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

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~~A first tentative structure for~~Revised Preliminary Draft of Principles regarding the Enforceability of Close-out Netting [Agreements/Provisions[1]][2]

(prepared by the Secretariat)

Introduction[3]

The enforceability of Close-out Netting [Agreements/Provisions[4]] contributes to the stability of financial systems.[5] It allows eligible parties to reduce their exposure towards their counterparties to a net position. By this means, close-out netting reduces the risk that the inability of one financial market participant to meet its obligations leads to a chain of failures or difficulties of other market participants (contagion effect).

Close-out netting establishes a timely, efficient and impartial resolution mechanism for the covered financial contracts in the event of default of one party allowing for continuity of the nondefaulting party's business. It provides certainty about the covered financial contracts and thus allows for

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[1] In its first meeting, the Study Group discussed whether the term "Agreement" was broad enough to encompass all netting mechanisms that exist today. Some participants voiced concerns and favoured a broader term such as "Netting Provision" (cf. Doc. 4 [42], p. 9). The problem might be addressed in a proper definition clarifying that "For the purpose of these Principles, an agreements does not require negotiations between the parties. It can be contained in regulatory acts, rule books of central counterparties or General Terms and Conditions."

[2] Square brackets indicate proposals made during the first meeting of the Study Group from 18 to 21 April 2011 to amend or delete their content.

[3] The Study Group decided in its first meeting to describe the fundamental objectives and mechanisms of insolvency law in the future instrument and to explain why they are not in conflict with the protection of the Close-out Netting mechanism (cf. Doc. 4 [64], p. 12).

[4] Cf. footnote 1 on the terminology discussion relating to "Agreement" and "Provision".

[5] This fact is today widely recognized (cf. for the ongoing Regulatory debate the "Report and Recommendations of the Cross-border Bank Resolution Group" of the Basle Committee on Banking Supervision that refers close-out netting in Recommendation 8 [p. 36 - 39] in a list of mechanisms capable of mitigating systemic risk in the first place along with collateralisation, segregation of client assets and standardisation - http://www.bis.org/publ/bcbs169.pdf).

predictability about the allocation of assets and risks in insolvency. This promotes stability in the financial market and fosters transactions. The protection of Close-out Netting [Agreements/Provisions[6]] aims therefore at achieving objectives that are largely consistent with and supportive of common objectives of general insolvency laws.[7] Indeed, insolvency regimes typically aim at preserving the insolvency estate to allow equitable distribution to creditors and at providing for timely, efficient and impartial resolution of insolvency and for certainty in the market.[8]

Definitions

1. "Close-out Netting [Agreement/Provision[9]]" means [an agreement/a provision] [relating to eligible financial contracts][10] between two [or more][11] parties under which, on the occurrence of an enforcement event in relation to one of the parties, [either or both][12] of the following should occur, or may at the election of the other party occur, [whether through the operation of set-off, novation or otherwise][13]:

Alternative a[14]

– 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;

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[6] Cf. footnote 1 on the terminology discussion relating to "Agreement" and "Provision".

[7] Special protection given to netting [Agreements/Provisions] might appear to conflict with some insolvency objectives. Upon taking a closer look, however, the protection reveals to be consistent with the fundamental objectives of insolvency law. The objective of maximizing the value of insolvency assets may have to stand back behind the predictability of contractual relations (Key objective 2 of the UNCITRAL Legislative Guide to Insolvency Law, p. 10 f) if that is critical to investment decisions. The objective of equitable treatment of creditors should be seen in the context of a fair attribution of risks and should reflect the commercial bargains the different creditors have struck with the debtor (Key objective 4 of the UNCITRAL Legislative Guide to Insolvency Law, p. 11 f). A liquidator cannot have greater rights than the insolvent party whose estate he inherits or manages. The insolvent party would only be entitled to claim a single net obligation. Any rule of insolvency that disrupts this pooling of obligations and entitlements and allows cherry-picking within what is economically one single asset would create both uncertainty and unfairness (cf. Doc. 4 [21] p. 5 f). Largely the same objectives are also pursued by bank resolution mechanisms (cf. the Preamble of Annex 1 to the Consultative Document "Effective Resolution of Systemically Important Financial Institutions" issues by the Financial Stability Board on 19 July 2011 (p. 23) and Key Attribute 5.1 of the same Annex, p. 26 (http://www.financialstabilityboard.org/publications/r_110719.pdf)).

[8] The objectives of insolvency law are taken from Recommendations 1-4 [paras. 4-13] of the UNCITRAL Legislative Guide to Insolvency Law of 25 June 2004 (http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf).

[9] Cf. footnote 1 on the terminology discussion relating to "Agreement" and "Provision".

[10] The Study Group agreed that the list of the eligible parties and eligible financial contracts needed to be integrated into the definitions (cf. Doc. 4 [39], p. 8).

[11] The Study Group considered deleting the words "or more" and thus limiting the Principles to bilateral netting (Cf. Doc. 4 [43], p. 9 f.). However, it postponed a decision in that regard.

[12] One participant at the first meeting of the Study Group cautioned that the definition would also apply to netting agreements without aggregation since it was sufficient that "either or both" indents were fulfilled and since the first indent did not require aggregation. The participant voiced the opinion that the definition should require all three elements of netting: termination/acceleration, valuation and aggregation (cf. Doc. 4 [46], p. 10).

[13] Several participants proposed to add the words "whether through the operation of set-off, novation or otherwise" to the definition and referred to the wording of the definition of close-out netting agreements in Art. 2 (1)(n) of the EU Financial Directive 2002/47/EC (Cf. Doc. 4 [45], p. 10).

[14] 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]).

– [an account is taken][15] of what is due from each party to the other in relation to such [accelerated][16] 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.

Alternative b[17]

1) one or more eligible financial contracts are terminated and the obligations or entitlements thereunder are liquidated and/or the obligations or entitlements under one or more eligible contract are accelerated;[18]

2) a close-out value, market value, liquidation value or replacement value is calculated or estimated in respect of each obligation or entitlement or group of obligations or entitlements;

3) a net balance of the values calculated is computed into a net sum.[19] A single obligation of one eligible party to the other equal to that net sum payable by the eligible party from whom the larger amount is due to the other replaces all obligations and entitlements between the eligible parties.[20]

~~2. "Umbrella netting agreement" means or of a set of connected close-out netting agreements.~~

2. ~~3.~~ "Enforcement event"[21] means, in relation to a Close-out Netting [Agreement/Provision], 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/Provision]

– the other party is entitled to elect the operation of the Close-Out Netting [Agreement/Provision], or

– the operation of the Close-out netting occurs.

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[15] One participant at the first meeting of the Study Group explained that the wording "an account is taken" was taken from the bankruptcy law of the UK, which referred to set-off. He suggested that the definition should be broadened to encompass other means of aggregation (Cf. Doc. 4 [47], p. 10).

[16] Varying views were expressed during the first meeting of the Study Group as to whether the second indent of the definition needed to refer also to acceleration (Cf. Doc. 4 [40], p. 9).

[17] Alternative definition based on the three-step approach generally accepted by the Study Group (cf. Doc. 4 [17-20] p. 4 f. and [39] p. 8 f) and adapted from the "netting" definition of the ISDA Model Netting Act 2006 Version 2 (published October 10, 2007).

[18] The Study Group might wish to consider whether obligations that have already fallen due but have not been fulfilled prior to the enforcement should be covered by this definition.

[19] The Study Group might wish to consider whether the netting mechanism implies a logical order of acceleration and then aggregation or whether the order is irrelevant. The findings might be clarified in an explanatory note.

[20] The first tentative structure for Principles regarding the Enforceability of Netting Agreements (Doc. 3) preserved in draft Principle 13 the application of legal requirements "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". That provision has now been redrafted so as to deal essentially with the time frame for termination and valuation. The Study Group might wish to consider whether the term commercially reasonable as used in Art. 4 (6) of the EU Financial Collateral Directive entails any element other than the time factor on which guidance might be appropriate.

[21] Adapted from the Geneva Securities Convention, Article 31(h); EU Financial Collateral Directive, Article 2(1)(l).

3. ~~4.~~ "Insolvency proceeding"[22]

4. "Eligible financial contract" means any contract between eligible parties generating a fluctuating forward exposure by reference to market movements in some assets (e.g. commodities, indices) [,which for commercial and risk control reasons is closely connected to contracts of the same kind][23], such as in particular[24]

- Derivatives instruments (including forwards and options that are physically settled, spot transactions [...]);
- Securities financing transactions (including repurchase securities, margin loans [...]);
- [- Money market services and deposits ("deposit netting", including interbank landing and deposits, money market overnight facilities [...])[25]]

This includes contracts on the maintenance of financial instruments and contracts generating obligations under master-master agreements, under clearing and settlement arrangements and under title-transfer arrangements relating to such eligible financial contracts.[26]

5. "Eligible party" means any natural or legal person who acts for purposes other than for their personal, family or household use.[27]

Formal requirements for Close-out Netting [Agreements/Provisions][28]

6. ~~5.~~[29] The creation, validity, ~~perfection~~ [effectiveness against third parties,][30] enforceability or admissibility in evidence of a Close-out Netting [Agreement/Provision] should not be dependent on the performance of [any formal act][31].

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[22] The Study Group decided to postpone a decision on the definition of insolvency proceedings (cf. Doc. 4 [45], p. 10.) The original proposal – which was adapted from Article 1(h) of the Geneva Securities Convention, was as follows: *"Insolvency proceeding" means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation*.

[23] Definition based on the proposal for a generic definition of eligible financial contracts that was discussed controversially by the Study Group (cf. Doc. 4 [100-103], p. 18 f).

[24] Positive enumeration based on Doc. 4 [103-107], p. 19 f. A decision as to whether a negative or positive definition of eligible financial instruments shall be drafted has not yet been taken (cf. Doc. 4 [103], p. 19).

[25] Varying views were expressed at the first meeting of the Study Group towards the inclusion of money market services and deposits (cf. Doc. 4 [105], p. 20).

[26] The Study Group agreed in its first meeting that master-master agreements should be covered by the future instrument and discussed whether obligations arising under title-transfer arrangements and contracts on the maintenance of financial instruments needed and merited the same protection (cf. Doc. 4 [104], p. 20).

[27] Adapted from Art. 2(a) of the United Nations Convention on contracts for the international sale of goods of 1980 (CISG). An alternative wording adapted from Art. 2(a) of Directive 2005/29/EC of 11 May 2005 concerning unfair business-to-consumer commercial practices, from Art. 2(1)(f) of Directive 2008/122/EC of 14 January 2009 on the protection of consumers in respect of certain aspects of timeshare, long-term holiday product, resale and exchange contracts and from Recommendation 2 of Commission recommendations of 12 May 2010 on the use of a harmonised methodology for classifying and reporting consumer complaints and enquiries (2010/304/EU) could be: *"Eligible party" means any natural or legal person other than consumers. "Consumer" means any national person who is acting for purposes which are outside that person's trade, business, craft or profession.*

[28] Cf. Doc. 2 [93-94]; [283]-[289].

[29] Adapted from the EU Financial Collateral Directive, Article 3(1).

[30] The Study Group decided to delete the term "perfection" since it might create confusion: under UK Law, for example, perfection refers only to pledges, while under French Law, it is a synonym for making rights effective

7. ~~6.~~ [32] Principle 6 is without prejudice to any~~the~~[33] requirement that a Close-out Netting [Agreement/Provision] shall be evidenced in writing or any legally equivalent form.

8. ~~7.~~ [Notwithstanding[34] the general rule set out in Principle 6, ~~Principle 5 is without prejudice to any requirement regarding~~ States may require the registration of the financial contracts covered by the Close-out Netting [Agreement/Provision] with a trade repository or similar organisation [for purposes of prudential supervision][35]. A failure to comply with that requirement should not affect the creation, validity, ~~perfection~~ [effectiveness against third parties,][36] enforceability or admissibility in evidence of a Close-out Netting [Agreement/Provision].][37]

9. ~~8~~ The creation, validity, ~~perfection~~ [effectiveness against third parties,][38] enforceability or admissibility in evidence of a Close-out Netting [Agreement/Provision] should not depend on the use of standardised terms, ~~as~~ for example the terms of specific trade associations.

Enforceability of Close-out Netting [Agreements/Provisions][39]

10. ~~9.~~ A Close-out Netting [Agreement/Provision] should take effect in accordance with its terms.[40]

11. ~~10.~~ Except as otherwise provided in a Close-out Netting [Agreement/Provision], a Close-out Netting [Agreement/Provision] 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.~~[41]

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against third parties (cf. Doc. 4 [55], p. 11). The expression "effectiveness against third parties" is taken from Artt. 11, 12 of the Geneva Securities Convention.

[31] The Study Group was concerned that the term "formal act" might be not sufficiently precise and at the same time not broad enough to encompass all possible enforcement requirements (cf. Doc. 4 [56], p. 11).

[32] Adapted from the EU Financial Collateral Directive, Article 3(2).

[33] It was proposed to replace the direct article "the" with its indirect equivalent "any" to clarify that the Principles did not intend to establish a writing requirement but simply did not displace existing writing requirements (cf. Doc. 4 [57], p. 11).

[34] The expression "without prejudice" was considered to be misleading since it implied that draft Principle 8 was incompatible with draft Principle 6. Therefore, one participant proposed to replace the expression with the term "notwithstanding" (cf. Doc. 4 [59], p. 12).

[35] One participant suggested that the expression "for purpose of prudential supervision" was superfluous (cf. Doc. 4 [60], p. 12).

[36] The Study Group decided to delete the term "perfection" (see above fn. 30).

[37] The Study Group might want to consider whether the Principle excludes other possible consequences of failure to comply with a registration requirement. On more general terms, some participants proposed to delete the draft Principle since they considered that the clarifications made in draft Principle 8 belonged into the commentary (cf. Doc. 4 [58], p. 11).

[38] The Study Group decided to delete the term "perfection" (see above fn. 30).

[39] The Study Group discussed in its first meeting whether the Principles should address the interplay between netting protection and banking resolution powers. It agreed that it should keep this question under consideration (cf. Doc. 4 [28-33], p. 7f.).

[40] Adapted from the Geneva Securities Convention, Article 32, and Article 7(1) EU Financial Collateral Directive. This reproduces the original sentence which was met with strong support by the participants of the first meeting of the Study Group. To the extent however that draft Principle 10 might be understood as merely reflecting a general principle of law, the Study Group may wish to consider whether the purpose of this provision could be more clearly specified either by combining it with draft Principle 13 or with draft Principle 11 along the lines of Art. 4 of the ISDA Model Netting Act 2006 Version 2 (published October 10, 2007).

[41] Adapted from the Geneva Securities Convention, Article 33(3)(b); Article 4(5) EU Financial Collateral Directive.

[...][42]

12. ~~11.~~ Notwithstanding Principle 10, any provision in an eligible financial contract that suspends, conditions, or extinguishes a payment obligation of a party that would otherwise exist, solely because of such party's status as a nondefaulting party in connection with the insolvency of the other party, and not as a result of the exercise by a party of any right to offset, set-off or net obligations that exist under the eligible financial contract or the obligations thereunder or the applicable law ("walkaway" clause) shall not be enforceable.[43]

~~After the commencement of 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.~~ [44]

13. ~~12.~~ Except as otherwise provided in the Close-out Netting [Agreement/Provision], a Close-out Netting [Agreement/Provision] should be enforceable without any requirement that:[45]

- [prior] notice of the intention to operate the Close-out Netting [Agreement/Provision] should have been given [prior to the opening of insolvency proceedings][46];
- the terms of the realisation or the operation of the Close-out Netting [Agreement/Provision] 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/Provision] be operated in any prescribed manner.

14. ~~13.~~ Principle 10 does not affect the application of any rule of law pursuant to which the termination of the contracts [as part of the operation of a Close-out Netting [Agreement/Provision]] must be conducted within a brief timeframe (e.g. ... business days) and

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[42] The Study Group planned to expand the draft Principle to include an enumeration of insolvency principles that shall be disapplied to Close-out Netting [Agreements/Provisions] ("insolvency carve-out", cf. Doc. 4 [64], p. 12). This part of the draft Principle has yet to be formulated (cf. also Doc. 2 [44]-[54]; [292]-[296]).

[43] Several participants considered that the Principles should address the issue of walk-away clauses (cf. Doc. 4 [66-60], p. 13). The proposal is adapted from § 210(c)(8)(F) of the Dodd-Frank Act. An alternative formulation could be adapted from Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, Annex III, Nr. 3(b)(iii): *Notwithstanding Principle 11, any provision in a contract which permits a non-defaulting counterparty to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor ("walkaway clause") shall not be enforceable.*

[44] Several participants considered the original draft Principle 11 to be redundant in the light of draft Principle 9 (today draft Principle 10) and cautioned that a description of the netting process in the section on the enforceability of Close-Out Netting [Agreements/Provisions] might invite a party to infer that insolvency protection is given to close-out netting only under different or additional conditions (cf. Doc. 4 [65], p. 12).

[45] Adapted from the Geneva Securities Convention, Article 33(3)(a); Article 4(4) EU Financial Collateral Directive.

[46] The proposal to clarify in the Principles that a notice of the intention to operate the close-out netting agreement does not have to be given "prior to the opening of insolvency proceedings" was made in view of the fact that parties to a netting agreement cannot serve the notification of termination after the opening of insolvency proceedings in certain jurisdictions. The parties in these jurisdictions had to rely on automatic termination. However, automatic termination was considered to be the cause of many practical problems (cf. Doc. 4 [70], p. 13 f).

the valuation of the respective obligations of the parties must be completed within an additional brief timeframe (e.g. business days).. ~~*in a commercially reasonable manner.*~~ [47]

15. ~~14.~~ A Close-out Netting [Agreement/Provision] 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 /Provision is agreed to][48] 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.[49]

16. ~~15.~~ A Close-out Netting [Agreement/Provision] should remain enforceable [as regards the remaining financial contracts][50] even if one or more of the covered [financial contracts][51] otherwise eligible for netting[52] are ineffective, void or voidable.

~~**Enforceability of umbrella netting agreements**[53]~~

~~16. An umbrella netting agreement should take effect in accordance with its terms. Principles 3 - 9 apply accordingly.~~

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[47] The Study Group considered that a nondefaulting party should not have an indefinite "power to wait and see". Such a power arises under certain close-out netting agreements, which grant a nondefaulting party the right to withhold payments upon the default of its counterparty while at the same time not allowing the defaulting party to terminate the contract. The Study Group envisaged to provide for a time limitation on termination and valuation but has not yet decided on the length of this time limitation. One participant cautioned that any reference to a "commercially reasonable manner" was too vague and might encourage litigation. Some participants preferred therefore to determine a fixed time limitation in the Principles whilst one participant proposed to address the time limitation on a case-by-case basis in the supervisory framework (cf. Doc. 4 [72-78], p. 14 f.). Some experts proposed to distinguish between providing a time limitation on the continuation of conditions precedent (e.g. under Sect. 2(iii)(a) of ISDA Master Agreement) on the one hand and on the termination of transactions on the other hand. They felt that the a time limitation on the continuation of conditions precedent was sufficient to abolish the "power to wait and see" and explained that a time limitation on termination has not been suggested or requested by any public authority so far. The Study Group might wish to consider this distinction in its discussions and might wish to decide which time limitations should be provided for in the Principles. The current proposal is based on fixed time limitations for termination and valuation, the lengths of which will have to be determined by the Study Group. A proposal for time limitations determined in a supervisory framework would be: *Principle 10 does not affect the application of any rule of law pursuant to which the termination of the financial contracts and/or the valuation of the underlying obligations must be conducted within a timeframe defined in [name of a supervisory framework].*

[48] Cf. footnote 1 on the terminology discussion relating to "Agreement" and "Provision".

[49] Adapted from the Geneva Securities Convention, Article 37; EU Financial Collateral Directive, Article 8(1). This draft Principle does not exclude the possibility that an obligation is avoided for reasons other than the mere fact that it was created during a suspect period (e.g. for reasons of fraud). The Study Group might wish to consider the method for recalculating the single payment obligation in the event that the creation of any such obligation is avoided.

[50] It was proposed to amend the phrase "as regards the remaining financial contracts" to clarify that Principle 17 was not intended to enable the parties to count an invalid transaction into the netting calculation but simply held that the presence of one invalid transaction would not prevent netting from being effective (Cf. Doc. 4 [84], p. 16).

[51] It was proposed to replace the term "financial contract" by a broader term to encompass also obligations under the regime of unjust enrichment. The Study Group considered that obligations arising under the regime of unjust enrichment based on payments made under a transaction that was subsequently challenged, declared void or turned out to be void should be protected by the Principles (cf. Doc. 4 [82], p. 16).

[52] The amendment was proposed to clarify that the inclusion of one ineligible – but otherwise effective and valid – transaction – into a close-out netting agreement could not take the entire agreement out of the scope of netting protection (Cf. Doc. 4 [83], p. 16).

[53] Cf. Doc. 2 [290]-[291].

Conflict of laws (Optional section)

18. 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.

19. 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 18 are concerned if the parties have not made express provision to that effect.

20. 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.

Notice