



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

***First Meeting***  
**Rome, 18 – 21 April 2011**

UNIDROIT 2011  
Study LXXVIII C – Doc. 4  
Original: English  
July 2011

**REPORT**

(prepared by the UNIDROIT Secretariat)

Introduction	2
I. General discussion	2
II. Basic assumptions for the future instrument	3
A. Determining the scope of the future instrument	3
B. Harmonisation of the understanding of netting and the mechanism protecting its enforceability	4
C. Exempting netting agreements of insolvency law restrictions	5
D. The interplay with regulatory bank resolution powers	7
E. Discussion on the form of the instrument	8
III. Consideration of the tentative draft structure for a future international instrument on close-out netting (UNIDROIT - Study 78C – Doc. 3)	8
A. Definitions	8
B. Formal requirements for close-out netting agreements	11
C. Enforceability of close-out netting agreements	12
D. Enforceability of umbrella-netting agreements	16
E. Conflict of laws	17
F. Eligible financial contracts	18
G. Eligible parties	21
APPENDIX I Agenda	23
APPENDIX II A first tentative structure for Principles regarding the enforceability of netting	25
APPENDIX III agreements (UNIDROIT – Study 78C – Doc. 3)	26

## **Introduction**

1. The *Study Group on principles and rules on the netting of financial instruments* – set up pursuant to a decision taken by the UNIDROIT Governing Council at its 89<sup>th</sup> session, held in Rome from 10 to 12 May 2010<sup>1</sup> and endorsed by the General Assembly of the organization at its 67<sup>th</sup> session held on 1 December 2010<sup>2</sup> - met in Rome at the seat of UNIDROIT from 18 to 21 April 2011.
2. The study group agreed to use as a basis for its deliberations a 'Preliminary draft Report on the need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution' ('the Report'), which had been prepared for the UNIDROIT Secretariat by Mr. Philipp Paech<sup>3</sup>.

### **I. General discussion**

3. The Study Group began its deliberations with a general discussion on the desirability and feasibility of developing an international instrument on the enforceability of close-out netting. There was agreement that today's fragmentation of the various national netting schemes might severely limit the effectiveness of close-out netting as a risk-mitigation tool in international financial markets. The financial crisis had once more shown the need for legal clarity and certainty for netting agreements. Hence, the participants of the Study Group agreed that there was a need for an international instrument to enhance the consistency and cross-recognition of the national netting schemes and to provide guidance on netting schemes for developing countries.
4. The Study Group also agreed upon a set of fundamental objectives of the project:
  - Netting should be available and enforceable in all financial markets.
  - The understanding of netting and the mechanism protecting its enforceability should be harmonised – if this was not completely possible, cross-recognition should be enhanced.
  - A clear and compatible conflict-of-law regime should be developed that ensured legal certainty and clarity.
5. The Study Group further addressed the issue of parallel legislative activities in various States and international fora. It envisaged to interact with the *European Commission* and the *Cross-border Bank Resolution Group (CBRG)* of the Basel Committee in different communicating phases. For the time being, communication should take place through participants who are engaged in both fora.
6. Conflict-of-laws issues should be examined in cooperation with a sub-group of the *Hague Conference* that might be set up for that purpose. UNIDROIT and the *Hague Conference* should reach out to their respective constituencies to determine how to formalise any future cooperation according to the proceedings of the organisations.

---

<sup>1</sup> <http://www.unidroit.org/english/documents/2010/cd89-conclusions-e.pdf>.

<sup>2</sup> <http://www.unidroit.org/english/documents/2010/ag67-09rev-e.pdf>.

<sup>3</sup> Preliminary draft Report on the need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution, prepared by Dr. Philipp Paech, London School of Economics and Political Science. The Report can be (<http://www.unidroit.org/english/documents/2011/study78c/s-78c-03-e.pdf>).

## **II. Basic assumptions for the future instrument**

### **A. Determining the scope of the future instrument**

7. The Study Group proceeded to consider the scope of the future instrument. It noted that different types of netting structures existed in practice: settlement netting in daily transactions, in payment systems and close-out netting, which was used as a means to mitigate risks. A high level of consensus was reached that settlement netting did not raise particular problems if close-out netting was enforceable in a jurisdiction. The Study Group agreed therefore to focus on close-out netting. It decided to clarify either in the preamble or the commentary to the future instrument that the limitation to close-out netting agreements was without prejudice to the protection of other forms of netting or other risk-mitigation techniques.

#### **1. CCP netting and multilateral netting**

8. The Study Group then moved to consider the treatment of multilateral netting in the future instrument. Some participants explained that cross-entity multilateral close-out netting – netting between entities that have not created mutuality of their obligations in a first step – was very rare in practice. They noted that most multilateral netting structures applied payment netting or novation netting (e.g. in trade compressions or foreign exchange settlement) but rarely close-out netting. Multilateral close-out netting raised considerable problems. Hence market participants would try to establish a bilateral relationship – sometimes even very artificial ones.

9. Against this background, some participants expressed the opinion that the Study Group should not address multilateral netting. They argued that it would be a very complex task to address pure cross-entity multilateral close-out netting and that it would not be worth the effort since multilateral close-out netting had little relevance. A proponent of this view conceded, however, that it might be helpful to set up a separate provision, which clarified that a close-out netting agreement could be part of a multilateral agreement. Another proponent stressed that the Study Group should also not address the creation of mutuality. He argued that creating mutuality was essentially a question of contract law.

10. Other participants felt that the issue of multilateral netting should be analysed in more detail and should be addressed in the future instrument. One participant explained that even in Central Counterparty (CCP) structures that created bilateral relations with each of the parties<sup>4</sup>, the transformation of multilateral into several bilateral relations brought about perfection issues. Some proponents of addressing multilateral netting cautioned against discriminating between different types of multilateral structures that existed in clearing and settlement arrangements today. They explained that a number of sometimes very significant set-ups existed which provided in their rulebooks that single net positions became due between each of the parties or towards the collectivity of the other participants. Those structures – especially with running accounts – gave rise to different legal issues which needed to be addressed.

#### **2. Collateral arrangements**

11. The Study Group considered whether the future instrument should protect collateral arrangements created in connection with the close-out netting agreement. It concluded that two aspects needed to be distinguished:

---

<sup>4</sup> The bilateral relationship is generally established by replacing the respective obligations between the parties with corresponding rights and obligations towards the CCP through novation.

- (a) the process of closing-out the obligation to return equivalent collateral against the matching “secured” obligation under a title transfer collateral agreement and
- (b) the true realisation of collateral.

12. The Study Group agreed that the obligation to redeliver collateral (a) could be netted under the close-out netting agreement. Several participants proposed to clarify in the definition of eligible obligations<sup>5</sup> that the term ‘obligation’ included obligations arising out of a title transfer arrangements (i.e. valuating the contractual obligation in return for fungible securities).

13. Varying views were expressed on the question whether the instrument should address the realisation of collateral (b). Some participants supported addressing collateral arrangements in the future instrument. They explained that a title transfer mechanism was inherent in some financial contracts (e.g. repos, securities and stock borrowing transactions) but that there were differing market practices with respect to taking collateral for other transactions (e.g. swaps, foreign exchange or commodity contracts). The latter transactions were predominantly realised on the basis of title transfer in some markets, and based on pledge or security interest in others. The proponents of addressing collateral arrangements argued that the future instrument should not disadvantage one of the two different mechanisms destined to achieve the same results - taking collateral – over the other.

14. Many participants cautioned against addressing the realisation of true pledge collateral (b) in the future instrument. They maintained that legal and practical arguments outweighed the market argument raised by the countervailing opinion. The legal argument was that the legal mechanisms for realising a pledge and for close-out netting differed considerably. The practical arguments were that pronouncements on pledge could give rise to completely different policy debates and thus burden the project with unnecessary difficulty. In addition, many instruments already protected collateral arrangements – amongst others the Geneva Securities Convention<sup>6</sup>. The proponents of this view proposed to simply make a cross-reference to Chapter 5 of the Geneva Convention in the commentary of the instrument as guidance for those countries who might be interested.

#### ***B. Harmonisation of the understanding of netting and the mechanism protecting its enforceability***

15. The Study Group noted that netting – initially an economic concept about settling the flow of claims on a net basis – had evolved to one of the most important risk-mitigation techniques. Netting had found varying translations into national laws in this process. Some jurisdictions applied the techniques of set-off and novation, some enacted particular netting statutes and some chose a non-comprehensive approach by disapplying certain provisions of the insolvency law to netting agreements. The Study Group further noted that also the notion and mechanisms of set-off varied greatly between jurisdictions.

16. To avoid misunderstandings based on pre-existent terminology, the Study Group agreed to take a functional approach defining netting in terms of its results. The Study Group realized that it had to bear in mind that the future instrument needed to be translated into the national legislative framework at a later stage. It might therefore need to evaluate different possibilities to integrate the functional elements of netting into the national legislation and propose changes to the national laws at a later stage

17. Based on the functional definition of netting proposed in the Report, the Study underscored the three characteristic elements of netting, namely:

---

<sup>5</sup> Cf. below (III.F.), p. 18 ff.

<sup>6</sup> UNIDROIT Convention on Substantive Rules for Intermediated Securities (Geneva, 2009). The text is available in English and French (original language), Chinese and Russian (unofficial translations) under <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm>.

1. Termination/Acceleration

The financial contracts are terminated and accelerated so that the obligations fell due.

2. Valuation

Each contract is validated and evaluated.

3. Aggregation/Determination of the net balance

The values are computed into a net sum that becomes the only obligation of the parties.

18. The Study Group agreed that each step could be achieved either by contractual or by statutory means. Contractual set-off was the most common approach and was included in securities lending agreements and in the ISDA context. One participant raised the question whether freedom of contract could be allowed with regard to all three steps. He wondered whether a netting agreement – thus a contract – could supersede statutory set-off provisions if set-off took place by an operation of law under certain jurisdictions.

19. One participant encouraged the Study Group to develop a functional definition for the first step of netting. He drew attention to the fact that the terms 'acceleration' and 'valuation' entailed different consequences. If the Study Group used the term 'acceleration', it would imply that the underlying obligations fell due – and would therefore be available for set-off in some countries. If the Group decided to use the word 'termination', it would entail that the obligations disappeared or were discharged and substituted by one single claim. He suggested that it was not necessary to use either term in the future instrument and proposed to formulate that outstanding obligations were 'discharged/disappeared' or that 'one claim arose' (through novation or set-off). Another participant cautioned the study group not to focus too much on due and non-due obligations.

20. The Study Group noted that the last step – which reflected the set-off mechanism – could be designed in various ways. If it was to include compensations for non-performance, market values would have to be determined in the previous step – since only the compensation sum took part the aggregation.

### **C. Exempting netting agreements of insolvency law restrictions**

21. The Study Group realised that each of three elements of netting faced challenges under the mandatory rules of insolvency law: Termination interfered with the right to cherry pick, valuation with crystallization and aggregation with set-off restrictions. Therefore, all three of them could potentially be attacked as contrary to the anti-deprivation and *pari passu* rule of insolvency laws.

Against this background, the Study Group considered it essential to explain in the future instrument why it remained within the fundamental objectives of public interest and fair treatment of creditors to exempt netting from insolvency law restrictions. The following justifications for netting protection were adduced:

- (a) Systemic concerns: The Study Group noted that the argument that netting was an efficient risk-mitigation mechanism to reduce systemic risk was well established and generally recognised by regulators<sup>7</sup>; hence, it would not have to be explained in detail.
- (b) The principle of recognition: The Study Group considered it a basic principle that a liquidator could not have greater rights than the insolvent company whose estate he inherited or managed. And the insolvent party was only entitled to claim the net sum. Liquidation was not intended to confer windfall benefits on the insolvent company.
- (c) The clash between close out-netting and traditional rules of insolvency law was not as important as it appeared to be. Netting did not contravene any of the key drivers of

---

<sup>7</sup> cf. Recommendations 8 and 9 of Report and Recommendations of the *Basel Committee on Banking Supervision*, set up by the *Bank for International Settlements* (<http://www.bis.org/publ/bcbs162.pdf?noframes=1>), p. 38 *et seq.*

insolvency policy. To elaborate this justification, classic netting arrangements needed to be divided into two categories:

- First, collateral enforcement mechanisms (e.g. close-out of repos or stop-lending agreements). The protection of those should be relatively uncontroversial because collateral agreements were a recognized exception to the rules of deprivation and *pari passu*-distribution.
- Second, netting under most sorts of derivatives contracts. The Study Group found that netting served in this context as a mechanism to fix the value of a unitary asset at the time of insolvency. Thus it protected a solvent party from being exposed to a one-way bet on the market by the liquidator. In that regard, the aggregation element of the netting mechanism deprived the liquidator of capacities: he lost the capacity to cherry-pick amongst the obligations between the counterparties. However, the Study Group felt that it was a generally recognized principle that a liquidator could not cherry-pick within one single asset.<sup>8</sup> From an economic perspective, a book of derivative business was commercially a single asset. Therefore, it was justified to exempt it from the insolvency restriction of cherry-picking.

22. Based on those findings, the Study Group concluded that netting merited protection. It was aimed to establish a fair distribution of risks between different creditors – and thus had the same objective as insolvency rules. Rules of insolvency that would disrupt netting and allow cherry-picking within what is economically one single asset would create both uncertainty and unfairness.

23. Some participants suggested that the Study Group would have to explain in the future instrument why each obligation of each party that the Group would define as eligible for close-out netting<sup>9</sup> merited protection from the general insolvency regime. In the light of the grounds cited above, a protection would be justified if it did not contradict the objectives of insolvency law but was designed as a legitimate protection for the counterparty against uncontrolled credit risk that arose from market movement.

24. The Study Group proceeded to consider protection mechanisms for close-out netting agreements. It noted that different national approaches existed today. Some countries had chosen to exempt close-out netting of the application of the entire insolvency law, whereas others had chosen to disapply only those provisions of the national insolvency law that specifically interfered with the netting mechanism.

25. The Study Group agreed to adopt a hybrid approach in the future instrument: A general rule providing that close-out netting agreements should be enforceable notwithstanding the commencement or continuation of insolvency proceeding should be complemented by a non-exhaustive list of provisions that should not be invoked to preclude the enforcement of netting agreements.

26. The Study Group decided that the non-exhaustive list of exemptions to insolvency law should be built on the enumeration of possible obstacles to netting enforcement listed by Mr. Paech in paras. 47 et seq. (p. 20 f.) and para. 105 (p. 33 f.) of the Report. This list will be reviewed and amended in the course of the project.

27. Participants of the Study Group further suggested to establish a two-tier structure instead of one single list with insolvency carve-outs mainly for educational purposes. This approach should facilitate the understanding of the proposal since insolvency law differed greatly amongst

---

<sup>8</sup> The Study Group noted that the rationale that one single asset should not be subject to cherry picking was recognised in many countries in the context of contracts of goods, where the not performed counter-transaction was exempted from the insolvency regime.

<sup>9</sup> See below the section on eligible financial contracts (III.F., p. 18-21 ) and eligible parties (III.G., p. 21 f. )

jurisdictions: In a first tier, the Study Group could explain the general principles of insolvency law (e.g. *pari passu* treatment of creditors and preserving the value of an insolvency estate) whereas the second tier could contain the non-exhaustive list of insolvency law provisions that shall not interfere with netting agreements. Others proposed to incorporate *ipso facto* clauses, moratoria and provisions interfering with the protection of collateral rights into the list. The Study Group has not come to a decision on these propositions yet.

#### ***D. The interplay with regulatory bank resolution powers***

28. The participants of the Study Group expressed the common understanding that netting should not jeopardize restructuring measures. Both instruments should rather go hand in hand since they aimed both at a reduction of systemic risk. The Study Group acknowledged that it was preferable also for the solvent counterparty to save a viable business. Its situation would not be negatively affected by resolution powers since all mechanisms and proposals of the regulatory fora did not entail cherry-picking capacities (cf. Recommendation 9 of the Basle Cross-border Bank Resolution Group<sup>10</sup>).

29. Varying views were expressed, however, as to the approach to take with respect to some regulatory measures that are currently being discussed in the regulatory sphere, in particular moratoria and bail-ins. The Study Group considered thoroughly the effects of those measures and came to the conclusion that those regulatory measures could prevent the enforcement of close-out netting in particular circumstances. One participant of the Study Group gave the example of moratoria or suspensions of payments imposed on a bank at very late stage of a crisis. A moratorium in that stage might result in a failure to pay and thus trigger the close-out under a master agreement. However, from a contract law perspective, the moratorium would impede payments under the master agreement. Thus set-off would not be recognized. If insolvency proceedings were then opened, set-off limitations would apply and prevent the enforcement of the netting agreement.

30. In that connection, some participants of the Study Group pronounced themselves in favour of an express statement in the principles that the three steps of netting - termination, validation of each single transaction and aggregation - should neither be affected by substantive insolvency law nor by regulatory intervention. The proponents of this wide approach argued that regulatory measures such as moratoria, haircuts or subordinations could and should only apply to the payment of the close-out amount calculated at the end of the three-step netting process. They believed that their view did not conflict with the resolution powers envisaged by the regulatory fora because regulators were mainly concerned about triggers, i.e. the fact that a transfer of business by a supervisor might trigger the close-out netting.

31. Others cautioned against any pronouncements on the effectiveness of regulatory measures in a civil law instrument and advocated that the Study Group should concentrate on substantive law and conflict-of-laws issues - at least in a first step. The balance between the interests of the non-defaulting party and other stakeholders had yet to be found in the regulatory sphere. One participant explained that it had not even been decided yet whether a moratorium suspended the trigger for the close-out or just the payment of the net sum and suggested to concentrate on private law matters for the time being. Another participant proposed to draw the line of netting protection between insolvency and pre-insolvency measures: only measures taken in true insolvency situations should be covered by the future instrument. This distinction was questioned by several participants. One participant explained that bank resolution generally took place outside insolvency proceedings. The last proposal would render the future instrument useless in many important situations. Another participant argued that both - bank resolution tools and insolvency

---

<sup>10</sup> *Bank for International Settlements/Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, <http://www.bis.org/publ/bcbs162.pdf?noframes=1> (hereinafter: Basel Committee CBRG Report), Recommendation 9, p. 42.*

law – had the same economical objective: saving a bank in growing concern while attributing losses to unsecured and uninsured creditors. The sheer fact that different legal techniques were employed could not justify the such a different netting protection.

32. A third Group of participants took intermediate positions. They cautioned against pronouncements on the validity of regulatory measures but suggested to guard against unattended side effects of regulatory measures by illustrating how netting would be affected by certain measures. One participants proposed to develop recommendations for market participants how to prepare for resolution measures – especially in the cross-border context. Others suggested that the Study Group could contribute to a common understanding of netting and delimitate the interaction between substantial law and regulators.

33. The Study Group agreed on the need for continuing its discussion of regulatory measures.

#### ***E. Discussion on the form of the instrument***

34. The Study Group considered the advantages and disadvantages of a soft law and a hard law instrument. It agreed to start working on principles for two reasons: first, principles could be adopted timelier which would increase the chances to influence the current discussion at international level. Second, principles allowed for more educational content. Some participants voiced the opinion that a Model Law was the better instrument and stated that the Study Group might envisage to develop a Model Law if the principles became articulated and detailed enough.

35. The Study Group agreed to keep the question of the form of the instrument under consideration.

### ***III. Consideration of the tentative draft structure for a future international instrument on close-out netting (UNIDROIT - Study 78C – Doc. 3)***

36. On behalf of the Secretariat, Mr Paech had prepared 'a first tentative structure for Principles regarding the enforceability of netting agreements' that was distributed to the Study Group before its first meeting and is annexed hereto as APPENDIX III.<sup>11</sup> The Study Group expressed the common understanding that the structure and tone of the proposal provided a sound basis for future discussions and for the core recommendations.

37. The Study Group agreed to change the heading of the instrument to reflect that it only dealt with close-out netting.

#### ***A. Definitions***

38. As preliminary consideration on the structure, the Study Group came to a consensus that the list of the eligible parties and eligible financial contracts would have to be integrated into the definitions. A possible hook could be to define the term "obligations" in the close-out netting definition.

##### ***1. "Close-out netting agreements"***

39. The Study Group noted that the proposal to define "Close-out netting agreements" in a structure with two indents mirrored in essence Art. 31(3)(j) of the Geneva Securities Convention. It discussed briefly whether this structure should be altered to **reflect the three elements of**

---

<sup>11</sup> The document is also available on the internet under <http://www.unidroit.org/english/documents/2011/study78c/s-78c-03-e.pdf>.

**netting** – acceleration/termination, valuation and aggregation - identified before<sup>12</sup>. It noted that an example for a three-indent approach could be found in the ISDA Model Netting Act. The Study Group postponed a decision on the structure.

40. The Study Group further noted that the proposed definition referred to **acceleration only in its first indent**. It understood that the definition was based on the assumption that acceleration was not a precondition for close-out netting but an optional feature: The current definition would allow parties to determine in their contract whether they considered acceleration to be necessary or not. One participant of the Study Group cautioned against such an open formulation and argued that it might create confusion between close-out netting (which applied to obligations that had not fallen due) and other forms of netting (of due obligations). Other participants of the Study Group spoke in favour of the proposed approach and argued that payment and settlement systems as well as an ISDA Master Agreement did not imply acceleration. One participant opined that the acceleration of claims should not be made a prerequisite for close out netting without analysing the possible consequences first. A decision has not been taken.

41. The Study Group proceeded to consider on more general terms whether the Principles should address netting provisions in clearing and settlement systems. Some participants were however critical of this proposition. They argued that those structures were complex and that netting agreements within those systems had different objectives than insolvency protection, i.e. preserving the integrity of the system and preventing interruption of the ongoing business of the platform. The Study Group should not devote much time to address these structures since they used specific provisions tailored to their needs. A majority of participants stated that the Group needed to have a better understanding of these structures before further deliberation. The Study Group solicited the Secretariat to prepare a comparative table showing the relevant provisions of and on clearing payment and settlement systems.

42. Several participants of the Study Group raised concerns regarding the term '**close-out netting agreement**'. They favoured the use of a broader term such as 'netting provision' which was also the expression used in the Geneva Securities Convention and the Financial Collateral Directive<sup>13</sup>. The participants advocating for the wider approach argued that the term close out netting 'agreement' risked to create unjustified distortions between provisions that apply the same mechanism and might even have the same wording based only on their nature. They further explained that the term 'agreement' might be understood to imply negotiations – which could cause problems even for CCP netting, especially in those jurisdictions where the rulebook of the CCP needed to be endorsed by a supervisor. They further pointed to the fact that a number of arrangements by the Eurosystem Central Banks contained close-out netting provisions and that the nature of those arrangements varied – some might have the nature of a central bank regulatory act, some might be set up by General Terms and Conditions, others by negotiated contracts. The speakers could see no policy reason why only some of those provisions merited protection. One participant – though favouring the term 'agreement' – conceded that the term 'agreement' might cause problems in jurisdictions with statutory insolvency close-out provisions. Some participants pointed to the fact that all the arguments against the term 'agreement' would be without relevance if the Study Group decided that the Principles should protect private agreements only. They recommended focussing on the protection of private agreements and argued that only a contractual approach could avoid surprising outcomes. They explained that the effect of a conflict between a netting agreement and statutory insolvency netting procedures was difficult to predict.

43. The Study Group inferred from the wording '**between two or more parties**', that the current draft would also cover multilateral close-out netting<sup>14</sup>. Those participants of the Study Group who had advocated not to address close-out netting in the future instrument suggested to

---

<sup>12</sup> cf. Section II.B. on p. 4 f.

<sup>13</sup> Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements.

<sup>14</sup> Cf. the discussion on multilateral netting in section II.A.1. on p. 3.

delete the words “or more” in the definition or to reformulate that phrase. Others reiterated their view that the Study Group should not focus on bilateral relations only. One participant proposed as an alternative to leave the question open and to simply formulate: “It is an agreement under which...”. No decision has been taken regarding multilateral close-out netting.

44. It was further proposed to add the words ‘either by notice or automatically’ to the phrase ‘[...] under which, on the occurrence of an enforcement’ in order to integrate the method of termination into the definition. Another participant conceded that it would be possible to integrate the definition of the enforcement event into the definition of close-out netting agreements but advocated to keep the two separate blocks since this would facilitate the analysis.

45. Invoking the definition of close-out netting in the EU Financial Collateral Directive<sup>15</sup>, one participant proposed **to add** to the definition of close-out netting **‘whether through the operation of set-off, novation or otherwise’**. Other participants endorsed the proposition.

46. With view to the wording **‘either or both’** introducing the two indents, one participant drew attention to the fact that the proposed definition would apply also to netting agreements without aggregation since the first indent required only the acceleration and valuation of the respective obligations. The participant voiced the opinion that the definition should refer to all three elements of netting.

47. As to the expression **‘account is taken’** in the second indent, one participant explained that the wording was taken from the bankruptcy law of the UK, which referred to set-off. The participant inferred that the definition should be opened to other means of aggregation.

## **2. “Umbrella- netting agreements”**

48. The Study Group noted that umbrella-netting agreements differed from ordinary netting agreements only insofar as they included net-obligations arising under the underlying netting agreements into their netting mechanism. The Study Group found that the definition of close-out netting agreements was broad enough to encompass also netting of net-sums and concluded that there was no need for a separate regime for umbrella-netting agreements. The proposed definition should be deleted to prevent confusion. The Study Group considered that it would be helpful to elaborate on umbrella-netting agreements in a commentary to the Principles.

49. The Study Group concluded that umbrella-netting agreements might require special protection regarding the eligibility of net-sums for netting. It agreed to clarify in the definition of eligible obligations – not just in a commentary - that a net-amount arising from the operation of another close-out netting could be an eligible obligation in the close-out netting.

## **3. “Enforcement events”**

50. One participant invited the Study Group to discuss whether automatic termination should be abolished. He proposed to delete that option from the definition and argued that automatic early termination had raised many problems in practice. Several participants pronounced themselves against deleting automatic early termination. They argued that it was a common feature in many securities financing transaction master agreements (on repos, securities, lending agreements) and that probably the majority of master agreements in bank portfolios provided for automatic early termination upon bankruptcy. They warned that if the Principles abolished automatic early termination, this would inevitably result in a renegotiation of thousands of master agreements. They agreed however that the issue should be further explored.

---

<sup>15</sup> Art. 2, para. 1 (n) of the EU Financial Collateral Directive states: ‘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, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise: [...indents...].

51. One participant noted that legislators and regulators – not only from emerging markets – might welcome guidance on the interaction of the future instrument with other international instruments such as Chapter H of the UNCITRAL Legislative Guide to Insolvency. The participant proposed to explain in a principle, preface or recital how the future instrument is intended to interrelate with other instruments to the extent such a pronouncement of UNIDROIT on other instruments was appropriate.

#### **4. "Insolvency proceedings"**

52. In view of the fact that it had not adopted a common position towards reorganisation measures yet, the Study Group decided to postpone the discussion on insolvency proceedings. It agreed that the proposed definition should be footnoted to inform third parties that the Study Group was aware of the interference with regulatory measures and had it in consideration. One participant invited the Study Group to also keep in mind the conceptual distinction between measures directed against the triggers for netting and against netting enforcement.

#### **B. Formal requirements for close-out netting agreements**

53. Turning to formal requirements, one participant remarked that the instrument should be minimal on formalities since he believed them not to be a big challenge.

54. Several participants raised the question of transparency and cautioned not to create the impression that the instrument was giving leeway to circumvent notification requirements. One participant suggested that the Study Group should identify and address possible objections. To give an example, he mentioned that third parties might get the impression that the instrument created a secret lien without transparency. They might also wonder why registration requirements – if they were included in private law provisions – should not also be sanctioned also by private law mechanisms such as the invalidity of the agreement.

55. In a clause-by-clause analysis, the Study Group noted that the term '**perfection**' used in **draft principles 5 and 8** might create confusion. Under UK-Law, for example, the term perfection referred only to pledges, while under French Law, it was a synonym for making rights effective against third parties. Both meanings did not fit into the context. The Study Group agreed to delete the term.

56. Some participants expressed their concern that the term '**formal act**' in **draft principle 5**, was not sufficiently precise and at the same time not broad enough to encompass all possible enforcement requirements (e.g. the requirement of explicit approval of netting by a committee or additional administrative act in China). Yet they conceded that an enumerative approach, which could be envisaged as an alternative solution, entailed the risk of leaving important issues out. Since no perfect solution was likely to be found, it was suggested to clarify the intended meaning of the term in a commentary or in the draft principle itself.

57. Regarding **draft principle 6**, it was suggested to replace the direct article '**the**' in the term 'the requirement' by the indirect form of 'any requirement' to underline that the future instrument did not intend to establish a writing requirement but simply did not displace existing writing requirements.

58. Varying views were expressed regarding the **need for draft principle 7**. Some participants of the Study Group suggested that it should be deleted. They felt that draft principle 7 essentially clarified that a failure to comply with the enumerated requirements could not render the netting agreement void and argued that those remarks belonged in the commentary, not in the principles. Other participants argued that it was important to clarify in draft principle 7 that a registration requirement, while being permissible, should not impair the validity of the netting agreement under commercial law. They explained that the need for such a draft principle was illustrated, for instance, by the new Russian netting legislation under which the registration of netting was in fact a prerequisite for the validity of the netting agreement.

59. Some participants remarked that the expression '**without prejudice**' in **draft principle 7** was misleading and should be replaced. They explained that draft principle 7 simply applied the rule of draft principle 5 – holding that the creation, validity and enforceability of a close-out netting agreement should not be dependent on the performance of any formal requirements – to registration requirements. They felt that the expression 'without prejudice' was not suited to describe the interplay between the draft principles since it implied that draft principle 7 might be incompatible with draft principle 5 and needed to be given priority. One participant proposed to use the term 'notwithstanding' instead of the expression 'without prejudice'.

60. Also regarding **draft principle 7**, one participant objected to the fact that it singled out registration requirements with **trade repositories**, another participant suggested that the expression '**for purposes of prudential supervision**' might be superfluous.

### **C. Enforceability of close-out netting agreements**

61. With view to the structure of the draft principles on insolvency law, the Study Group endorsed the fact that draft principle 9 stipulated the general rule that netting should be enforceable in accordance with its terms and was accompanied by draft principles that addressed particular insolvency law problems.

#### **1. Draft principles 9 and 10**

62. Assuming that the Group was working on Principles, one participant proposed to replace draft principle 10 by a draft principle containing the non-exhaustive list of exemptions from mandatory insolvency law the Study Group envisaged developing. He favoured a two-tier structure for the new draft principle 10. The first tier should explain the fundamental objectives and mechanisms of insolvency law while the second tier should enumerate in a non-exhaustive list of those insolvency principles that should not be used to invalidate the enforcement of netting agreements. The participant clarified that the first tier should rather go into the commentary if the Study Group decided to develop a Model Law instead of Principles. In the same line of thought another participant suggested to weave the non-exhaustive insolvency list either into draft principle 10 or into draft principles 9 and 10 taken together. He also proposed to include two elements into the new draft principle 10: first, an explanation why the fundamental principles of insolvency law were not in conflict with the protection of the close-out netting agreements and second the enumeration of insolvency carve-outs.<sup>16</sup>

63. One participant proposed to add a draft principle or to include into the commentary of the section a list of those principles of insolvency law, which would continue to apply. As an example he cited the principles connected to fraud, the avoidance of a close-out netting agreement as preference or the termination of a temporary stay.

64. Another participant asserted that the words "**subject to any contrary provision of a netting agreement**" in **draft principles 10 and 12** were redundant: He considered that the general rule of draft principle 9 applied also to the following principles. It expressed that a netting agreement should be enforced in accordance with its terms – which implied that a contractual provision could set additional requirements. He saw no need to reiterate that fact in the following draft principles.

#### **2. Draft principle 11 and walk-away clauses**

65. Several participants expressed the view that **draft principle 11** was redundant in the light of draft principle 9 and the definition of close-out netting agreements. They argued that it simply

---

<sup>16</sup> Cf. Section II.C, p. 5 f.

explained the netting mechanism once again and cautioned against unnecessary repetition: parallel definitions might invite a party to infer that there is a difference in the legal regime.

66. One participant suggested that draft principle 11 could address the question of **walk-away clauses**<sup>17</sup>, which was not answered by draft principle 9. He explained that certain bankruptcy laws provided that master agreements might only be recognised and enforced if they required full two-way payment, in other words, if they did not allow the non-defaulting party to walk away. Other jurisdictions did not regard walk-away clauses as contrary to the principles of mandatory insolvency law.

67. Several participants of the Study Group agreed with the proposition to explicitly address walk-away clauses whereas one participant cautioned that the Group should not be over-ambitious. The Study Group considered three possible approaches to walk-away clauses:

1. to prescribe that walk-away clauses should not be enforced,
2. to leave the states the choice whether they wanted to give effect to walk-away clauses or
3. to require full two-way payment as far as banks were concerned but to allow walk-away clauses in other areas.

68. Referring back to the justification for the protection of netting agreements, which presupposed that the agreement should not be confiscatory in nature, several participants considered that walk-away clauses should not be enforceable. They explained that there was a tendency to limit one-way payments in the regulatory sphere and gave the example of the United States. In a case concerning the insolvency of Drexel<sup>18</sup>, one Court had recognized one-way payment. Regulators had since taken steps with respect to certain entities (i.e. banks and systemically important institutions) to prevent the enforcement of one-way payments. They further pointed to the fact that netting agreements which contained a walk-away clause were not recognised for Basle capital purposes.

69. One participant spoke in favour of the third approach and cited the case *Parigan vs. Robinson* in which the judge granted a one-way payment even in the absence of a contractual provision in that regard<sup>19</sup>. He concluded that a fortiori, a contract which provided for one-way payment should be enforceable. The participant further drew attention to the fact that one-way payment clauses were used in the market and that the parties to those agreements considered them to be perfectly legitimate as a matter of freedom of contract. In connection with the fairness-arguments against one-way payments, he took the position that it was also not fair to oblige a non-defaulting party to make the entire payments under a contract at once whereas the same party normally would have had the time to pay off over many years if the counterparty had not defaulted. On that ground, the participant advocated not to include a strict anti-walk-away provision into the future instrument.

### **3. Draft principle 12**

70. In view of the first indent of draft principle 12, one participant reverted to the previous discussion on early termination<sup>20</sup>. He endorsed the finding that automatic termination caused many problems in practice and should be revisited by the Study Group. He explained that in certain jurisdictions, the parties to a netting agreement could not serve the notification of termination after

---

<sup>17</sup> A walk-away clause is a provision which permits a non-defaulting counterparty to make only limited payments, or no payments at all, to a defaulting party, even if the defaulting party is a net creditor.

<sup>18</sup> *Drexel Burnham Lambert Products Corp. v Midland Bank PLC*, No. 92 Civ. 3098, 1992 US Dist. LEXIS 21223 (S.D.N.Y. 9 Nov 1992).

<sup>19</sup> *Peregrine Fixed Income Ltd vs. Robinson Department Store Plc*, decision of the High Court of Justice (Queen's bench division) of 18 May 2000.

<sup>20</sup> Cf. section III.A.3. on p. 10, para 49.

opening insolvency proceedings and therefore had to rely on automatic termination. He suggested that the future instrument should address this practical need for automatic termination and proposed to add or amend the first indent of that draft principle along the following lines: notice of the intention to operate the close-out netting agreement should have been given 'prior to the opening of insolvency proceedings'.

71. On more general terms, one participant proposed that statutory termination and liquidation rules should be overcome. Referring to the German termination and liquidation provisions that prescribed a valuation of the assets based on their value at the fifth day after opening of the insolvency proceedings<sup>21</sup>, he explained that a backward calculation of market prices was not only challenging from the operational perspective, but might end up with incorrect calculations if the market had moved on. One participant expressed doubts whether jurisdictions relying on statutory close-out (e.g. Germany, France) would abolish their traditional approach based on draft principle 9 alone. He suggested that the Study Group would have to bring forth some convincing reasoning.

#### **4. Draft principle 13 and time limits for termination and valuation**

72. Many participants considered that draft principle 13 needed to be reworked. Regarding the document structure, one participant proposed that draft principle 13 should not only take into account draft principle 12 but the basic idea of draft principle 9 and the entire section, which was to establish a balance between primacy of contractual provisions and public interests.

73. One participant raised the question of whether there was a need for such a provision at all. He explained to the Group that draft principle 13 was modelled on Art. 4(6) of the EU Financial Collateral Directive<sup>22</sup>, which served a very particular purpose: Art. 4(6) of the Financial Collateral Directive had been drafted with the intention to ease the opposition against an original proposal of the Commission to abolish ex ante-court authorisation for realising pledged assets. The Commission had had the intention to enable fire-sales, which required the possibility to take the collateral fast. However, the proposal had faced strong opposition. To compensate for abolishing the ex ante-authorisation, the Commission had introduced Art. 4(6) to enable judicial review of the pledge transfer ex post. The participant queried if such a draft principle was necessary in an instrument on netting and pointed to the fact that taking pledge involved human behaviour whereas the valuation of obligations in the netting mechanism concerned only a judgment of asset prices. This could be stipulated with detail ex ante in the contracts. The Study Group took note of those concerns but there was a preponderance of opinion that draft principle 13 was appropriate and necessary but needed to be reworked.

74. One participant cautioned against obliging the non-defaulting party to calculate the close-out amount in a 'commercially reasonable manner'. He argued that such a formulation would provoke lawsuits on the reasonableness - amongst others - of the timeframe for the close-out.

75. Based on that intervention, one participant raised the question on more general terms as to whether a non-defaulting party should be free to determine the timing of the close-out upon default of the counterparty. He explained that certain master agreements granted a non-defaulting party the right to withhold payments upon default of a counterparty while at the same time not allowing the defaulting party to terminate the contract. If the defaulting party of such a contract was in the money at the time of its default, the combination of both elements gave a non-defaulting party the comfort of not being forced to precipitate a close-out and thus in a sense a "power to wait and see".

---

<sup>21</sup> Sect. 104 (2) and (3) of the German Insolvency law.

<sup>22</sup> Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements.

76. The Study Group agreed that there was a need to address the issue in the future instrument for three reasons: First, the participants noted that conflicting decisions of Courts in Australia<sup>23</sup>, in the US<sup>24</sup> and in the UK<sup>25</sup> had created legal uncertainty about the recognition of clauses stipulating a right to withhold payment. Second, they observed that such clauses were widely used in the financial market (e.g. Art. 2(a)(iii) of the ISDA Master Agreements of 1992 and 2002 and Art. 9 of the EFET General Agreement for natural gas trading contained such a provision). Third, it was argued that the Study Group itself should try to reconcile and balance the conflicting policy imperatives at stake: an efficient protection of the solvent party and an effective insolvency solution for the public and unsecured creditors. One participant cautioned that policy makers might feel reluctant to adopt these principles if they got the impression that the proposals might run against the general public.

77. The Study Group agreed that the “power to wait and see” needed to be limited. So long as counterparties had reasonable flexibility to close-out their position in conditions which allowed them to do so properly, the solvent counterparty should not have indefinite power to play the market against the general creditors. The Study Group has not yet reached an agreement as to whether the limitation should be set by a flexible or fixed time limit. It took note of the fact that ISDA had found no alternative to a hard time limit in a membership-wide consultation on the issue of Art. 2(a)(iii) and might be implementing a time limit into its Master Agreement via a Protocol in the future. One participant advocated against setting a fixed time limit for all transactions but proposed to address the calculation period on a case-by-case basis in the supervisory framework. He explained that the timeframe necessary to value the close-out amount varied greatly depending on the number and nature of trades included in the portfolio.

78. One participant pointed to the fact that the Study Group will have to distinguish two timing issues: 1) the time limit for termination and 2) the time-limit for the completion of the close-out process after having terminated.

#### **5. Draft principle 14**

79. The Study Group considered the scope of the netting protection in suspect periods as proposed by draft principle 14. It stressed that the word ‘solely’ was important. Due to that word, draft principle 14 excluded only the operation of a blanket zero-hour rule (e.g. under English insolvency law, all transaction entered into after the presentation of a winding-up petition were automatically void, subject to revalidation of the court). It followed that the draft principle would not apply to transactions entered into during a suspect period, which implied an element of fraud or were deemed suspect because they secured pre-existing debt. The latter transactions could be treated as invalid, reversed or declared void by any jurisdiction. On the basis of that general understanding, the Group agreed that remaining questions should be clarified in the course of the drafting process. One participant proposed to clarify in the future instrument that entering into an ISDA master agreement could be considered as a preferential transfer under bankruptcy and insolvency laws. He argued that such a clarification might help in discussions with academic critics who suggested that the effect of safe harbours was to exempt netting agreements entirely from insolvency law.

---

<sup>23</sup> *Enron Australia v. TXU Electricity Ltd.* [2003] NSWSC 1169, New South Wales Supreme Court, Decision of 11 February 2005.

<sup>24</sup> United States Bankruptcy Court for the Southern District of New York, Bench Ruling of 15 September 2009 Ordering Metavante Corporation to make payments to Lehman Brothers Special Financing Inc. In spite of a contractual right to withhold payment under Art. 2(a)(iii) of the ISDA Master Agreement of 1992.

<sup>25</sup> Amongst others: High Court of Justice in London, *Lomas and others v JFB Firth Rixson, Inc and others*<sup>2</sup> [2010] EWHC 3372.

80. One participant deduced from the previous findings that a netting agreement concluded in a suspect period with regards to pre-existing debt could be void or voidable under national law whereas an agreement relating to future debts would not be put into question.

81. The Study Group further noted that draft principle 14 protected not only the netting agreement but also the underlying obligations in suspect periods. One participant proposed to limit the protection to the close-out netting agreement itself. A majority however considered it important to protect also the underlying obligations. The proponents of this opinion argued that netting agreements merited special protection only because of the nature of the underlying obligations and that the stability of netting infrastructures might be called into question if the obligations were not included in the protection of draft principle 14.

#### **6. Draft principle 15**

82. Relating to draft principle 15, one participant proposed to replace the term 'financial contracts' by a broader term that covered also more individual obligations or payment obligations. He explained the need for a wider formulation by giving the example of an obligation that was paid during a suspect period thus giving rise to the question as to whether the payment could be avoided as preferential if the counterparty was declared insolvent, on the one hand, or whether, on the other hand, the payment benefited from the netting protection. He expressed the view that these obligations should be protected. Other participants replied that they understood from the standard documentation that payments which were clawed back retroactively were covered by the netting agreement. In the US, for instance, payments with respect to eligible contracts were considered as settlement payments and were thus shielded from the general insolvency law. In support of the proposed amendment to draft principle 15, one participant noted that it remained unclear whether payments made under a transaction that was subsequently challenged, declared void or turned out to be void fell within the scope of the netting protection. He explained that it had been discussed several times in drafting committees whether those obligations arising under the regime of unjust enrichment were protected by the netting agreement. The participant proposed to clarify that payments made in expectation of the enforceability of both the netting agreement and the underlying obligation should be protected. For this reason, he endorsed the proposal to broaden the term 'financial contracts'.

83. One participant proposed to add the words 'otherwise eligible for netting' to the term 'financial contracts' in draft principle 15. He explained that in a number of countries the inclusion of one ineligible - but otherwise effective and valid - transaction into an agreement could take the entire agreement out of the scope of netting protection. The Study Group endorsed the proposal.

84. Another participant proposed to include the phrase 'as regards the remaining financial contracts' into draft principle 15 so as to clarify that the presence of one invalid transaction in a netting set would not prevent netting being effective in respect of the valid transactions. He feared that an unwary reader might misunderstand draft principle 15 to be a leg-up provision which enabled the parties to count an otherwise invalid transaction into the netting calculation.

#### **D. Enforceability of umbrella-netting agreements**

85. In the light of the previous decision that there was no need for a separate regime for umbrella-netting agreements<sup>26</sup>, the Study Group agreed to delete the Section.

---

<sup>26</sup> Cf. Section III.A.2 on p. 10, para 48 f.

**E. Conflict of laws**

86. The Study Group considered the different laws governing the netting process with the view to developing a clear and compatible conflict-of-laws regime. Some participants proposed that the Study Group would have to consider the law applicable to the netting agreement (*lex contractus*), the law governing the insolvency proceedings (*lex concursus*) and also the law governing the underlying contracts. Other participants objected that the law governing the underlying contracts was not relevant for the future instrument. They argued that a netting agreement was to be qualified as a unitary contract that incorporated the underlying obligations and that the law applicable to those obligations was not relevant.

87. One participant proposed that the Study Group might wish to consider the law governing capital controls. Another participant replied that, to his knowledge, foreign capital controls would not affect the validity of the agreement – unless the performance of an obligation under the master agreement was required by the law of the forum’s conveyance principles if those were governed by the foreign law.

88. Some participants pointed to particular risks under the conflict-of-laws regime that came with a functional definition of netting agreements: for instance, there was a risk that the future instrument could be based on incompatible understandings of the netting mechanism in the substantive section and in the conflict of laws section. This risk should be avoided by defining the netting mechanism in substantive law first before returning to the conflict-of-laws issues. There was also a risk that a national judge decided that a netting agreement needed to take effect as set-off and applied the conflict-of-laws rules of set-off to the contract – including the provisions on *renvoi*.

89. One participant declared that the group needed to understand to what extent the governing law would change if the conflict-of-law rules regarding setting or novation applied.

90. As a last preliminary remark, a participant proposed to include a technical rule into the conflict-of-law provisions that a portfolio of multitude trades should not be separated.

91. One participant explained that the scope of the applicable law should be clarified in the future instrument – even though the provisions of most master agreements contained a provision on the scope of the *lex contractus*. He explained that the future instrument was not limited to netting under master agreements and that the proposed clarification might be useful for other netting contracts.

92. The Study Group was generally of the view that a choice of law provision should be subject to party autonomy and should be supplemented by a fall-back rule. One participant expressed some doubts concerning the fall-back rule and raised the question whether parties should benefit of the recommendations that had not even paid attention to the choice of law. The Study Group agreed that the choice of law provision should not be subject to form requirements.

93. The Study Group held a general discussion on the relationship between choice of law clauses and insolvency law. Some participants expressed their support for the findings on insolvency in the Report<sup>27</sup> but noted that the scenarios depicted were not exhaustive. One participant explained that courts in certain jurisdictions would open insolvency proceedings against a company on the basis that only one branch of the company was located in the jurisdiction and would still apply the universality principle. This could give rise to competing insolvency proceedings.

94. One participant drew attention to the proposal of draft principle 19 and stressed that it contained a provisions that was contrary to the objectives of the netting project: It stipulated that the *lex concursus* should be entitled to avoid the netting agreement. He suggested that this provision should be deleted or amended. Another participant wondered whether it might be

---

<sup>27</sup> Cf. p. 33 of the Report (para. 104).

advantageous to clarify in the instrument that insolvency law constituted the main possible impediment to the enforcement of netting agreements.

95. The Study Group further discussed whether proprietary aspects of taking collateral needed to be addressed by a conflict-of-laws provision. Some participants drew attention to the fact that most netting mechanisms involved only the obligation to transfer collateral but did not involve the proprietary aspects of taking the collateral. Even the question whether a security was held in property or had been converted into a right to redeliver certain securities was ultimately a question of fact, not of property law.<sup>28</sup> Also the obligation under derivatives transactions to deliver a certain amount of specified securities was a contractual claim not a proprietary asset. Against that background, the participants argued that it was not necessary to deal with proprietary aspects in the conflict-of-laws section.

96. The Study Group agreed to request the Secretariat, in consultation with the permanent Bureau of the Hague Conference, to develop a draft for a conflict-of-law regime for consideration at a later stage.

#### ***F. Eligible financial contracts***

97. The Study Group discussed several approaches to draw up a list of eligible financial contracts but has not taken a decision on the approach to adopt in the future instrument yet.

98. One participant suggested that the Study Group should make netting available to all contracts. If the Group should take a different view, he proposed to explain at least in the commentary the reasons for limiting the instrument to certain contracts. He argued that such an explanation was necessary since the basic mechanisms of netting - set-off and early termination - were available to every contract and every party in many jurisdictions.

99. The majority of participants took the view that it was necessary to limit the protection of close-out netting to certain types of contracts. Varying opinions existed, however, whether a generic or an enumerative approach would be best to serve the purpose.

100. Some participants favoured a **generic approach**. They proposed to define the eligible contracts through a generic test that should be supplemented by a non-exhaustive list of products that fall under the test to illustrate the type of instruments envisaged in the definition. The proponents of this opinion conceded that it might be more challenging to draft a generic test but argued that an enumerative approach had the disadvantage that it might not cover all relevant transactions. Even if the Group was fortunate enough to draw up a complete list of today's transactions, that list would rapidly become dated. They further stated that a generic approach would compel the Group to isolate particular features of the protected categories of transactions which would also help to explain to legislators and critical audiences why a particular instrument merited special protection. For this reason, a generic approach could make the understanding and adoption of the instrument easier.

101. One participant proposed two main components for a generic test

(a) Fluctuating forward exposure

The contracts needed to give rise to ongoing rights and obligations that generated a fluctuating forward exposure by reference to market movements in some assets, e.g. commodity, index or reference in the contract.

(b) Close connection

The netted assets were - if not composite assets - for good commercial and risk control reasons closely connected (thus formed a single net asset).

---

<sup>28</sup> The participant referred to a question that arose in a Lehman case, where on party deposited securities and at one point the question arose whether the counterparty retained property in the securities.

The participant explained that the second element of the definition showed that it would not only be unfair but also produce unpredictable results and thereby systemic risk, if one asset that was managed as a single asset was split up.

102. Some participants wondered whether the proposed elements of the test were very compelling in view of the contracts that merited protection. The element of fluctuating exposure (a) would not encompass binary trades which should be treated as derivatives since they were managed and traded like derivatives. The close-connection element (b) might create problems for assets that were separately risk managed in different parts of the bank. One participant proposed that the generic test should rather be seen as a policy-guiding test and be integrated into the commentary. He argued that he could draft a money market loan that complied with both criteria and explained that fluctuating forward value (a) existed already in foreign exchange transactions or in the loans that were linked to an Euribor. The close-connection criterion (b) could be met also by margin lending that was structured more loosely without daily valuation and margining, since there was always a corresponding financial instrument financed by it. Another participant argued that the close-connection criterion ran against national legislation. For a long time, it was a fundamental strain of thought in European countries that it was not possible to establish connection in a contract with the intention to enable a set-off. After a long controversy, legislation was passed to allow for set-off even if the connection was established only in a contract. The participant cautioned that the Study Group should not reintegrate an objective close-connection test against that background. The participant who made the proposal endorsed that the future instrument should not put into question that connection might be established in a contract because this would remove the legal certainty the Group was trying to achieve.

103. Other participants favoured an **enumerative approach**. Different options were discussed how to structure the approach.

(a) Some favoured a positive definition:

The Study Group would have to draft a comprehensive list of all eligible contracts like it had been done in the ISDA Model Law.

As an alternative it was discussed to only list product categories with some examples of the contracts covered.

(b) Others favoured a negative definition:

The approach envisaged to draft a general rule that all contracts were covered that was supplemented by a list of exceptions.<sup>29</sup> Some participants noted that the negative approach would give the highest level of legal certainty.

104. In a general discussion, the Study Group considered which obligations should be covered. The following obligations were being discussed:

(a) Financial derivatives

The Study Group noted that a list of derivatives could be found in the Annex to the MiFID Directive<sup>30</sup>, but that the list had been drafted for passporting/licensing purposes not for insolvency purposes and that it contained a few omissions that had led to confusion.

Ex. → *forwards and options that were physically settled*

(e.g. in the gas, coal and electricity market)

→ *spot transactions*

It was argued that those should be covered since it was impossible to clearly delineate where the spot ended and the forward started.

---

<sup>29</sup> The participant noted that this method was also used in the safeguards order of the UK Banking Act.

<sup>30</sup> Directive 2004/39/EC of 21 April 2004 on markets in financial instruments (amending Directives 85/611/EEC, 93/6/EEC and 2000/12/EC and repealing Council Directive 93/22/EEC).

(b) Securities financing transactions

The second category consisted of instruments with two legs - one security leg and one cash leg - which were daily margined and subject to a close-out mechanism.

Ex. → *repurchase securities*  
→ *margin loans*

(c) Money market services and deposits (deposit netting)

The Study Group considered whether some market services or deposits should be covered that occurred in non-typical deposit and market loan transactions.

e.g. → *interbank landing and deposits*  
→ *money market overnight facilities.*

(d) Obligations arising under master-master agreements and clearing and settlement arrangements

(e) Obligations arising under title-transfer arrangements

(f) Obligations arising under contracts on maintenance of financial instruments

105. The Study Group came to a general agreement on the first two categories (a, b) which would have to be analysed in more detail in future debates. With view to the definition of financial derivatives, one participant advocated to adopt a broad definition regarding the references taken in derivatives contracts to shares, bonds, commodities (including metals, indices, prices, allowances, straight-trades), in credit-default swaps and weather derivatives<sup>31</sup>.

106. However, many participants expressed doubts regarding the third category of instruments – money market services and deposits (c). Some cautioned that the scope of the principles should not be overreached, else the Group might jeopardise the success of the instrument. Any add-on features that went beyond the core of the instrument should not stand in the way of acceptance. They stressed that it was necessary to justify the special protection given to each of the categories under the objectives of insolvency law. Against this standard, it seemed justified to protect the first two categories of instruments consisting of high-volume traded, quick, daily transactions with a significant importance for the financial markets. The same justification would not apply to the third category of instruments (c). Other mechanisms like set-off were sufficient for their needs.

107. Other participants argued that there were strong policy objectives to also protect inter-bank deposits, loans for custody prime brokerage, securities financing transactions and margin lending. They argued that interbank deposits were risk-managed like the other protected instruments and assured the funding of the bank's activities on the derivative side. Deposit netting had even been recognised under the Basel II framework and was included in the master agreements of central banks. The proponents of including the third category of products into the list of eligible contacts argued that these products needed the protection of the principles since there were few alternatives to netting when it came to securing these obligations: set-off required payments that were due and that was not always the case. If the banks used pledge, they would lose the flexibility of using their cash-balances. In addition, some working balances fluctuated and could therefore not be secured by pledges under certain laws (e.g. German law). A broad definition of the eligible contracts – it was said – would also help prevent circumvention. Financial institutions in some jurisdictions were very creative in structuring loans and deposits into derivatives if those were not eligible for netting under the rules under which they operated: they would combine a single act swap and credit support annexes with an independent amount where – irrespective of the exposure – one party had to post cash-collateral to the counterparty. From a functional view, the outcome of these transactions was nothing but a loan. The argument that loans and deposits should be included into the instrument simply because there might be circumvention was criticised

---

<sup>31</sup> The participant referred to the list on p. 77, para. 302 of the Report.

by one of the participants. She argued that regulatory arbitrage was always possible. It was for the regulators to determine whether there was circumvention and to address those strategies.

108. One participant suggested that the list of eligible contracts might depend also on the method used for the protection of netting agreements. He explained that legislators around the world had adopted different mechanisms: Some countries had established a 'special treatment' approach, which consisted in a broad substantive law protection of the netting agreement (i.e. netting was exempted from the entire insolvency law). In compensation for the wide scope of substantive law protection, netting was available only for a defined number of financial obligations. Other countries chose to make only a small number of amendments to their insolvency laws (e.g. provided for an anti-cherry picking provision) but made no restrictions concerning the eligible obligations. The participant concluded that there would be no need to restrict the scope of eligible obligations under the second approach. By contrast, if the Study Group argued on the basis of the 'special treatment' approach, it would have to make it clear that each protected obligation was not only a single assets but also a financial market asset.

109. Another participant suggested that it might be useful to define the eligible financial contracts partly with reference to eligible parties and to come to a basic rule through that nested structure.

### **G. Eligible parties**

110. The Study Group considered two approaches to define the eligible parties: either to make netting available to everyone, possibly with the exception of consumers or to restrain it to habitual market participants. The proponent of the last proposal argued that it would give the States flexibility to carve out certain groups of individuals and corporations from the netting protection. Another participant cautioned against this definition and explained that some laws used the definition of parties habitually involved in financial transfers. It caused many lawsuits since it invited a counterparty that was not clearly a bank or similar financial institution to challenge the validity of the netting agreement in Court once a close-out netting agreement was to be enforced.

111. The Study Group favoured an all-encompassing definition of eligible parties for two reasons: First, it noted that netting benefited the counterparty of the bankrupt institution and therefore also clients of an insolvent bank. Second, it realised that an enumerative approach of eligible parties would require finding a durable definition of a bank, a fund, an insurance, etc on the global level.

112. It was further agreed that natural persons should not be excluded since wealthy individuals often acted on the market much the same way as hedge funds. They would not understand why they should not benefit from netting protection.

113. Varying views were expressed as to whether consumers should be excluded from the list of eligible parties. Several participants cautioned that consumers always raised particular policy concerns and advocated to exclude consumers. They also pointed to the fact that the Study Group would have to take into consideration all existing consumer protection laws if it was to include consumers into the definition of eligible parties. In addition, one participant expressed the view that netting was not always beneficial for consumers. He mentioned a case of mis-selling of derivatives in a country in which consumers had not been sufficiently informed about payment risks. The fact that the banks in that country were not allowed to close-out the obligation under the derivatives contracts against deposits of the consumers obliged the banks to enforce the obligations in Court – which challenged the entire transaction. Other participants advocated not to exclude anyone from the list of eligible parties. They argued that it was difficult to distinguish consumers from partnerships, family-managed hedge funds or family offices and also to determine at what point in time a consumer became an entrepreneur. These difficulties in practice could be avoided if the definition of eligible parties did not contain any exceptions. They further argued that it would be very disadvantageous for consumers to be allowed to invest in derivatives but to deprive them of the corresponding safeguard mechanism. One participant proposed a mixed

approach that was practised in some countries. If netting was to be applied to financial instrument transactions, it was sufficient if one party fell under the definition of eligible parties. But when it came to netting of cash settlements or the delivery of commodities, both parties needed to be an eligible party.

114. It was suggested that some of the objections of participants against excluding consumers could be faced by defining consumers as persons acting for personal or household matters.

115. One participant cautioned that the future instrument might be challenged if the scope of application was too broad. The Study group should therefore consider a narrow definition of eligible obligations if it favoured a wide definition of eligible parties.

116. In conclusion, there was a preponderance of opinion in favour of an open definition of eligible parties that should contain an exception for consumers.

**APPENDIX I****LIST OF PARTICIPANTS**

Mr Edosa K. AIGBEKAEN	Uniform Law Commissioners Director (Legal) and Secretary to the Commission Securities & Exchange Commission Nigeria
Mr Carl BJERRE	University of Oregon Law School Professor of Law - Private Sector Adviser - Uniform Law Commissioners United States of America
Mr Diego DEVOS	General Counsel Bank for International Settlements (BIS) Switzerland
Mr Ignacio GÓMEZ-SANCHA	Managing Partner GÓMEZ-SANCHA Abogados Spain
Ms Joyce HANSEN	Deputy General Counsel and Senior Vice President Federal Reserve Bank of New York United States of America
Mr Holger HARTENFELS	Managing Director and Senior Counsel Legal Regulatory & Governance Deutsche Bank AG Germany
Mr Hideki KANDA	Professor of Law University of Tokyo Japan
Mr Klaus LÖBER	Head of Oversight Division European Central Bank (ECB) Germany
Mr Guy MORTON	Senior Partner Freshfields Bruckhaus Deringer United Kingdom
Mr Philipp PAECH	Professor at the London School of Economics and Political Science (LSE) Department of Law United Kingdom <i>Adviser to the Secretariat</i>
Ms Béatrice PASSERA	Banque de France Direction des Services Juridiques - Service du Droit Communautaire et des Marchés Financiers France

Mr Martin PLENIO	Deputy General Counsel and Head Legal Services Swiss National Bank Switzerland
Mr Stanislaw SOLTYSINSKI	Poznan Soltysinski Kawecki & Szlezak Legal Advisers Professor of Law - A. Mickiewicz University Poland Member of the UNIDROIT Governing Council <i>Chairman of the UNIDROIT Study Group</i>

### **OBSERVERS/ OBSERVATEURS**

EUROPEAN COMMISSION (EC)	Mr Rogier WEZENBEEK Directorate-General for the Internal Market and Services
HAGUE CONFERENCE ON PRIVATE INTERNATIONAL LAW	Mr Christophe BERNASCONI First Secretary
INTERNATIONAL MONETARY FUND (IMF)	Mr Wouter BOSSU Senior Counsel - Legal Department
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION (ISDA)	Mr Edward H. MURRAY Chairman of the Financial Law Reform Committee Partner - Allen & Overy LLP
	Mr Peter M. WERNER Senior Director
THE WORLD BANK	Ms Sau Ngan WONG Senior Counsel Finance, Private Sector Development & Infrastructure Legal Vice Presidency

### **UNIDROIT**

Mr Jose Angelo ESTRELLA FARIA	Secretary-General
Ms Annick MOITEAUX	Associate Officer
Mr Nicolas CHARRON	

**APPENDIX II****AGENDA**

1. Opening of the meeting
2. Adoption of the agenda and organisation of the meeting
3. Overview of the project
  - a. Institutional background of UNIDROIT
  - b. Co-operation with the EU Commission and other international bodies
  - c. Co-operation with the private sector
  - d. Envisaged outcome of the project
4. Overview of the findings of the preliminary draft report (UNIDROIT 2011 – Study 78C – Doc. 2)
5. Consideration of the need and feasibility of an international instrument on the enforceability of close-out netting
  - a. Delimitation: Issues of insolvency, commercial, property law, etc. as opposed to issues pertaining to the regulatory/supervisory sphere
  - b. Imperative 1-B: Clear and compatible conflict-of-laws regime regarding close-out netting
  - c. Imperative 1-C: Harmonisation of the understanding of netting and the mechanism protecting its enforceability
  - d. Imperative 1-D: Clarification/Harmonisation of the list of eligible parties, eligible contracts and of formalities
6. Consideration of a tentative draft structure for a future international instrument on close-out netting (UNIDROIT 2011 - Study 78C – Doc. 3)
  - a. Overview
  - b. Organisation of discussions on a tentative set of rules and explanations
  - c. Development of a tentative set of rules and explanations
7. Summary of findings; planning of further work
8. Any other business
9. Closing of the meeting

**APPENDIX III****UNIDROIT Study Group on principles and rules on the netting of financial instruments****First Meeting  
Rome, 18 – 21 April 2011**UNIDROIT 2011  
Study LXXVIII C – Doc. 3  
Original: English  
April 2011**A first tentative structure for  
Principles regarding the enforceability of netting agreements***(as considered by the Study Group)***Definitions**

1. “Close-out netting agreement”<sup>32</sup> means an agreement between two or more parties under which, on the occurrence of an enforcement event in relation to one of the parties, either or both of the following should occur, or may at the election of the other party occur:
  - the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;
  - an account is taken of what is due from each party to the other in relation to such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.
2. “Umbrella-netting agreement” means or of a set of connected close-out netting agreements.
3. “Enforcement event”<sup>33</sup> means, in relation to a close-out netting agreement, an event of default of one of the parties or other event in relation to one of the parties on the occurrence of which, under the terms of that close-out netting agreement,
  - the other party is entitled to elect the operation of the close-out netting agreement, or
  - the operation of the close-out netting occurs;
4. “Insolvency proceeding”<sup>34</sup> 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.

---

<sup>32</sup> Adapted from the Geneva Securities Convention, Article 31(j); EU Financial Collateral Directive, Article 2(1)(n). Cf. Doc. 2 [83-85], [109]-[110], [278]-[282].

<sup>33</sup> Adapted from the Geneva Securities Convention, Article 31(h); EU Financial Collateral Directive, Article 2(1)(l).

<sup>34</sup> Adapted from the Geneva Securities Convention, Article 1(h).

**Formal requirements for close-out netting agreements**<sup>35</sup>

5. The creation, validity, perfection, enforceability or admissibility in evidence of a close-out netting agreement should not be dependent on the performance of any formal act.<sup>36</sup>

6. Principle 5 is without prejudice to the requirement that a close-out netting agreement can be evidenced in writing or any legally equivalent form.<sup>37</sup>

7. Principle 5 is without prejudice to any requirement regarding the registration of the financial contracts covered by the close-out netting agreement with a trade repository or similar organisation for purposes of prudential supervision. Failure to comply with that requirement should not affect the creation, validity, perfection, enforceability or admissibility in evidence of a close-out netting agreement.

8. The creation, validity, perfection, enforceability or admissibility in evidence of a close-out netting agreement should not depend on the use of standardised terms, as for example the terms of specific trade associations.

**Enforceability of close-out netting agreements**<sup>38</sup>

9. A close-out netting agreement should take effect in accordance with its terms.<sup>39</sup>

10. A close-out netting agreement should be enforceable notwithstanding the commencement or continuation of insolvency proceedings in relation to one of the parties to the agreement. This principle is subject to any contrary provision of the netting agreement.<sup>40</sup>

11. After the commencement of an insolvency proceeding:

- the net sum is payable to the insolvent party by the other party if it is owed by the latter;
- if the insolvent party owes the net sum to the other party, the latter becomes creditor in the insolvency proceeding to the amount of the net sum.

12. A close-out netting agreement should be enforceable without any requirement that:<sup>41</sup>

- prior notice of the intention to operate the close-out netting agreement should have been given;
- the terms of the realisation or the operation of the close-out netting agreement be approved by any court, public officer or other person; or
- the realisation be conducted by public auction or in any other prescribed manner or the close-out netting agreement be operated in any prescribed manner;

subject to any contrary provision of the netting agreement.

---

<sup>35</sup> Cf. Doc. 2 [93-94]; [283]-[289].

<sup>36</sup> Adapted from the EU Financial Collateral Directive, Article 3(1).

<sup>37</sup> Adapted from the EU Financial Collateral Directive, Article 3(2).

<sup>38</sup> Cf. Doc. 2 [44]-[54]; [292]-[296].

<sup>39</sup> Adapted from the Geneva Securities Convention, Article 32, and Article 7(1) EU Financial Collateral Directive.

<sup>40</sup> Adapted from the Geneva Securities Convention, Article 33(3)(b); Article 4(5) EU Financial Collateral Directive.

<sup>41</sup> Adapted from the Geneva Securities Convention, Article 33(3)(a); Article 4(4) EU Financial Collateral Directive.

13. Principle 12 does not affect the application of any rule of law pursuant to which the valuation of the respective obligations of the parties as part of the operation of a close-out netting agreement must be conducted in a commercially reasonable manner.<sup>42</sup>

14. A close-out netting agreement or an obligation covered by it should not be treated as invalid, reversed or declared void solely on the basis that the agreement is entered into or the obligation is incurred during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in relation of one of the parties.<sup>43</sup>

15. A close-out netting agreement should remain enforceable even if one or more of the covered financial contracts are ineffective, void or voidable.

#### **Enforceability of umbrella-netting-agreements<sup>44</sup>**

16. An umbrella-netting agreement should take effect in accordance with its terms. Principles 9 - 15 apply accordingly.

#### **Conflict of laws<sup>45</sup>**

17. Any question in respect of the matters stated below should be governed by the law of the country which has been chosen by the parties as governing the close-out netting agreement:

- the validity and effectiveness of the close-out netting agreement, including formal steps to be taken to render the agreement valid and effective;
- the question of which types of financial contracts can be covered by the close-out netting agreement.

18. The reference to the law of a country is a reference to its substantive domestic law, excluding its rules of private international law. The choice of law made in a close-out netting agreement should prevail over any previous differing choice-of-law clause contained in a contract covered by the close-out netting agreement to the extent that the matters specified in third sentence of Principle 17 are concerned if the parties have not made express provision to that effect.

19. Any question in respect of the matters stated below should be governed by the law governing the insolvency proceeding which may have been commenced in respect of one of the parties to a close-out netting agreement:

- the avoidance of a close-out netting agreement as a preference or a contract in fraud of other creditors of the insolvent;
- the termination or temporary stay of a close-out netting agreement as a consequence of the commencement of the insolvency proceeding.

#### **Eligible parties**

To be determined, *cf.* Doc. 2 [98]-[100] and [305]-[307].

---

<sup>42</sup> Adapted from the Geneva Securities Convention, Article 35; EU Financial Collateral Directive, Article 4(6).

<sup>43</sup> Adapted from the Geneva Securities Convention, Article 37; EU Financial Collateral Directive, Article 8(1).

<sup>44</sup> *Cf.* Doc. 2 [290]-[291].

<sup>45</sup> *Cf.* Doc. 2 [102]-[106].

**Eligible financial contracts**

To be determined, *cf.* Doc. 2 [95]-[97] and [297]-[304].

**Any additional principles regarding commercial/insolvency law issues arising in the context of cross-border bank resolution**

Such issues might relate to civil/insolvency law issues in respect of bank resolution procedures as such or to adjacent issues as for example the treatment of collateral arrangements in respect of regulatory transfers, *cf.* Doc. 2 [165]-[269], including footnote 151.