decided that it should be based on a broad definition of insolvency proceedings of the UNIDROIT Geneva Convention. That definition should appear in the first paragraphs of the commentary. [43] With view to the document structure, one participant suggested splitting up draft principle 7: A general provision stating that a close-out netting provision should be enforceable in accordance with its terms - in particular as regards the requirements under the current draft Principle 7(a) and (b) - should be separated from the pronouncements on insolvency law. He argued that such a separation could facilitate the understanding the different scopes of the current Draft Principles 7(a) and (b) on the one hand and 7(c) on the other.

61. Another participant invited the Study Group to pronounce itself about the interplay of the enforceability of close-out netting with payment system laws. The legal treatment of an obligation

[43] *Cf.* supra para. [7], p. 7.

that was subject to close-out netting provisions but also to a particular regime protecting the finality of settlement in a the payment system should be explained in the commentary.[44]

1. Subparagraph 7(a)

The Study Group discussed how Draft Principle 7(b) related to Draft Principles 4 and 5. It concluded that Draft Principles 4 and 5 governed the formation of close out netting agreements whereas Draft Principle 7(a) addressed enforcement requirements. The participants noted that the enforcement requirements for commercial contracts cited as examples in paragraph [96] were broadly the same as addressed in Draft Principles 4 and 5. To avoid misunderstandings, discrepancies or mismatches between both provisions, they suggested that it would be better to replace the enumeration in paragraph [96] with an explicit reference to Draft Principles 4 to 6.

62. In the same spirit of avoiding misunderstandings, the Study Group agreed to delete the second half sentence "*or those required for commercial contracts generally*".

> *„The law should not impose enforcement requirements beyond those specified in the close-out netting provision itself* ***or those required for commercial contracts generally****."*

This half sentence was based on Articles 7 and 4(6) of the EU Financial Collateral Directive 2002/47/EC[45] and replaced the former Draft Principle 13, which had enshrined the standard of a "commercially reasonable manner"[46].

2. Subparagraph 7(b)

63. Some participants suggested that Draft Principle 7(b) might be misunderstood to render an unenforceable obligation enforceable.

> *„A close-out netting agreement should remain enforceable even if one or more of the financial contracts covered are unenforceable."*

They proposed to rephrase the provision. It should be clarified that Draft Principle 7(b) was destined to prevent that the inclusion of unenforceable obligations into the netting set affected the operation of the close-out netting provision as regards the remaining obligations. To address that concern, some participants proposed to introduce the concept of severability. The commentary should explain the consequences of the inclusion of unenforceable obligations: The unenforceable obligations had to be severed from the netting set and disregarded for the calculation of the net sum. The close-out netting was, however, effective for the remaining contracts.

64. Some participants pointed to the fact that the same problem of one dubious transaction affecting the enforceability of the entire netting set existed also in other circumstances. They explained that in a number of jurisdictions the inclusion of one transaction that was perfectly enforceable but ineligible for netting could put into doubt the enforceability of the entire close-out netting operation. The Study Group decided that Draft Principle 7(b) should be amended to address also the problem of ineligible transactions contaminating the entire netting set.

65. The same contamination problem appeared in the complex situation of secondary, territorial insolvency proceedings in multi-branch structures. [47] The participants agreed that the

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[44] *Cf*. Art. 3 of the Settlement Finality Directive 98/26/EC as amended by 2009/44/EC that provides for the European context that *"Transfer orders and netting shall be legally enforceable and binding on third parties even in the event of insolvency proceedings against a participant, provided that transfer orders were entered into the system before the moment of opening of such insolvency proceedings as defined in Article 6(1). This shall apply even in the event of insolvency proceedings against a participant (in the system concerned or in an interoperable system) or against the system operator of an interoperable system which is not a participant."*

[45] Directive 47/2002/EC of 6 June 2002 on financial collateral arrangements (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF) as amended by Directive 2009/44/EC (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:146:0037:0043:EN:PDF).

[46] *Cf*. Doc. 3, Draft Principle 13, p. 3 and Doc. 9, para. [104], p. 29.

problem of multi-branch issues should be addressed at a later point in time since it was closely related to the question of the applicable law and thus to the conflict of laws section.

3. Subparagraph 7(c)

66. The Study Group noted that the commentary to **Draft Principle 7(c)(iii)** was missing. It agreed that the reasoning behind that provision as well as its interplay with Draft Principle 7(c)(iv) should be clarified in a proper commentary. One participant explained that Draft Principle 7(c)(iii) was conceived to address anti-deprivation cases. It was destined to clarify that the conclusion of a close-out netting agreement did not by itself constitute an undue preference for one creditor to the detriment of the others.

67. The Study Group further noted that the wording of **Draft Principle 7(c)(iv)**, which recommended the disapplication of suspect periods, was limited to the conclusion of the close-out netting agreement itself. It did not apply to entering into the underlying obligations.

> *„a close-out netting provision should not be unenforceable solely on the basis that it was entered into during a prescribed period before, or on the day of but before, the commencement of the proceeding.*"

Referring back to previous discussions[48], a majority of participants advocated for restoring the broader formulation of the provision which had encompassed the entering into the underlying transactions. One participant advocated on the contrary for keeping the limited scope of application. He felt that the Principles, including Draft Principle 7(c)(iv), should be limited to the conclusion and operation of the close-out netting mechanism itself. The focus of the entire instrument should be to protect the conclusion and operation of the close-out netting mechanism, not the underlying obligations. For this purpose, it was sufficient that Draft Principle 7(b) shielded the close-out netting mechanism against contaminations by an invalid or ineligible underlying obligation[49].

68. Another participant pointed to the fact that the definition of eligible obligations under Draft Principle 3 encompassed obligations under title transfer collateral agreements. He concluded that Draft Principle 7(c)(iv) should correspondingly also apply to the conclusion of the collateral arrangements entered into in the context of a netting agreement. Other participants endorsed the proposal that 7(c)(iv) should apply not only to the conclusion and operation of the close-out netting itself, but also to the conclusion of the eligible obligations and to the entering into collateral arrangements.

69. One participant voiced the concern that Draft Principle 7(c)(iv) might give rise to misunderstandings. Read in the context of the chapeau of Draft Principle 7, which stated that a close-out netting protection should be enforceable in accordance with its terms, the provision could be understood to disapply all insolvency clawback provisions, those relating to suspect periods or zero-hour rules as well as avoidance provisions based on undue preference and knowledge. He suggested clarifying that the insolvency clawback regime was not affected by the Principles, except for those rules that relied solely on timing (suspect periods and zero-hour rules). A commentary to the term 'solely' of the black letter text should make clear that Draft Principle 7(c)(iv) did not apply to insolvency provisions based on fraud, knowledge, undue preferences and the like. The Study Group agreed that this explanation should be given without enumerating particular clawback concepts because the insolvency law was too diverse in the various jurisdictions and applied a variety of concepts. The wording should rather be broad and general enough to encompass the variety of these options. This approach should, however, not foreclose the possibility of giving examples.

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[47] *Cf*. supra, para. [13 et seq.], p. 8 et seq. for an explanation of the problem.
[48] *Cf*. Doc. 9 para. [106 et seq.], p. 29 et seq.
[49] *Cf*. supra paras. [65 et seq.] on Draft Principle 7(b).

70. With regard to editorial choices, one participant proposed to replace the phrase "*should not be unenforceable*" in Draft Principle 7(c)(iv) by formulations along the lines of "*should not be declared invalid or void*" or "*should not be revised*" to reflect that the provision dealt with initially valid and enforceable agreements that were later - in a separate act justified by reasons of unjustified preference - declared void or invalid.

71. Another participant proposed to expand Draft Principle 7(c)(iv) or to introduce a new subparagraph to protect contracts made on market terms from the general insolvency law. He gave the example of spot trades and derivatives made at market terms, the legs of which were so balanced at the time of their conclusion that their market value was zero at that point in time.

4. Key Considerations, explanations and commentary to Draft Principle 7

72. With regards to the first key consideration to Draft Principle 7, one participant proposed to rephrase the first sentence.

> "*The enforceability of close-out netting often conflicts with a number of* ***general commercial and*** *insolvency law issues*."

He maintained that the statement was correct and important regarding the insolvency law modifications but suggested to soften it in relation to the commercial law side. The participant explained that there were little conflicts with general commercial law in major financial market jurisdictions and cautioned that the sentence as it stood could dissuade policy makers from adopting the Principles.

73. Turning to the commentary, the Study Group discussed the application of the Principles to some forms of amicable (pre-)insolvency proceedings which were addressed in the last sentence of **paragraph** [**89**].

> *"In this context, it is worth noting that procedures which are technically not insolvency proceedings such as* ***amicable creditor settlements, are also included in the scope of protection (which leaves, however, unaffected the possibility to change the close-out netting provision by agreement)****."*

The Study Group considered whether the general statement of Draft Principle 7 that the close-out netting operation should remain unaffected was true for all types of amicable proceedings. The participants looked at different amicable creditor settlement proceedings such as the French 'Procedure de sauveguarde'[50] and some forms of voluntary arrangements and schemes under English law[51] to better understand the nature of those proceedings. The Study Group concluded that the term 'amicable proceedings' encompassed a broad variety of proceedings, some involving statutory, administrative and judicial elements. It discerned different types of amicable proceedings - purely contractual agreements, voluntary arrangements concluded under a statutory regime and regimes that were subject to some sort of judicial or administrative approval. One participant suggested that purely contractual proceedings differed from the others in relation to close-out netting. Being governed entirely by the contract, it depended entirely on the consensual agreement with the counterparty of the netting agreement whether the amicable (pre-)insolvency agreement overruled the close-out netting agreement or not. Thus it was not adequate to make pronunciations in that regard. The Study Group felt, however, that there would be room for an application of the Principles if there was an official nature to the reorganisation or restructuring proceedings. One participant drew attention to the fact that the cited paragraph [89] had tried to establish exactly what had been agreed: as a rule the close-out netting operation should remain

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[50] A new proceeding introduced into Art. L.620-1 to L.627-4 of the French Commercial Code destined to prevent creditors from enforcing their claims even in a pre-insolvency stage destined to allow the undertaking to recover. L.628.1-628.7 of that Commercial Code regulate the even faster 'procédure de la sauvegarde financière accélérée'.

[51] *Cf*. Part VIII of the Insolvency Act 1986 provides for a voluntary arrangement and Part XXVI of the Companies Act. 2006 provides for a scheme of arrangement for corporate insolvency proceedings.

unaffected by amicable creditor settlements, but a contractual agreement of the parties could of course provide otherwise. The Study Group agreed that the passage should be refined to clarify the exact scope of the Principles with respect to amicable creditor settlement proceedings. It found it wise to look into and make reference to the work of other organisations such as the UNCITRAL soft law instruments on insolvency law. [52]

74. One participant drew attention to the fact that the functional approach of the Principles required their transposition to the laws of the various jurisdictions. In that process, some jurisdictions might characterise close-out netting as set-off despite the statement in paragraph [2] of the introduction that close-out netting was functionally and conceptually different from traditional set-off. The participant voiced the concern that jurisdictions which characterised close-out netting as set-off might come to the conclusion that their laws were compliant with the Principles since they admitted insolvency set-off, for instance. This equalisation implied the risk that national limitations to set-off would be applied to close-out netting. To address that concern, the participant advocated for expressing clearly in the commentary that jurisdictions that applied traditional national instruments such as set-off or novation for the transposition of the Principles into their national laws would have to amend their respective set-off or novation laws.

75. Looking also to the implementation of the Principles into national laws, one participant raised the question as to the enforceability of close-out netting under Sharia Law. In reply, another participant advised against focussing on those aspects. He explained that ISDA had run a project to develop Sharia compliant derivatives documentation[53] and shared the findings. First, research had shown that the concept of close-out netting did not pose a particular problem in the Middle Eastern countries. What should be noted, however, was that some of the countries of the Gulf Cooperation Council (GCC) [54] did not have a (proper) insolvency law and that the Principles might thus lack the legal framework to embed them. Another aspect of those jurisdictions was that the existing provisions were likely to be based on or related to the Sharia. As a matter of public policy, a conflict with Sharia principles could not be addressed with legislative measures in the commercial area.

76. With respect to the commentary to paragraph 7(c)(i) in paragraphs [104] to [106], one participant reminded the Study Group that it had intended to address the issue master-master agreements. It should be clarified that an insolvency administrator should not be entitled to cherry-pick amongst several master agreements that were subject to a single master-master agreement.

77. The Study Group further agreed to rephrase the last sentence of paragraph [106] dealing with cherry-picking.

> *"Those jurisdictions that accommodate close-out netting tend to solve the conflict between cherry-picking and enforceability of netting provisions by disallowing the selection of isolated contracts but giving the insolvency administrator* ***the right to decide whether the net amount is to be paid or not****."*

One participant raised the question if cherry-picking should be disapplied also regarding the entire master agreement, thus regarding the payment of the net sum. A majority of participants considered that the insolvency administrator's right to either affirm or repudiate the whole master agreement as a single contract should remain unaffected. They explained that a rejection of the master agreement either entailed the calculation of the net sum and its payment to the insolvency estate in case the insolvent party was in the money or the payment out of the insolvency estate as an unsecured creditor if the insolvent party was out of the money. If the insolvency administrator assumed the netting set, the counterparty would still be free to exercise its close-out rights. Hence, cherry-picking of the entire master agreement did not constitute a problem. The commentary

[52] http://www.uncitral.org/uncitral/uncitral_texts/insolvency.html.

[53] *Cf.* the ISDA/IIFM Tahawwut Master Agreement available under http://www.isda.org/publications/isdamasteragrmnt.aspx (*cf.* also ISDA's press release of 1 March 2010 under http://www.isda.org/media/press/2010/press030110.html).

[54] Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

simply had to be clear that the cherry-picking right applied only to the level of the single agreement and not to the underlying transactions. The Study Group agreed that the interaction between cherry-picking rights and the operation of the close-out netting agreement should be explained in the commentary.

G. A new Draft Principle 8 on resolution measures by regulatory authorities

78. The Study Group decided to introduce a new Draft Principle 8 which sets out the relationship between the resolution measures recommended in the Key Attributes of the FSB and Draft Principle 7. [55]

III. Finalisation of the instrument

79. The UNIDROIT Secretariat proposed to amend the substantive law issues of the Principles in accordance with the decisions taken. The final draft would then be sent to the participants of the Study Group.

80. As regards the conflict of laws issues, the study prepared by the UNIDROIT Secretariat had been sent out to private international law experts. The UNIDROIT Secretariat was also consulting with authors of two independent conflict of laws studies, which were published recently. [56] The Secretariat announced to provide a revised paper on conflict of laws issues at a later stage.

81. The Secretariat announced that it would soon seek the approval of the UNIDROIT Governing Council to convene of a Committee of Governmental Experts and expressed the hope that the Principles could be finally approved by the Governing Council in 2013.

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[55] *Cf.* Supra paras. [5]-[8] on p. 6f.for the discussion and findings of those resolution measures.

[56] *Virgós/Garcimartín*, „Conditional Conflict of Laws Rules: A Proposal in the Area of Bank Resolution and Netting in Cross-border Scenarios” (yet unpublished); *Grégory Minne*, „Les règles de conflit de lois en matière de compensation dans le secteur financier“, ALBJ 2011, 7 et seq.

APPENDIX I

LIST OF PARTICIPANTS

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UNIDROIT SECRETARIAT

Mr José Angelo ESTRELLA-FARIA	Secretary General
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Mr Ole BÖGER	

APPENDIX II

UNIDROIT Study Group on principles and rules on the netting of financial instruments

Third Meeting
Rome, 7 – 9 February 2012

UNIDROIT 2012
Study LXXVIII C - Doc. 10
Original: English
January 2012

ANNOTATED DRAFT AGENDA

1. Opening of the meeting

2. Adoption of the agenda and organisation of the meeting

3. Reports on the proceedings of relevant institutions

   (a) Financial Stability Board

   (b) EU Commission

4. Preliminary discussion

5. Consideration of the Third Preliminary Draft of the Principles on Close-out Netting of Financial Instruments (UNIDROIT 2012 – Study LXXVIII C – Doc. 11)

6. Summary of the findings; planning of further work

7. Any other business

8. Closing of the meeting

ANNOTATIONS TO THE DRAFT AGENDA

Item No. 1 Opening of the meeting

1. The meeting will be held at the seat of UNIDROIT (Via Panisperna 28, 00184 Rome) and will be opened on Tuesday, 7 February 2012 at 10:00 hours.

Item No. 2 Adoption of the agenda and organisation of the meeting

2. Meeting hours will be from 10:00 to 13:00 and 14:30 to 18:00 hours.

Item No. 3 Reports on the proceedings of relevant institutions

3. Mr Devos (Bank for International Settlements) will give a brief status update on recent regulatory developments, in particular on the findings of the Financial Stability Board of November 2011. Mr Wezenbeek (European Commission) will report on netting-related EU developments.

Item No. 4 - **Preliminary discussion**

4. At its second meeting in September 2011, the Study Group postponed a decision on certain fundamental issues. In particular, it agreed to await clarifications of the Financial Stability Board before deliberating on the interplay between close-out netting and crisis management powers (Doc. 9, p. 17 [52-53]). The Study Group has further not taken a decision as to whether the draft Principles should extend to the underlying contracts and obligations, to certain netting-related provisions of master agreements and/or to statutory netting provisions (Doc. 9, p. 14-17 [36-51]). Last, it decided to review the Principles with view to their application in multilateral structures and in particular in CCPs (Doc. 9, p. 18-20 [57-63]). The Study Group may wish to address these issues at its third meeting.

Item No. 5 - **Consideration of the Third Preliminary Draft of Principles on Close-out Netting of Financial Instruments**

5. The Secretariat invites the members of the Study Group to analyse the Third Preliminary Draft of Principles on Close-out Netting (Doc. 11). Pursuant to the decisions taken at the second meeting of the Study Group, the Draft was amended by extensive explanatory material and by a definition of eligible contracts and parties.

6. The Study Group further agreed in its second meeting to review whether payment, clearing and settlement systems (Doc. 9, p. 18 [54-56]) and collateral arrangements (Doc. 9, p. 20 [64-66]) were sufficiently covered by the Draft Principles or whether the draft needed to be amended to address the particularities of those arrangements.

The Study Group may also wish to consider the implications of any possible decision to enlarge the scope of the instrument on the structure of the Principles.

APPENDIX III

UNIDROIT Study Group on principles and rules on the netting of financial instruments

Third Meeting
Rome, 7 – 9 February 2012

UNIDROIT 2012
Study LXXVIII C - Doc. 11
Original: English
January 2012

Preliminary Draft Principles regarding the Enforceability of Close-out Netting Provisions

(Prepared by Mr Philipp Paech, member of the Study Group, on behalf of the UNIDROIT Secretariat) [57]

Introduction

1. Financial institutions and other financial market participants in their daily operations basically apply two types of mechanism designed to reduce their risk exposure. First, they provide to each other security or collateral. In addition, they may agree that close-out netting shall apply to the financial contracts into which they enter with each other. Both mechanisms, security/collateral on the one hand and close-out netting on the other hand, serve the same purpose, that is, to ensure that one party's exposure to the other parties' solvency and to considerable changes in the value of the relevant assets is kept at manageable levels. Both mechanisms are capable of independently mitigating counterparty risk as well as market risk. Taken together, security/collateral and close-out netting form the spearhead of modern risk management in the financial market.

2. The notion of close-out netting is a relatively new addition to the legal terminology and it is not particularly well-defined. Broadly speaking, close-out netting is often understood as resembling the classical concept of set-off applied upon default or insolvency of one of the parties. However, close-out netting encompasses many additional elements and is functionally and conceptually different from traditional set-off.

3. Close-out netting arrangements are widely used in the financial market by private sector entities, in particular banks, but also private non-financial institutions. In the public sector, entities such as, especially, central banks and supranational financial institutions such as development banks make use of netting arrangements. Close-out netting is typically applied to transactions such as derivatives, repurchase and securities lending agreements, and other kinds of financial transaction that tend to carry a high counterparty and/or market risk.

4. Regulatory authorities (most recently, the *Cross-border Bank Resolution Group* of the Basel Committee on Banking Supervision) strongly encourage the use of such netting arrangements (alongside collateral) because of their beneficial effects on the stability of the financial system.

5. However, these beneficial effects are particularly palpable in the event of the insolvency of a counterparty. In that case, the use of close-out netting assumes that the legal effects stipulated

[57] This draft is partly based on Document 2, Document 3 and Document 6 of the UNIDROIT Study Group and on the deliberations of all its members during their two meetings in 2011. The author and the UNIDROIT Secretariat would like to thank Ms Joyce Hansen and Mr Hideki Kanda, members of the Study Group, for their useful comments on an earlier draft of this document.

to that end by the parties (the close-out netting provision) will be recognised by and be enforceable under the applicable insolvency law. Globally, however, the current *status quo* is that while many jurisdictions recognise netting in insolvency, the extent to which they do so and the scope and legal effects differ. Other jurisdictions do not clearly recognise netting, and the legal practice in such jurisdictions often resorts to the principles governing set-off, failing to recognise the fundamental differences between the two mechanisms. This global 'patchwork' is unsatisfactory in cross-jurisdictional situations, since it exposes the financial market participants' risk management to unnecessary legal uncertainty and may even jeopardise it.[58]

6. An additional aspect of the enforceability of netting agreements has come to the fore since the beginning of the recent financial crisis: regulatory authorities, while underlining the usefulness of netting, have contemplated the need for a brief moratorium on the netting mechanism in pre-insolvency or insolvency situations affecting a financial institution, so as to allow the regulator the time needed to decide if and how to save an ailing entity for reasons of systemic stability. The Financial Stability Board has recently provided guidance as to how the regulatory interest should be reconciled with financial firms' and its regulators' need to rely on the enforceability of close-out netting for risk management and mitigation purposes.

7. The emerging international regulatory consensus regarding the interplay between close-out netting and bank resolution is set out in the FSB report on bank resolution.[59] However, this newly developing regulatory approach has to deal with a patchwork where the relevant legal mechanisms in which close-out netting is embedded are not compatible or comparable across borders. Therefore, the sensitive connection of regulatory measures such as moratoria on termination or portfolio transfers to the essential insolvency and commercial law framework might fail in certain cases. Notably, regulatory measures aimed at restricting close-out netting in bank resolution procedures might be less effective. Further, the global patchwork leads to situations where portfolios of financial contracts covered by close-out netting agreements are difficult to transfer to a cross-border acquirer. This situation calls for a more harmonised and streamlined framework regarding close-out netting on which market participants and regulatory can rely across all financial markets.[60]

8. First steps have meanwhile been taken towards an international consensus on the principles underlying the legal cornerstones regarding enforceability of close-out netting agreements. The Geneva Securities Convention sets out an optional framework for the protection of collateral transactions. This protection extends to netting agreements provided they are concluded as part of a collateral transaction. The Convention therefore contains a definition of close-out netting and a key rule on enforceability.[61]

9. Furthermore, netting has also been recognised in the work of UNCITRAL on cross-border insolvency. Notably, the *Legislative Guide on Insolvency Law* refers to the enforceability of netting as a feature to be considered when designing insolvency law, and advises that netting of financial contracts should be allowed under the applicable insolvency procedure.[62]

10. The aim of the following principles is to provide detailed guidance to national legislators seeking to revise or introduce national legislation relevant to the functioning of close-out netting. These principles are designed to improve the enforceability of close-out netting, especially in cross-jurisdictional situations, in order to provide a sound basis, in commercial and insolvency law terms, for risk management and mitigation by financial institutions and for the application of regulatory policies in the international context.

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[58] *Cf.* for a detailed analysis Document 2, 1st Part, in particular pp. 32 *et seq.*

[59] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, section 4, in particular section 4.3.

[60] *Cf.* for a detailed analysis Document 2, 2nd Part, in particular pp. 68 *et seq.*

[61] UNIDROIT Convention on Substantive Rules for Intermediated Securities, adopted in Geneva on 9 October 2009; in particular Article 31(3)(j) and Article 32(3).

[62] UNCITRAL, Legislative Guide on Insolvency, 2005, Recommendations 7g) and 101-107.

Principle 1: Definition of 'Close-out netting provision'

Alternative (c)[63]

1. "Close-out Netting Provision" means a contractual agreement relating to Eligible Financial Contracts between Eligible Parties under which, on the occurrence of a predefined event in relation to one of the parties, the respective obligations of the parties under such Eligible Financial Contract are reduced, so as to result in a single net obligation representing the aggregate value of all combined obligations, which is then payable by the relevant party. Depending on the contractual agreement and applicable law, close-out netting occurs automatically by operation of the contractual agreement or may occur at the election of the party which is not the party to which the predefined event relates.

Key considerations in respect of this definition

- The definition of close-out netting provision shall be broad so as to encompass different types of provision which achieve a functionally identical result.
- It shall not privilege one or the other legal method to achieve the result that may exist in different jurisdictions and in different standard market contracts.
- The definition shall exclusively relate to contractual close-out netting. Statutory provisions that achieve an identical or similar result are not addressed in this definition.

Explanation and commentary

'Close-out netting'

11. Close-out netting is best described in functional terms, *i.e.* by reference to a result. The process, in practical terms, is the following. A bundle of financial contracts between the parties is contractually covered by a netting agreement. Upon the occurrence of a predefined event, all non-performed contracts covered by the netting provision cease to be treated individually. Their aggregate value computed so as to result in one single net payment obligation. This obligation is owed by the party which is 'out of the money' to the party which is 'in the money'. This obligation *remains the only obligation to be settled and is generally due shortly after being determined.*

'Provision' and 'contractual agreement'

12. This definition covers contractual close-out netting, as opposed to statutory rules that may achieve an identical or similar result.

13. Where the result of close-out netting is achieved through a combination of statutory rules with contractual rules (*e.g.*, the right to terminate is statutory, acceleration, valuation and aggregation are arranged for contractually), these principles exclusively cover the contractual part, *cf. infra*, paragraph 22.

14. In practice, an agreement allowing for close-out netting between the parties may be included in standard master documentation (such as the ISDA Master Agreement), or be part of a tailor-made framework agreement, or be an entirely self-standing agreement. These principles

[63] Alternatives (a) and (b) of Principle 1 in Document 6 are retained. The explanations given here in relation to Alternative (c) could be applied accordingly.

therefore refer to "close-out netting provision", rather than to "arrangement" or "agreement", so as to encompass these various possibilities. However, the term 'close-out netting provision' covers only those parts of an agreement that actually implement the close-out netting mechanism itself, and nothing else. Definitions, schedules and annexes that the parties may have related to their agreement are covered only to the extent that their content is necessary for the proper operation of the close-out netting mechanism.

15. The internal rules of clearing, settlement and payment systems, as well as central counterparties are also contemplated by this definition. Despite the fact that they are usually approved by the relevant regulatory authority, the character of the relationship between the system and its participants is, or in any case is treated by this instrument as, one of commercial law (membership agreement, by-laws) as regards the treatment of the assets to be settled in the system.

'In relation to eligible {financial} contracts'

16. *Cf.* relevant definition.

'Between eligible parties'

17. *Cf.* relevant definition. Financial contracts concluded between two parties may be settled either bilaterally, between the parties themselves, or through a central entity interposed between the parties. Close-out netting is *equally important* in both scenarios.

18. Bilateral settlement between the parties is the standard case and covered by these principles.

19. These principles also cover 'central clearing' as a collective term for the functionalities of central counterparties, net payment systems and clearing and settlement systems in general. Central clearing applies by virtue of contractual agreements between market participants or as a legal requirement. The arrangement works by interposing a central entity between the parties to every financial contract, so that it becomes 'buyer to every seller and seller to every buyer'. In other words, the bilateral settlement obligations that exist between the system's participants are entirely replace by bilateral obligations between each participant and the central clearing entity (there are very few truly multilateral clearing mechanisms). Consequently, the net risk exposure is calculated on a bilateral basis, so that each participant's exposure exists exclusively against the central entity. Thus, given that, from a legal point of view, central clearing breaks down to strictly bilateral relationships, considerations in respect of bilateral close-out netting generally apply to central clearing. This applies both inside and outside insolvency of the participants and the system. Therefore, legal certainty requires also that the conversion of the original contractual relationships between the clearing participants into bilateral relationships between each participant and the central clearing entity is insolvency-proof.

20. Truly multilateral close-out netting is probably an exceptional case. Under such a scheme, more than two parties compute their mutual exposure on a multilateral basis, employing functionalities similar to those used in close-out netting, capped by a system of mutual cross-assignments. It is used as a tool to circumscribe the exposure of one market participant *vis-à-vis* a multitude of other, independent market participants, typically a bank managing its risk exposure under one single netting agreement against several entities belonging to the same group of companies (hence this form of netting is also called 'cross-affiliate netting'). The recognition of a multilateral netting agreement by the applicable insolvency law depends in part on whether the law is able to accommodate the lack of mutuality of the relevant contracts or on whether the 'mutuality' created through cross-guarantees, cross-collateralisation agreements or similar arrangements is recognised. Truly multilateral close-out netting is *not* covered by the above definition.

‘Predefined event’

21. The event that usually triggers the application of the netting provision (the ‘predefined event’) is commonly referred to in the relevant documentation as the ‘termination event’, ‘enforcement event’ or ‘default event’. Close-out netting can occur both in situations where both parties are solvent and in the event of the insolvency of either, since it is the parties to the netting agreement themselves that determine the trigger for the operation of the mechanism. This event may consist, for example, in one of the parties defaulting on one or more of its obligations, or in its filing for insolvency, in the appointment of a state administrator or a similar intervention by the public authorities, or in the opening of an insolvency proceeding or an administration, resolution or restructuring procedure. Netting agreements additionally include external circumstances as termination events, such as the objective impossibility of performing an obligation under one of the financial contracts, or the downgrading of one of the parties’ credit rating following its merger with another company.

22. It is worth noting that the event triggering termination may be determined, in certain jurisdictions, under the relevant legislation itself. In particular, the insolvency of one of the parties may lead to the termination of all open contracts by operation of the statutory law. Parties may supplement this statutory consequence of the termination event with additional contractual rules providing for other elements needed to achieve the result of close-out netting (*cf. supra,* paragraph 13). Such arrangements are likewise envisaged by the present definition.

‘Reduced so as to result ...’

23. A close-out netting mechanism is commonly understood as resulting in a single payment obligation owed by the party that is ‘out of the money’ to the party that is ‘in the money’. However, are a number of different functional steps can be used to achieve this result, and these can potentially be based on a number of differing legal concepts.

24. A netting mechanism generally involves several or all of the following steps: (i) termination of the financial contracts, (ii) acceleration of obligations, (iii) valuation of the contracts’ value, and, (iv) aggregation to result in an overall net amount. The order of acceleration, aggregation and valuation can vary according to the actual netting agreements. Not all netting clauses need all of these steps to come to the functional result of close-out netting. Which elements are needed and used depends, rather, on the design of the relevant provision and the boundaries under the applicable law. Examples:

- *Termination of each contract; valuation of each contract; aggregation of all values to form one net payment obligation.*
- *Acceleration of each contract, valuation of each contract, aggregation of all values to form one net payment obligation.*
- *Termination of each contract; valuation of each contract; aggregation of all values to form one net payment obligation; acceleration of the net obligation.*
- *Termination of each contract; valuation of each contract; creation of a new (immediately due and payable) payment obligation representing the overall value.*
- *Etc.*

25. These functional steps merely describe what happens in practical terms. The relevant close-out netting provision in combination with the applicable law need to provide the necessary legal concepts, since the result (a single net payment obligation) is first and foremost a legal one. The legal concepts and terminology that underlie these steps differ, depending on the design of the netting provision and on the law applicable to it.

26. Concepts such as termination, cancellation, close-out, rescission, *etc.* achieve the same functional result of putting an end to the relevant open contracts.

27. Acceleration is a term used to express the concept that an obligation becomes due and payable before the contractually agreed date; there might be other legal concepts and terms to achieve an identical functional result such as the replacement of the original and as yet unmatured obligation with a new obligation that must be performed immediately ('novation').

28. The aggregation element collapses all relevant contracts or the value resulting from them so as to produce one single obligation. This is functionally the same result as the outcome of classical set-off of all valued and payable obligations. Also novation (*i.e.*, the parties agreement that after termination of all open contracts a *new* obligation arises representing the relevant aggregate value) is a suitable concept to achieve the effect of aggregation.

29. The valuation of the terminated contracts or the entire (aggregate) contractual relationship generally seeks to establish a fair and commercially reasonable compensation for the party that was 'in the money'. The valuation is usually (but not necessarily) effected by the non-defaulting party under a mechanism which has been pre-defined in the agreement. The parties are free to define the valuation mechanism and may use concepts such as replacement- or market value or any other method that allows for a practicable valuation process and a fair and commercially reasonable result.

'Payable by the relevant party'

30. Where close-out netting occurs in the context of the insolvency of one of the parties, and the net amount is positive for the solvent party, that party is paid from the insolvency estate as an unsecured creditor and may therefore lose some or the entirety of its claim. In the amount of this net sum, the position of the solvent party vis-à-vis the insolvent estate is no better than that of any other party: it needs to be secured in order to be certain of payment and the same requirements apply regarding the necessary proof of the claim. Where the net amount is positive for the insolvent party, the solvent party must pay the insolvency estate.

Automatic or elective operation of the close-out netting mechanism

31. Depending on the specific contractual agreement, close-out netting either occurs automatically, by operation of the contractual agreement ('automatic termination', which is not allowed in a number of jurisdictions), or it may occur at the discretion of the party which is not the party to which the predefined event relates. The extent to which the non-defaulting party should retain the freedom to close-out after the predefined event has occurred is currently under discussion. Close-out netting provisions employing either elective or automatic termination are covered by these principles.

Principle 2: Definition of 'eligible party'

2. 'Eligible party' means

a) a person other than a natural person,

b) a partnership or unincorporated association (whether or not its membership includes natural persons), and

c) any other person designated as an eligible party under the law of the relevant State.

Key considerations in respect of this definition

- The definition of 'eligible party' determines and restricts the scope of these principles, in conjunction with the definition of 'eligible financial contract'. Therefore, the application of these principles to a legal relationship between two parties depends on whether both are eligible parties, and, *cumulatively*, whether the relevant legal relationship represents an eligible contract.
- The definition of eligible parties, as a criterion for determining the personal scope, should be shaped in a broad and comprehensive manner. The main issue to be taken into account is consumer protection. Many jurisdictions apply specific measures with a view to protecting consumers. National legislators/regulators shall determine the extent to which the application of these principles is compatible with the relevant consumer protection policy.
- Other restrictions regarding the personal and material scope (apart from excluding consumers) frequently exist in national law; these are both highly diverse and difficult to categorise conceptually from an international point of view. The key question appears to be whether a certain kind of *business* should be able to be included within the ambit of netting. From the point of view of international compatibility, this issue would be best tackled in a precise and consistent manner by restricting the definition of eligible contracts, while leaving the definition of eligible parties as broad as possible.

Explanation and commentary

Paragraph (a)

32. Paragraph (a) covers the greater part of all parties contemplated by these principles. It follows the key consideration that the personal scope of these principles should be as broad as possible, given that it is well-nigh impossible properly to classify the different types of actor on the financial market.

33. In particular, professional actors in the financial market, such as banks and securities firms, will usually be organised in a form other than that of a natural person. They are covered by paragraph (a).

34. Commercial firms such as airlines, energy dealers, producers of chemical industrial goods, etc., are likewise covered. They use derivative contracts for hedging purposes on an ongoing basis. Such contracts typically contain netting clauses.

35. Public law entities are also covered to the extent that they are 'persons', *i.e.*, that they have legally recognised personality. This includes states and their divisions, including central banks. Moreover, more or less independent bodies of public law with legal personality are likewise included such as municipalities as well as agencies that are constitutionally independent from the state.

Paragraph (b)

36. The inclusion of the term 'unincorporated associations' guarantees that organisations such as universities, religious associations, football clubs, etc. are covered, since they may participate in the financial market to a considerable extent.

37. It should be noted that it is quite easy in many jurisdictions to form such unincorporated associations and for them to be given some legal recognition, with few formalities required. This includes associations of natural persons which, if acting as individuals, would fall within the remit of paragraph (c). The fact of being associated and of engaging in eligible financial contracts places such groups of individuals within the scope of these principles.

Paragraph (c)

38. This paragraph reflects the policy considerations raised by the possible participation of individuals in financial market transactions. States may decide

- not to apply these principles to individuals at all,
- to apply these principles only to restricted classes of individual such as professionals and other sophisticated or high-net-worth individuals,
- to apply these principles to restricted classes of individual and in respect of certain types of eligible financial contract into which these individuals may enter,
- to apply these principles to individuals only to the extent that they contract with a counterparty falling within the ambit of *paragraphs (a)* or *(b)*.
- Such a decision will generally be made within the overall framework of the relevant state's rules and policy on the protection of individuals in general and of consumers in particular.

39. This paragraph aims to cover persons commonly referred to as 'natural persons' (*cf.* also the negative use of that definition under *paragraph (a)*). However, the principles intentionally do not use this term in *paragraph (c)* in order to avoid confusion with the category described under *paragraph (b)*. Natural persons organised in a partnership or an association and acting as such fall within *paragraph (b)*, although many jurisdictions would still regard them as natural persons in legal terms. As a consequence, *paragraph (c)* covers natural persons acting individually, or 'individuals'.

40. Unincorporated entrepreneurs (merchants) are covered by *paragraph (c)* even where they conduct themselves as incorporated companies. As a consequence, they fall within the scope of the netting principles only if and to the extent that they are designated as eligible parties under the law of the relevant state.

<u>Principle 3: Definition of 'eligible [financial] contract</u>

3. 'Eligible [financial] contract' means

a) derivative instruments,
'derivative instrument' means an option, forward, future, swap, contract for differences or other transaction in respect of a reference value that is, or may in the future become, the subject of recurrent contracts in the derivatives markets.

b) repurchase agreements, lending agreements and margin loans relating to securities, money market instruments and units in collective investment schemes,

c) title transfer collateral arrangements,

d) [deposits,] [to the extent designated by the law of the relevant State,]

e) [loans,] [to the extent designated by the law of the relevant State,]

f) contracts for the sale, purchase or delivery of

1.- securities

2.- money market instruments

3.- units in a collective investment scheme

4.- currency of any country, territory or monetary union

5.- gold, silver, platinum, palladium, iridium, or any other precious metal

6.- any other fungible commodity,
'Fungible commodity' means a commodity that is or may in the future become the subject of recurrent contracts in the spot, forward or derivatives markets.

g) agreements under which a party undertakes (whether by way of surety or as principal debtor) to perform obligations assumed by another person under any agreement referred to in paragraphs [a] to [f].

h) claims based on the principle of unjustified enrichment and occurring in connection with one of the above types of transaction, whether or not the parties agreed to that transaction in a legally effective manner.

<u>Key considerations in respect of this definition</u>

- From the perspective of the purely legal mechanisms involved, netting is possible in respect of all mutual contractual relationships the value of which can be expressed in an amount of currency. However, in the event of default of one of the parties, netting offers special treatment of the non-defaulting party in relation to the insolvent's general creditors. Therefore, there need to be elements justifying a contractual relationship being covered by a netting arrangement. There are three such elements.

- *Single relationship*: contracts entered into on the understanding that they are connected to each other should be covered. (i) A first such case is the quasi 'natural' category of transactions in which the single relationship is directly implied. For example, swaps or repurchase transactions are entered into on the understanding that the mutual rights and obligations (which are legally distinct from each other) within a single transaction cannot be separated by the parties and should not be looked at separately in the event of one of the parties becoming insolvent (*i.e.*, no cherry picking should apply in relation to only one leg of these transactions). (ii) In a second category of cases, this single relationship is

wider and created contractually by the parties. However, given that close-out netting leads to special treatment in the event of insolvency, this contractual single relationship can only be established where there are good objective reasons to deal with a multitude of financial contracts on a collective basis. The main reasoning here is that it is more efficient for parties to monitor and manage their mutual risk exposure on the basis of an overall assessment of all contracts outstanding between them.

- *Rapid changes of value*: A second justification for applying close-out netting to certain of the parties' mutual rights and obligations stems from the fact that the volatility of the value of certain financial transactions would expose parties to considerable market and credit risk which they would have difficulty managing if they were not allowed to terminate such transactions upon the occurrence of one of the pre-defined termination events, in order to determine gains and losses and to re-hedge their portfolio. Any stay on termination imposed by (in particular) insolvency law would lead to the contractual close-out rights being delayed. Rapid and significant changes in the contract value during this time might expose the non-defaulting party to a multiple of the anticipated counterparty and market risk which cannot be hedged any more in an appropriate way.
- *Systemic risk*: A third justification is the avoidance of systemic risk. This element flows partly from the second justification. In deteriorating market conditions, the ability to terminate contracts and thus to limit exposures is important in guarding against the situation where the failure by one of the parties to perform its obligations causes its counterparty likewise to become unable to perform its obligations vis-à-vis third parties.

Explanation

General

41. The term 'financial contracts' is understood in a broad sense and also includes contracts that might be categorised as 'commercial' contracts. It is impossible to make a neat distinction between financial contracts, on the one hand, and commercial contracts, on the other hand. For instance, futures and forwards are both used by industrial and commercial companies to hedge price swings in relation to raw materials, *etc*. Application of these rules to contracts entered into by energy traders, airlines and similar businesses would be beneficial as these face similar exposures to rapid price swings as face financial firms.

Paragraph (a) – Derivative instruments

42. The term 'derivative instrument' describes a financial contract the value of which depends on a reference value. The reference value can consist of rates or indices, or of any other measure of economic value, or of factual events. In today's markets, the reference value usually consists of a rate, yield, price or index relating to interest rates, currencies, transferable securities, money market instruments, commodities, precious metals, credit risk, energy, emissions, economic or monetary statistics, actuarial or other insurance-related data, meteorological data, freight forward rates, bandwidth or property. However, other reference values are also conceivable.

43. Derivative instruments will typically fulfil all three criteria (*cf.* key considerations, *supra*) for inclusion into the scope of eligible contracts. First, two typical financial market participants like banks, merchant banks, funds, insurance companies, etc will always regard the multitude of their open derivative instruments with each other as one single relationship. The risk monitoring and assessment will be done by the parties on an aggregate basis.

44. Derivative instruments also pass the test of the second criterion, *i.e.* exposure to considerable market and credit risk. They are the paradigmatic high volatility transactions with

rapid and significant price movements. Rapid price movements combined with huge outstanding notional amounts and transaction volumes also pose the threat of systemic risk (third criterion).

45. Financial markets subdivide derivatives contracts into a number of categories, notably options, forwards, futures, swaps, contracts for differences, and their respective subcategories. The boundaries between these categories are not always clear-cut. Moreover, the list of derivatives categories can never be exclusive, in view of the need to cater for future market developments and differences in categorisation. Therefore, the underlying consideration is that these principles apply to all derivatives covered by the definition in the preceding paragraph, regardless of which category market practice may attribute to them.

46. Certain types of derivative can be either physically settled or cash settled. Both are included within the scope of these principles.

47. For the purpose of these principles, it is immaterial whether the relevant contracts are entered on-exchange or off-exchange, or whether they are settled 'over-the-counter' or through a clearing mechanism or central counterparty (*n.b.* that in the latter cases, a bilateral close-out netting agreement between the central entity and the system participant emerges, *cf. supra* paragraph 19).

Paragraph (b) – Securities repurchase agreement, securities lending and margin loans

48. Paragraph (b) covers three methods of securities financing: sale and repurchase agreements, securities lending agreements, and margin loans.

49. A repurchase agreement is a combination of two processes simultaneously agreed upon between the same parties: first, the sale and outright transfer of an asset (*e.g.* a bond), and second, the subsequent repurchase and re-transfer of that same asset at a slightly higher price. This type of agreement is driven by cash needs, *i.e.*, in functional terms, it has the same effect as a loan. The cost of financing (reflected, under a loan agreement, by the payment of interest) is here expressed in the price difference between the sale and repurchase legs of the transaction.

50. Securities lending entails that the securities are made available to the counterparty under a pledge and a simultaneous agreement to retransfer them at a predetermined point in time. The borrower must provide collateral (*e.g.* in the form of cash) to the lender for the duration of the arrangement. Securities lending is mostly driven by the borrower's need for a certain type of securities.

51. In functional terms, the mutual flows of assets are identical for both types of transaction. Both types consist of a pair of reverse transactions. Although in both cases, each separate transaction could be regarded as legally independent, neither a repurchase agreement nor a securities lending agreement should be at risk of unbundling in an insolvency procedure. Therefore, a repurchase or a securities lending agreement *per se* fulfils the first element of justification mentioned above (single relationship, first case).

52. In much the same way, under a margin loan money is advanced by a bank to its customer to purchase financial instruments on condition that the bank can subsequently regard these financial instruments as collateral securing the loan. Again, the two prongs of such arrangements are (i) a flow of cash in one direction, and, (ii) the provision of rights over securities (collateral) in the other direction. The collateral can be provided under a title transfer arrangement or a non-title transfer arrangement (*cf. paragraph (c), infra*), *i.e.*, depending on the arrangement, ownership of the securities is transferred to the bank.

53. Where two parties have a multitude of repurchase, securities lending and margin lending agreements, these are usually closely interconnected as the cash and collateral flows are managed on an aggregate basis rather than separately. As a consequence, there is an objective reason for the parties to cover their mutual exposures flowing from these types of transaction in a close-out netting agreement (single relationship, second case).

Paragraph (c) - Title transfer collateral arrangements

54. There are title-transfer collateral arrangements and non-title transfer collateral arrangements. They differ as to their nature and the analysis as to whether they are suitable to be included in a netting agreement differs accordingly.

55. The first type of collateral arrangement involves traditional security agreements such as pledge or charge. These are characterised by the fact that they are proprietary in nature and both the collateral provider and the collateral taker have proprietary interests in the encumbered asset. In particular, the collateral provider will usually retain legal title to the asset. This type of arrangement is not generally susceptible to close-out netting as commonly understood, since it is impossible to aggregate a net sum that encompasses these proprietary positions. This is because the characteristics of split property cannot be expressed in purely monetary terms.

56. Under a title transfer collateral arrangement, full legal title is passed to the collateral taker and the collateral provider receives a claim for transfer of the identical sum or asset at a later stage (*cf.* also *paragraph (b)*). There is no split property. As a consequence, the valuation and inclusion in the net amount of both legal positions (full title on the one hand – claim on the other hand) are possible.

57. An important hybrid category is the non-title transfer collateral arrangement which includes a right of use. In some cases, the relevant law permits parties to agree, generally or in effect, that the proprietary right may, under a non-title transfer collateral arrangement, be replaced, at the election of the collateral taker, by a right to the return of identical or equivalent assets. This is the case, in particular, where the agreement, sanctioned by the relevant law, permits the collateral taker to use the encumbered asset for its own purposes, in particular to 'rehypothecate' it, and subsequently to return not the *same* asset but an *identical* or *equivalent* one. In this instance, the residual property interest originally vested in the collateral provider ceases to exist in this instance and is replaced by a contractual claim for re-transfer. In other words, the use of the encumbered asset by the collateral taker for its own purposes transforms the legal characteristics of a non-title transfer collateral interest into those of a title transfer collateral arrangement. As both positions (full title on the one hand – claim on the other hand) can be given a clear market value, such an arrangement is capable of being included in a netting arrangement.

58. As is the case with repurchase agreements and securities lending agreements, the separate obligations which constitute a title transfer collateral agreement (and a non-title transfer collateral agreement including a right of use) should not be at risk of being unbundled by the insolvency law (single relationship, first case). Likewise, collateral is managed on an aggregate basis. For this reason, a multitude of collateral arrangements between two parties should also be capable of being included in the scope of close-out netting.

59. It is important to note that repurchase, securities-lending as well as title transfer-collateral agreements are collectively managed and monitored from the perspective of counterparty risk. Because of the functional convergence of these types of transaction, there is good reason to do so. Therefore, it makes sense to cover all transactions falling into one of these three categories by a netting agreement between two parties.

Paragraph (d) – Deposits

60. In considering whether and to what extent deposits should be included within the ambit of legislation aimed at and affirming the enforceability of close-out netting, domestic legislators and policymakers will need to give careful consideration to various policy objectives.

61. Loans and deposits are closely related from a functional perspective. Both are technically an advance of money (the principal) by one party to another, entailing a promise to return the principal at some point. Both generally, but not necessarily, carry the obligation to pay interest. A

more superficial difference concerns the parties' motivation. It is assumed that a borrower accepts the principal from the lender in order to satisfy its own funding needs, whereas the depositary rather takes the role of safe-keeper of the money in the depositor's interest. However, in practice, banks' traditional sources of financing have been their clients' deposits, a fact which rather blurs that distinction. From a functional and legal point of view, therefore, loans and deposits are akin to one another. From a regulatory point of view, on the other hand, deposits enjoy specific protection, most particularly the circumstance that traditionally, only licensed credit institutions ('banks') are able to take deposits.

62. The first question is whether there is a practical case for including deposits within the scope of these principles. (*e.g.*, deposits of one bank with another bank; of an industrial company with its bank; of a hedge fund with its prime broker). This question is to be considered from the viewpoint of professional market participants and of consumers.

63. As to professional market participants, the question of whether deposits should be covered by these principles relates mainly to the phenomenon of 'cash-pooling'.

64. Cash pooling occurs where member companies of the same group manage their cash reserves collectively. Typically, the positive credit balance of one member of the group is made available to any members that are in need of cash, through a common master cash account held by the parent company. A deposit (alternatively: loan) arrangement comparable to a revolving account facility exists between each member of the cash pool and the parent company, under which mutual repayment obligations are expressed as a net credit balance. Legally, mutual payment obligations are not settled until the member in question exits the cash pool arrangement (despite the fact that the current exposure is expressed as a net balance). However, the parties would not enter into such agreement if their exposure were not limited to the net exposure in the event of the counterparty's insolvency. If the insolvency administrator were able to cherry pick those deposits/loans which were favourable to the insolvent estate, and if it could at the same time set aside those that were unfavourable, the risk to the solvent party would be incalculable. It would therefore make sense for the common use of cash pooling arrangements to be included within the scope of these principles. In other words, deposits and loans made in the context of such arrangements should be eligible contracts.

65. The second question is, to what extent should deposits be included generally? This is relevant in particular in the context of consumer protection. There are two points to consider.

66. From a policy angle, there might be a need to prevent netting in respect of consumer deposits. Yet, netting is conceivable only where the deposit (*i.e.*, a bank's debt towards its consumer-customer) is paralleled by a customer debt with the bank, in particular a debt arising from a consumer credit, a house mortgage, or a payment obligation arising from the purchase of investment assets. In many jurisdictions, if the customer defaults, the bank would be allowed to set off or otherwise combine these mutual obligations or to realise a pledge taken over the deposit. Logically, the same should apply upon the bank's insolvency. It would be contrary to consumer protection imperatives to allow the insolvency administrator to cherry pick and uphold the consumer's debt to the bank while the bank's debt to the consumer (the deposit) was referred to the insolvency proceeding. While it might be tempting to bar netting or insolvency set-off and to refer the consumer to a deposit compensation scheme (*cf. infra*), this would ultimately result in the deposit compensation scheme supporting the bank's general creditors. Thus, regardless of whether the mechanism is regarded as set-off or netting, it does appear to be a measure that protects consumers both inside and outside the insolvency situation while taking the burden off the consumer compensation scheme (where applicable), as well.

67. A specific concern is that, if close-out netting were to apply between a bank and its customer, the bank would have a convenient means of realising payment claims against the customer stemming from risky investments arranged for the customer by the bank, in particular where the risks incurred had been actually or allegedly misrepresented. Regulators are chiefly

concerned about the scenario where consumers are first talked into an unfavourable and ultimately loss-making investment and the bank then enforces the resulting payment obligation by 'netting away' the consumers' deposit. However, it is questionable whether this – realistic – scenario can actually be resolved in the context of netting. First, the question of which product a bank is allowed to sell to consumers, as well as the framework preventing misrepresentations, are part of the rules on the conduct of business, traditionally a highly regulated area the aims of which cannot be achieved through commercial law considerations. Second, netting might also protect the customer in the event of the bank's insolvency. Third, the bank would be able to achieve the same result via set-off or by taking a pledge over the customer's deposit.

68. An additional issue to consider is that of deposit insurance schemes. The question is whether the possibility of including deposits in netting arrangements might conflict with the protection afforded to deposits under such schemes. In many jurisdictions, certain types of deposit are guaranteed in the event of the bank's insolvency. The legal setup of these schemes varies (insurance, mutual fund of banks, state guarantee, *etc*.). Generally, such protection schemes are limited to deposits made by consumers, although they occasionally extend to deposits made by small businesses. It is very rare for all deposits, including deposits made by any type of business, to be covered. If netting (or insolvency set-off) were to be precluded in the event of the bank's default, the consumer would have to perform on its debt vis-à-vis the bank (since the administrator will cherry pick this claim), whereas the insolvent estate would not perform on its own debt, *i.e.*, the deposit. Netting (or insolvency set-off) would eliminate the customer's exposure in this respect. To compensate the customer in such cases by means of a deposit insurance scheme would certainly protect the customer from loss but might distort the overall picture. If the customer is prevented (on the grounds that its deposit is protected) from invoking its counterclaim against the bank (the deposit), the deposit compensation scheme would ultimately contribute indirectly to increasing the insolvent estate, to the benefit of the general creditors.

Paragraph (e) – Loans

69. As in the case of deposits, the inclusion of loans within the scope of close-out netting needs to be considered carefully. At first sight, loans do not pose a particular risk that can be best prevented by the application of close-out netting. However, a number of factors indicate that the inclusion of loans might be worth considering in certain circumstances.

70. Loans mainly consist of a transfer and retransfer of cash. This functionality is identical to the cash leg of a repurchase agreement, a securities-lending agreement and a cash-title transfer collateral agreement. Carving out loans generally would pose the risk that a clear distinction between (ineligible) loans and the cash leg of the aforementioned (eligible) transactions would need to be made. This might be difficult, particularly in a cross-jurisdictional situation, and thereby create legal uncertainty.

71. The comments in respect of deposits and cash pooling equally apply to loans.

Paragraph (f) – Contracts for the sale and delivery of certain assets

72. *Paragraph (f)* relates to contracts for the sale and delivery of certain assets against payment in so far as they are not covered by the definition of derivative instruments, in particular futures and forwards. Consideration needs to be given to the extent to which the inclusion of contracts for the sale and delivery of certain assets into the scope of these principles is justified in light of the criteria mentioned in the *key considerations,* above.

73. Transactions involving (near) immediate delivery against payment do not appear to give rise to any particular risk which could only be sensibly addressed by including such transactions within the ambit of close-out netting.

74. A different case might be the spot market, where prices are agreed and paid immediately whereas delivery occurs within a time frame of under one month. A typical example is the spot market for crude oil.

Paragraph (g) – Surety agreements

75. This paragraph ensures that not only the (direct) parties to an eligible contract fall within the scope of these principles but also third parties that promise to perform on the obligation of another of the parties to that eligible contract. The most prominent of such arrangements are guarantee and indemnity arrangements or letters of credit, or other types of personal surety that may exist in different jurisdictions and regardless of the wording employed.

Paragraph (h) – Unjustified enrichment

76. Claims based on the principle of unjustified enrichment arise where assets have been obtained without a valid contractual basis. A simple example is the transfer of assets made despite the fact that the envisaged underlying agreement has not been properly concluded, for example due to an operational failure. Where the parties maintain an ongoing business relationship, such an eventuality is covered by a netting arrangement, and the envisaged, but invalid transaction would be covered by that netting agreement. It would appear natural to include claims based on unjust enrichment in that same netting agreement. These concepts are often covered by references to law merchant or normal business practice under the applicable laws.

Principles 4-6 on formal requirements for close-out netting provisions

4. The law should not make the creation, validity, enforceability or admissibility in evidence of a close-out netting provision dependent on the performance of any formal act, but the law may require that a close-out netting provision shall be evidenced in writing or any legally equivalent form[64].

5. The law should not make the creation, validity, enforceability or admissibility in evidence of a close-out netting provision dependent on the use of standardised terms of specific trade associations[65].

6. The law may require the registration of financial contracts covered by a close-out netting provision [and of the provision itself] with a trade repository or similar organisation for regulatory purposes. A failure to comply with such requirement should not affect the creation, validity, enforceability or admissibility in evidence of [the financial contracts and] the close-out netting provision[66].

Key considerations in respect of these principles

- Formal requirements that impinge on the legal enforceability of close-out netting provisions have considerable potential to create legal uncertainty in a cross-jurisdictional context.
- The enforceability of close-out netting should not depend on the use of standard documentation so as to allow for tailor-made close-out netting agreements and framework agreements, for individual changes to existing standard documentation or for market-led

[64] *Cf.* former Principles 6 and 7.
[65] *Cf.* former Principle 8.
[66] *Cf.* former Principle 9.

changes of standard documentation itself. The regulatory framework may impose restrictions in this regard; however, these must not hamper enforceability in commercial and insolvency law terms.

- Registration of financial contracts with trade repositories and similar organisations is an important feature of the supervisory framework. However, non-compliance with the duty to register financial contracts should not entail the non-enforceability of the relevant close-out netting provision [and of the financial contracts].

Explanation and commentary

77. The effect of non-compliance with formal requirements needs to be considered carefully. Where such non-compliance entails invalidity or unenforceability of a contract, the legislator should always have regard to the fact that *both* parties to a contract are affected by this consequence. The effect of a considerable number of contracts and/or a close-out netting provision being unenforceable can pose a significant risk to one or both of the parties. In particular in cross-jurisdictional situations, there is a significant risk that at least one of the parties might be taken by surprise by that consequence. Thus, where the rules on form aim at promoting safe and sound market conditions, it might be better to settle for other enforcement measures, such as fines, personal liability of staff, withdrawal of license, *etc.*, which can be imposed without creating additional legal uncertainty for the counterparty.

Principle 4

78. For the above reasons, in a cross-border context, any formal requirements other than writing (or equivalent forms) appear to create additional risk. There are two strands of such potential risk.

79. First, there is the general risk that, in a cross-border context, formal requirements other than writing are liable to be misunderstood or mishandled from an operational point of view. Such requirements might be overlooked, in particular as it cannot be excluded that different laws may be applicable within a single bundle of financial contracts covered by a netting agreement. The necessary steps might not be carried out simply for practical reasons such as language requirements.

80. Second, even if formal requirements are initially complied with under the first law, any possibility of transferring a close-out netting agreement (including the contracts covered) to a new, foreign entity would be in jeopardy since it is unlikely that the law of the acquirer would require compliance with exactly the same formal steps.[67]

- This aspect is particularly relevant where a holding company re-integrates with a hitherto legally independent foreign subsidiary, in which case all contractual agreements entered into by the subsidiary would from that point on be subject to a different insolvency law, *i.e.*, the law applicable to the parent company. It is unclear whether a financial contract transferred in this manner would be upheld in the event of the parent company's insolvency if the formal requirements regarding the close-out netting provision [or the underlying contracts] differed.
- It is equally relevant in the context of bank resolution powers, which usually include the possibility of transfer, by regulatory order, of part or all of a bank's business to a second (solvent) bank. If the receiving second bank is subject to a different insolvency law, and if that law imposes formalities on close-out netting provisions, it is very unlikely that the

[67] *Cf.* Doc. 2, p. 37 (Example 7), p. 71 (Example 17).

formalities (if any) under which the close-out provision was originally entered into would suffice.

Principle 5

81. Another issue is the tension between netting agreements contained in a standard master agreement and agreements between parties that wish to customise the close-out netting provision. If jurisdictions were to protect the enforceability of netting agreements only where the latter are included in standard documentation, individual amendments would imperil enforceability.

82. However, the relationship between two financial institutions can be quite an elaborate one and call for the master agreement to be customised to some degree. It is impossible to harmonise the extent to which such changes should be admissible, simply because there are too many different, individual situations. Hence, the concept of only protecting the enforceability of netting agreements that are part of standard documentation is not suitable in a cross-jurisdictional context.

Principle 6

83. In attempting to render the derivatives market more transparent, many jurisdictions have recently introduced or are about to introduce a duty to register certain types of standardised derivatives with a register or trade repository. This act of registration is required for prudential/supervisory purposes. It should not be made a condition for a financial contract's capability of being included in a netting agreement, since the motivation is not the same. Additionally, the legal consequences are different: non-registration as such, in the supervisory context, does not produce risk but will merely entail fines or similar sanctions. Where registration is a prerequisite for the enforceability of the netting agreement, any non-compliance with that requirement would actually create risk, since it would endanger enforceability in situations which the parties (and possibly also their regulator) might not have anticipated since non-registration in most cases will be a consequence of unintentional operational failure.

Principle 7: Enforceability of close-out netting

7. The law should ensure that a close-out netting provision is enforceable in accordance with its terms,[68] before and after the commencement of an insolvency proceeding in relation to one of the parties.[69] Without limiting the generality of the foregoing –

a) The law should not impose enforcement requirements beyond those specified in the close-out netting provision itself or those required for commercial contracts generally.[70]

b) A close-out netting agreement should remain enforceable even if one or more of the financial contracts covered are unenforceable.[71]

c) If an insolvency proceeding in relation to one of the parties has been commenced,

i. the insolvency administrator or court should not be allowed to demand from the other party performance on only some of the financial contracts covered by the close-out netting provision, while repudiating the remaining contracts;[72]

ii. the operation of the close-out netting provision should not be stayed;[73]

iii. the operation of the close-out netting provision should not be impaired by principles relating to the equal or* pari passu *treatment of creditors;[74]

iv. a close-out netting provision should not be unenforceable solely on the basis that it was entered into during a prescribed period before, or on the day of but before, the commencement of the proceeding.[75]

Key considerations

- The enforceability of close-out netting agreements often conflicts with a number of general commercial and insolvency law rules. This principle aims at protecting close-out netting agreements from the effect of the application of these rules.
- Close-out netting agreements shall be enforceable between the parties and against third parties, including the insolvency administrator and the general insolvency creditors, if applicable, of the defaulting party.
- However, close-out netting is not shielded against *every* rule of commercial or insolvency law. The demarcation between those legal rules that should not apply to close-out netting and other legal rules that should continue to apply requires careful consideration. Special attention should be paid to the compatibility of enforceable close-out netting agreements with supervisory authorities' bank resolution powers.
- For purposes of international compatibility, a common standard in this regard is of utmost importance.

[68] *Cf.* Former Principle 10.
[69] *Cf.* Former Principle 11.
[70] *Cf.* former Principle 13.
[71] *Cf.* former Principle 16.
[72] Newly inserted.
[73] Newly inserted.
[74] Newly inserted.
[75] *Cf.* former Principle 15.

<u>Explanation and commentary</u>

<u>Chapeau</u>

84. The *chapeau* of this principle aims at clarifying two aspects.

85. First, it makes sure that the scope of the protection covers non-insolvency situations as well as the insolvency of one of the parties to the netting provision.

86. Second, it is a 'catch-all' provision addressing all statutory rules that could potentially conflict with close-out netting provisions but should not (reservations apply, *cf. infra*).

87. The background of the formula '*before and after the commencement of an insolvency proceeding'* in the *chapeau* is as follows. Outside insolvency, a close-out netting provision is a bilateral contractual relationship. Since such a netting provision rarely clashes with policy, the law has scant reason to prohibit or limit its use. As a consequence, a netting agreement will generally be effective and enforceable as between two solvent parties.

88. The role of close-out netting in reducing counterparty and systemic risk becomes dominant in particular in the event of the counterparty's insolvency. However, rules of insolvency law intended to preserve the insolvency estate for distribution to creditors and to ensure equal treatment of the latter are potentially incompatible with essential features of close-out netting. One of the primary purposes of insolvency law is to determine the question of which creditors' claims should be prioritised over other creditors' claims. Insolvency law traditionally provides for tools such as 'cherry picking' and avoidance of contracts to put its insolvency policies into practice (*cf. infra*), and the application of such rules may render close-out netting provisions meaningless.

89. However, the enforceability of close-out netting is crucial both inside and outside insolvency. Accordingly, the purpose of the *chapeau* is to make clear that the law should protect the enforceability of a close-out netting provision throughout its lifetime and regardless of what type of procedure might be opened over one or both of the parties (regarding the special status of bank resolution procedures, *cf. infra*). To this end, the definition of 'insolvency proceeding' has been kept very wide (*cf.* [special definition]). In this context, it is worth noting that procedures which are technically not insolvency proceedings such as amicable creditor settlements, are also included in the scope of protection (which leaves however unaffected the possibility to change the close-out netting provision by agreement).

90. The wording '*enforceable in accordance with its terms'* is the core idea of these principles. It relates to the challenge posed to close-out netting provisions by some quasi-universally recognised legal rules. The best example is probably the insolvency administrator's right to 'cherry pick' (*cf. infra*), but there are others. However, the diversity of legal systems and of the rules within them makes it very difficult to find a general, international formula that precisely describes which commercial and insolvency law rules and principles cause problems. Such a description is possible only in relation to the most obvious rules, which are here captured under paragraphs (a)-(c). However, as close-out netting agreements are embedded in commercial and insolvency law in much the same way as any other contract, many other legal obstacles are capable of rendering a close-out netting agreement unenforceable. These are potentially numerous, but difficult to describe.

91. An important reason for this is that close-out netting is a new concept as yet not properly addressed in many jurisdictions, thereby forcing the courts to seek analogies to deal with this new matter.

92. A telling example of a conflict that might hamper the enforceability of close-out netting would be its assimilation to statutory set-off rights under commercial law and the resulting application of the requirements for set-off to close-out netting. Despite the fact that statutory set-off is more limited than netting, in the absence of any clarifying legal rule courts and insolvency administrators might apply its requirements in analogy to close-out netting agreements, thus

potentially distorting the enforceability of close-out netting. In particular, (i) set-off traditionally applies only to obligations that are due; (ii) set-off traditionally applies only to obligations flowing from the same agreement, or that are very closely connected to each other; (iii) set-off applies only to payment obligations or obligations of the same kind. As these requirements will rarely be complied with by a close-out netting provision, there is a real risk that it will be stayed or declared invalid.

93. However, as analogies like these are probably very diverse, there is a need for a 'catch-all' rule. This is why the *chapeau* prescribes that close-out netting, as defined in functional terms in *Principle 1*, should be generally enforceable.

94. It is obvious, though, that close-out netting provisions would never be allowed to trump certain other fundamental rules, such as the rules relating to misrepresentation and fraud. In certain cases, the distinction may be quite difficult to make (*cf.* in particular *paragraph (c)(iv) infra*). This is why in *paragraphs (a)-(c)* this principle sets out the most typical challenges to close-out netting provisions stemming from general insolvency and commercial law rules that should be disapplied.

95. Additionally, there are legal rules specifically intended to supersede close-out netting agreements, in particular rules applicable in the context of bank resolution.

Paragraph (a) – Additional enforcement requirements

96. The practical value and effect of close-out netting would be significantly diminished or even rendered void if the law were to impose formal, procedural or other specific requirements as conditions for the enforcement of close-out netting provisions that went beyond those that the parties might have contractually agreed. In particular, the requirements traditionally imposed on the realisation of security interests such as pledges, charges and mortgages should not be made to apply to close-out netting. Such specific requirements may include, for example,

- Notarisation or registration of the agreement with a public authority;
- prior notice to the defaulting party that the close-out netting provision may be put into operation;
- approval of the terms of the realisation or operation of the close-out netting agreement by a court or other public authority; or that
- the realisation be conducted by public auction or in any other prescribed manner, or that
- the close-out netting agreement be operated in a prescribed manner, or that
- the close-out netting agreement be subject to the requirements that may apply in the context of enforcing set-off.

97. It should be noted, however, that since the parties' contract is based on contractual freedom, they are free to include any of the above or similar requirements in the close-out netting provision, if they so wish.

Paragraph (b) – Non-enforceable financial contract included, no contagion

98. Another group of potential obstacles to the enforceability of netting provisions relates to the financial contracts covered. Where the applicable law characterises a particular type of contract as a non-enforceable contract, the enforceability of the netting provision as a whole, *i.e.*, with respect to the remaining financial contracts, might be endangered.

99. A first possible case relates to the inclusion of non-eligible contracts in the close-out netting agreement.

100. A second scenario relates to financial contracts that might not be enforceable *per se* in certain jurisdictions as a result of, for instance, legal rules of general commercial or contract law, *e.g.*, rules on misrepresentation or agency.

101. A rather prominent case relates to wagering or gaming prohibitions. This falls within the ambit of the previous group. Unenforceability on the grounds of such bans may in some jurisdictions be a cause for real concern, in particular in relation to derivative contracts.

102. Since the close-out netting provision and all the financial contracts to which it applies are often regarded as *one* contract, general principles of commercial law could hamper the enforceability of the bundle as a whole. A better solution would be to exclude from the netting mechanism only specific non-enforceable contracts once they have been identified.

103. It is important to note that this rule does not interfere with the question of whether the *single* contract, under the applicable law, is enforceable or not.

Paragraph (c)(i) – Cherry picking

104. In an insolvency proceeding, the insolvency administrator often has the right to 'cherry pick' from the insolvent party's non-performed contracts. This means that the insolvency administrator is entitled to require any counterparty to perform those contracts that are favourable to the insolvent estate.

105. Where cherry picking applies to the financial contracts covered by a close-out netting provision, the bundle of financial contracts intended to be covered by the close-out netting mechanism would be disassembled and the solvent party would have to perform all the contracts that were unfavourable from its perspective, whereas the insolvency administrator would not perform the favourable contracts – ultimately, the solvent party would be exposed to the full counterparty risk.

106. Cherry picking is essentially contrary to the characteristics of a single relationship set out *supra* (*cf*. *key considerations* in respect of Principle 3). Those jurisdictions that accommodate close-out netting tend to solve the conflict between cherry-picking and enforceability of netting provisions by disallowing the selection of isolated contracts but giving the insolvency administrator the right to decide whether the net amount is to be paid or not.

Paragraph (c)(ii) – Stay

107. Insolvency rules often impose a stay on all transactions with the insolvent estate as from the moment of the commencement of the proceeding. Such a stay would traditionally also inhibit the operation of set off. The reasoning is that further outflow of assets must be stopped and the insolvency administrator be given the right to repudiate all unfavourable contracts. However, a stay imposed on the termination of financial contracts might lead to contagion from the insolvent party to the solvent party in the sense that the latter becomes unable to perform on its own obligations vis-à-vis third parties ('systemic risk'). Further, from a conceptual angle, a stay appears unnecessary because the insolvency administrator should not have the right to choose among the open contracts (no cherry picking, *cf. supra*).

Paragraph (c)(iv) – Suspect periods, zero-hour rules

108. National insolvency laws often contain rules allowing the insolvency administrator or a court to avoid transfers or payments made prior to the opening of the insolvency proceeding, usually on the ground that not to do so would give an unjustified preference to one or more creditors over the remaining creditors, or give rise to unjustified deprivation of the insolvent estate of the relevant assets. In some jurisdictions, only transfers and payments that were made within a legally defined 'suspect period' can be avoided, whilst in other jurisdictions no time limit exists. In

the context of netting, the risk is that netting will be equated with performance of the obligations flowing from the financial contract.

109. However, the effect of close-out and termination under a netting agreement is not the same as that targeted by the insolvency avoidance rules. Parties cannot know at the time when they enter into a netting agreement which of them might subsequently become insolvent and which party will be 'in the money'. Thus, entering into a close-out netting agreement is neutral from the outset and equally beneficial or disadvantageous to both sides.

110. As netting agreements often define the termination event as something that might occur chronologically before but close to the opening of an insolvency proceeding (for example, the default of one of the parties), the netting mechanism might fall within the scope of the insolvency avoidance rules. Even in cases where the insolvency administrator's attempt to void the transfer or payment is subsequently overruled by a court, the netting agreement would not achieve its purpose of decreasing exposure to the counterparty's risk and avoiding contagion by the insolvency of one party affecting other participants in the financial market, which likewise constitutes a situation capable of creating systemic risk. As a consequence, the law should shield close-out netting provisions against rules on suspect periods and from zero-hour rules.

111. Consideration should be given to the question of whether this rule should also apply to the single financial contract covered by the close-out netting provision, *i.e.* whether a contract entered into during a suspect period cannot be avoided either. At any rate, if there were no such rule, any contagion of the entire bundle of contracts would be avoided under the rule described under *Paragraph (b)*.

Principle 8: Conflict-of-laws Rules for Close out Netting

[tbd.]