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**UNIDROIT Committee of governmental experts  
on the enforceability of close-out netting  
provisions  
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**Draft Principles regarding the  
enforceability of close-out netting provisions**

**COMMENTS**

***(submitted by Governments)***

**INTRODUCTION**

The UNIDROIT Secretariat has invited the Governments of its Member States as well as Regional Economic Integration Organisations, Intergovernmental Organisations and International Non-Governmental Organisations to formulate comments on the text of the UNIDROIT Draft Principles regarding the enforceability of close-out netting provisions (C.G.E./Netting/2/W.P. 2) and on a joint proposal submitted by the Governments of France, the United Kingdom and the United States of America concerning the principles on eligible parties and obligations (Draft Principles 3 and 4 of the revised draft in C.G.E./Netting/2/W.P. 2 - C.G.E./Netting/2/W.P. 4) for consideration by the Committee of Governmental Experts on the enforceability of close-out netting provisions at its second session from 4 to 8 March 2013.

As of the morning of 20 February 2013 the UNIDROIT Secretariat has received comments on the Draft Principles from:

the Governments of Poland, the People's Republic of China and Sweden.

These comments are reproduced hereunder.

**COMMENTS SUBMITTED BY MEMBER STATES**

***Poland***

*Comments to the "Joint proposal by the Governments of France, the United Kingdom and the United States of America concerning the principles on eligible parties and obligations" (C.G.E./Netting/2/W.P. 4)*

The proposals concern the definition of "eligible party" and "eligible obligations", which are of utmost importance for the Principles. A particular attention should be paid to the definition of

"eligible party" according to the abovementioned proposal, which narrows the subjective scope as compared to the current text of Principle 3 included in C.G.E./Netting/2/WP.2 (December 2012). The problem concerns natural persons "acting as individuals who may be considered professionals", i.e. operating in the financial market.

The current official proposal of UNIDROIT refers to regulations included in the national legislation - vide point 3c: "any other person or legal entity designated as an eligible party under the law of the relevant State".

The proposed definition according to "Joint proposal" contains a closed list: "any person or entity other than a natural person who is acting as a consumer and includes a partnership, unincorporated association or other body of persons". The definition will give rise to doubts in interpretation, since it is based on the definition of "consumer" and makes a reference to "other body or person", mainly due to differences in the national law systems; it is unclear and needs further discussion. Therefore, the working group should make the final decision on who should be granted the privilege of using the "close-out netting" clause. The discussion on the subject should be preceded by agreeing on the definition of "eligible obligations". It stems from Principle 1 which defines the subject matter of drafted Principles: "These Principles deal with the effects and the enforceability of close-out netting provisions that are entered into by eligible parties in respect of eligible obligations".

We also point to the position of Poland on the matter, presented in the document UNIDROIT 2012 - C.G.E./Netting/1/W.P.3 (September 2012), "*Comments submitted by Governments and Organisations*".

## ***People's Republic of China***

### ***China's comments for Further Modification of the Draft Principles***

1. Principle 2 describes the mechanism of close-out netting as "the due and undue obligations... are reduced to... a single net obligation...which is then payable by one party to the other". The question is whether the close-out netting provision results in a single obligation for the whole contract or for each of parties instead. According to the explanation and commentary (C.G.E./Netting/2/INF 1), close-out netting contains a function of set-off (in the aggregation step), but if there are obligations which could not be properly set-off due to law or to the disagreement on valuation between the parties, can the close-out netting allow each of the parties finally to carry a single obligation? It should be described more clearly in the principle.

2. Both of paragraph (c) and (f) in principle 4 can contain the security of third party, and the boundary between them is blurred, especially when the paragraph (c) erased the phrase "title transfer". So the classification of principle 4 deserves further consideration. Furthermore, the phrase "eligible obligation" in paragraph (c) and the phrase "sub-paragraphs (a) to (e)" refer to the same content, so it is suggested to adopt the same term in order to avoid ambiguity.

3. The phrase "laws and regulations" appears twice in principles 6 (2) and it's essential to judge if this phrase refers to the same content at each time. If not, it's better to differ the terms strictly.

4. Principle 8 removes the word "temporarily" in order to cover all stays of the operation of a close-out netting provision in resolution of financial institutions, rather than temporary stays. But we think that the word "stay" itself has already contained a meaning of "a temporary measure". Maybe it's better to use "invalid" or "unenforceable" instead.

5. Principles 6(2) and 7(2) both point out exceptions to the general rules of the operation of close-out netting provisions in order to prevent the Principles from being a safe harbor for fraudulent transaction. Meanwhile, principle 8 imposes restriction on applicability of close-out netting provisions as well. These exceptional clauses could be merged into one clause or one principle in order to emphasize certain limitations on the enforceability of close-out netting provisions.

## **Sweden**

### **Introduction**

Sweden welcomes the redraft of the principles and the opportunity to submit written comments.

This paper contains Sweden's preliminary comments on the draft principles and other related issues. Sweden reserves the right to alter or modify its position as presented in this paper.

### **General comments on the draft principles**

Sweden would prefer if the terminology in the Principles is in line with those standard form contracts which are commonly used on the market (see for instance agreements published by ISDA). It is beneficial for any set of rules on commercial areas if the wording of the rules relates to the practise on the market.

### **Specific comments on the draft principles**

#### **Principle 1: Scope of the principles**

Sweden supports the split of Principle 1 into two principles. Sweden also supports the amendments made in the commentary to the new Principle 1.

Sweden has noted there must be a misprint in footnote 7; the footnote contains a reference to 32(3) in the Geneva Convention, however no such Article exists in the Convention. Sweden presumes that the right reference should be Article 33(3).

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

##### *Amendments to the Principle*

Sweden welcomes the amendments to the Principle.

##### *Amendments to the Commentary*

Sweden supports the amendment about *walk-away clauses* and *wait-and-see-periods*. The amendment is a welcomed clarification.

#### **Principle 3 and 4: Definition of 'eligible party' and 'eligible obligation'**

##### *Natural persons – consumers*

Natural persons, who are not in a partnership or an unincorporated association seems to fall outside the minimum field of harmonisation (or the core pillar of harmonisation).

Sweden fails to see the reason for excluding natural persons acting individually from the core pillar of harmonisation but including natural persons acting jointly, for instance in a partnership.

Sweden understands the need to restrict the scope of eligible parties since close-out netting is an exception from insolvency law. However, it is possible to limit the scope vis-à-vis natural persons in other ways than just focusing on if the natural person in question acts individually or collectively.

In Sweden it is relatively common that high-net-worth individuals conclude netting arrangement with financial institutions such as clearing and/or settlement systems and central counterparties. Some of those individuals engage in commercial activities which are large enough to, in case of a default, affect financial stability. Since close-out netting provision also can decrease the costs of credit exposure substantially the exclusion of such high-net-worth individuals from the core pillar of harmonisation can have negative effects on both the attractiveness of the financial market and financial stability in Sweden.

Therefore it is reasonable from a Swedish point of view to draw a distinction between natural persons acting as professionals, businesspersons, entrepreneurs or merchants and any such person involved in a particular undertaking of activities, commercial or industrial, for the purpose of generating revenue on the one hand and consumers on the other hand.

Sweden prefers if the core pillar of harmonisation provides that natural persons not acting as consumers can be eligible parties.

Sweden can support a draft of Principle 3 and/or 4 which has the effect that natural persons (not including consumers) may only be considered as eligible parties if the other party of the netting arrangement is a financial institution or public authority.

Against this background Sweden cannot support the present draft of Principle 3.

#### *Eligible obligations*

Sweden welcomes the amendments in Principle 4. However the draft of that Principle could be made clearer. The Principle states that:

“derivative instruments, meaning an option, forward, future, swap, contract for differences or other transaction in respect of a reference value that is [, or in the future becomes,] the subject of recurrent contracts in the derivatives markets”

The underlined section can be understood as either an explanation of what kind of derivative contracts that are covered (i.e. an explanation which is referring to the first part of the subparagraph meaning that only derivative contracts where the value depends on a reference value are covered) or as an exemplification of what kind of derivative contracts that are covered (i.e. meaning that *also* derivative contracts where the value depends on a reference value are covered).

Neither of these possible interpretations of the Principle seems to be correct. According to Paragraph 52 in the comments, Principle 4 a) covers both physically settled or cash settled contracts. And Paragraph 48 indirectly states what is apparently obvious; the principle covers (apart from contracts with underlying asset) also contracts which depends on a reference value.

In order to avoid any uncertainty about the scope Sweden therefore proposes that the Principle is redrafted. One possible way of doing so is to insert the following:

"... an option, forward, future, swap, (...) or other transaction in respect of **an underlying asset or** a reference value that is (...) the subject of recurrent contracts..."

**Principle 9: Governing Law of Close-out Netting Provisions**

Sweden supports the principle.