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International Institute for the Unification of Private Law

PRINCIPLES ON THE OPERATION OF CLOSE-OUT NETTING PROVISIONS

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FOREWORD

It gives us great pleasure to present, on behalf of the International Institute for the Unification of Private Law (UNIDROIT), the UNIDROIT Principles on the Operation of Close-Out Netting Provisions which were adopted by the UNIDROIT Governing Council at its 92nd session (Rome, 8-10 May 2013).

These Principles are the outcome of two and a half years of intensive research and deliberations. The General Assembly of UNIDROIT at its 67th session (Rome, 1 December 2010) assigned the highest level of priority to the project of the development of an international instrument on netting. Following this decision, a Study Group of experts in the law of international financial markets was set up by UNIDROIT. It met three times between April 2011 and February 2012, to prepare a preliminary set of Draft Principles concerning the enforceability of close-out netting provisions. In order to ensure a balanced approach, UNIDROIT invited renowned experts to participate in this Study Group representing regulatory agencies, international organisations, legal practice and academia from jurisdictions which represent today's international financial centres as well as developing countries.

At its 91st session (Rome, 7-9 May 2012), the UNIDROIT Governing Council discussed the Draft Principles as prepared by the Study Group and agreed to convene a Committee of governmental experts for further consideration and finalisation of the Draft. The UNIDROIT Committee of governmental experts on the enforceability of close-out netting provisions met for two sessions, in October 2012 and March 2013, approving at its second session a revised set of the Draft Principles on the Operation of Close-out Netting Provisions which was submitted to the Governing Council for adoption the following May.

UNIDROIT would like to express its deepest gratitude to the Members of the Study Group and to the delegates to the Committee of governmental experts. Only their outstanding competence and personal commitment made possible the successful preparation of these Principles in such a short *timespan. Particular mention is deserved by Professor Stanislaw J. Sołtysiński (Poland), Member of the UNIDROIT Governing Council, who acted as chair of the Study Group, and by Ms Maria Rosina Vermaas (South Africa) and Mr Alexandre Pinheiro dos Santos (Brazil), who acted as chair of the Committee of governmental experts at its first and second session respectively.*

A special word of thanks goes to Mr Philipp Paech (London School of Economics), who undertook the task of preparing the first study of this project and acted as Rapporteur both for the Study Group and the Committee of governmental experts, to the members of the Secretariat, in particular the Senior Officers Ms Frédérique Mestre and Ms Marina Schneider for the extensive work done in preparing the French version of the Principles, to the Associate Officers Ms Annick Moiteaux and Mr Ole Böger, who temporarily joined the UNIDROIT Secretariat in order to help with the completion of this project, and to Ms Isabelle Dubois and Ms Carla Milani, to whose secretarial support the project is greatly indebted.

Last but by no means least, UNIDROIT would like to express its deepest appreciation to the Bundesverband Deutscher Banken (Berlin) for the generous financial support provided for the research activities related to this project.

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PRINCIPLES ON THE OPERATION OF CLOSE-OUT NETTING PROVISIONS

Introduction

1. Financial institutions and other financial market participants in their daily operations use a number of mechanisms designed to reduce their risk exposure. Amongst other things, they provide each other with security or collateral. In addition, they may agree that close-out netting will apply to the contracts into which they enter with each other. Both mechanisms, security/collateral on the one hand and close-out netting on the other hand, serve the same purpose, that is, to ensure that one party's exposure to the other parties' solvency and to changes in the value of the relevant assets is kept at manageable levels. Both mechanisms are capable of independently mitigating counterparty risk as well as market risk. However, in practice, their functions are intimately linked: where collateral and netting mechanisms are used cumulatively, netting reduces exposure in the sense that much less collateral has to be put up. Taken together, security/collateral and close-out netting are one of the primary tools of risk management in the financial market.

2. The notion of close-out netting is a relatively new addition to the legal terminology and it is not particularly well-defined. These Principles follow a functional understanding of the term 'close-out netting provision' (see *Principle 2*), the main elements of which are as follows: a close-out netting mechanism comes into operation either by means of a declaration by one of the parties when a pre-defined event occurs, in particular default or insolvency of its counterparty, or it is triggered automatically when such an event occurs. The mechanism extends to a number, often hundreds, of outstanding transactions between the parties that are contractually included in a netting provision. Once the close-out netting mechanism is triggered, whether automatically or by means of a declaration by one party, generally all transactions that are covered by the close-out netting provision are terminated and a value is determined for each under a pre-defined valuation mechanism, which may also take into account, *inter alia*, the identity and credit standing of the party responsible for

this determination and any existing credit support and other material terms of the parties' agreement. The sum value of all such transactions is then aggregated, resulting in a single net payment obligation. The net obligation remains the only obligation to be settled and is generally due immediately after being determined even though no debts may have been due and payable under the transactions covered by the close-out netting provision prior to the operation of the close-out netting mechanism.

3. Broadly speaking, close-out netting is often understood as resembling the classical concept of set-off applied upon default or insolvency of one of the parties. Traditionally, the concept of set-off applies only to parties with mutual debts of the same kind that are already due and payable, and that are legally distinct. Whether set-off occurs by contract, by unilateral declaration by one party or by operation of law, the parties' existing debts are set off against each other, such that the party with the smaller debt owes nothing, and the party with the larger debt owes only the difference between the two obligations. While overlap can occur between the concepts of set-off and close-out netting, these legal institutions are neither functionally nor conceptually identical and the latter mechanism encompasses additional elements, providing, for instance, for the netting of obligations not yet payable. Set-off as such is not addressed by the Principles. However, set-off falls within the scope of the Principles where the parties to a close-out netting provision have agreed within that provision that their mutual obligations should be set off, or where the applicable principles of law provide for a set-off as regards the aggregation element of a close-out netting provision (see *infra*, paragraph 36). In both situations, the protection of the operation of the close-out netting provision afforded by the Principles is applicable.

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

5. Regulatory authorities (most recently, the *Financial Stability Board* and the *Cross-border Bank Resolution Group* of the Basel Committee on Banking Supervision) strongly encourage the use of such close-out netting provisions (alongside collateral) because of their beneficial effects on the stability of the financial system.[1] The reason is that if, in the event of default, the counterparty market participants were to be required to calculate their claims on a gross basis instead of being creditors for the net amount only, the non-defaulting party might be exposed to levels of credit risk and market risk that are difficult to estimate and manage. The situation would be further exacerbated by the fact that there may be rapid changes in market values for the relevant types of transaction as well as uncertainty as to the risk of repudiation of contracts during the insolvency proceeding, against which the non-defaulting party might not be able to protect itself whilst being unable to terminate the contracts and re-hedge the position on the basis of its termination rights under the close-out netting provision. Consequently, the operation of close-out netting provisions reduces the risk that the inability of one market participant to meet its obligations creates or increases financial difficulties for counterparties which could lead to a chain of failures of market participants (contagion effect or systemic risk).

6. These beneficial effects can be particularly evident in the event of the insolvency of a party. In that case, the use of close-out netting assumes that the legal effects stipulated to that end by the parties (the close-out netting provision) will be recognised by and be enforceable under the applicable insolvency law. However, the current situation is that, even if some 40 jurisdictions[2] recognise netting in insolvency, the extent to which

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1 Bank for International Settlements/Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, Recommendation 8, p. 36 *et seq.*; http://www.bis.org/publ/bcbs169.pdf; Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, para. 4.1., http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

2 According to a list regularly updated by the International Swaps and Derivatives Association (ISDA), the following jurisdictions have accommodated close-out netting in their law: Andorra, Anguilla, Australia, Austria, Belgium Brazil, British Virgin Islands, Canada, Colombia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan,

they do so and the scope and legal effects of close-out netting provisions differ significantly. Furthermore, some jurisdictions do not clearly recognise netting, and the legal practice in such jurisdictions often resorts to the principles governing set-off, failing to recognise the fundamental differences between the two mechanisms. This global 'patchwork' is unsatisfactory in cross-jurisdictional situations, since it exposes the financial market participants' risk management to unnecessary legal uncertainty and may even jeopardise it.[3]

7. Close-out netting provisions have been effectively used as a risk mitigation tool in a bilateral context. However, there is some concern that, in times of pressure on financial markets, the enforceability of close-out netting provisions might increase the risk that counterparties of a distressed financial institution rush to exercise termination rights and close out their positions, thereby exacerbating systemic risk. While underlining the usefulness of close-out netting in general, regulatory authorities have contemplated the need for a brief stay on the netting mechanism in certain situations (especially in the context of resolution regimes) affecting a financial institution, so as to allow the resolution authority the time needed to decide whether and how to resolve an ailing financial institution in an orderly fashion so as to mitigate risks to financial stability.

8. The emerging international regulatory consensus regarding the interplay between close-out netting and bank resolution is set out in the *Financial Stability Board*'s Key Attributes of Effective Resolution Regimes for Financial Institutions,[4] which provide guidance as to how the regulatory intervention should be reconciled with the need of financial institutions and its regulators to rely on the enforceability of close-out netting for risk management and mitigation purposes. However, this newly

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Luxembourg, Malta, Mauritius, Mexico, New Zealand, Norway, Peru, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, South Korea, Spain, Sweden, Switzerland, United Kingdom and the United States. According to the same list, netting-friendly legislation is under consideration in the following jurisdictions: Argentina, Chile, Pakistan and Seychelles. Source: http://www.isda.org/docproj/stat_of_net_leg.html.

3 Cf. for a detailed analysis UNIDROIT 2011, Study LXXVIII C - Doc. 2, 1st Part, in particular pp. 32 *et seq.*

4 Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, part 4, in particular para. 4.3.

developing regulatory approach has to deal with a patchwork where the relevant legal mechanisms in which close-out netting is embedded are not compatible or comparable across borders. Therefore, the sensitive connection between, on the one hand, regulatory measures such as stays on termination or portfolio transfers and, on the other hand, the essential insolvency and commercial law framework might fail in certain cases. Notably, stays might achieve a better cross-jurisdictional effect on the basis of harmonised legal principles. Equally, legal uncertainties arising in the context of asset transfers to domestic or foreign bridge banks can be more effectively mitigated on the basis of a more consistent international picture of the underlying commercial and insolvency law. This situation calls for a more harmonised and streamlined framework regarding close-out netting on which market participants and regulatory authorities can rely across all financial markets.[5]

9. First steps have already been taken towards an international consensus on the legal cornerstones regarding enforceability of close-out netting provisions. The Geneva Securities Convention sets out an optional framework for the protection of collateral transactions. This protection extends to close-out netting provisions provided they are concluded as part of a collateral transaction. The Convention therefore contains a definition of close-out netting and a key rule on enforceability.[6]

10. Furthermore, close-out netting has also been recognised in the work of other international Organisations. Notably, the UNCITRAL Legislative Guide on Insolvency Law refers to the enforceability of close-out netting as a feature to be considered when designing insolvency law, and advises that close-out netting should be allowed under the applicable insolvency procedure.[7] Moreover, the European Union Member States have implemented

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[5] Cf. for a detailed analysis UNIDROIT 2011, Study LXXVIII C - Doc. 2, 2nd Part, in particular pp. 68 *et seq.*

[6] UNIDROIT Convention on Substantive Rules for Intermediated Securities, adopted in Geneva on 9 October 2009; in particular Article 31(3)(j) and Article 33(3).

[7] UNCITRAL, 2004 Legislative Guide on Insolvency, Recommendations 7(g) and 101-107.

a partly harmonised legal framework for close-out netting provisions.[8]

11. The aim of these Principles is to provide detailed guidance to national legislators of implementing States seeking to revise or introduce national legislation relevant to the functioning of close-out netting. The Principles are designed to improve the enforceability of close-out netting, especially in cross-jurisdictional situations, in order to provide a sound basis, in commercial and insolvency law terms, for risk management and mitigation by financial institutions and for the application of regulatory policies in the international context. The Principles are addressed to legislators and policy-makers of implementing States. They are not intended to be chosen by private parties to govern a close-out netting provision.

12. There are several situations in which the law of a State which has implemented the Principles may govern the operation of a close-out netting provision. Generally, the courts of an implementing State might apply their own law as the law of the forum, especially in insolvency proceedings opened under this law. Furthermore, the protection of the operation of close-out netting provisions afforded under the Principles might be applicable even in proceedings conducted under the law of a State other than an implementing State. This may be the case, for instance, where a rule of private international law or international insolvency law of the forum leads to the application of the law of an implementing State, or the parties have chosen the law of an implementing State and the choice of law is upheld by the competent court. However, the Principles do not attempt to propose such rules to determine the law applicable.

13. Implementing States are free to choose any suitable method for implementing the Principles, be it the enactment of specific legislation, the application of general principles of law or the removal of restrictions to the enforceability of close-out netting provisions in the context of insolvency proceedings. Implementing States are likewise free to extend their protection of the operation of close-out netting provisions beyond the minimum

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8 Cf. UNIDROIT 2011, Study LXXVIII C - Doc. 2, p. 24-25 for a brief description of the various rules in place.

scope of harmonisation as provided for under the Principles and may also in this regard choose any of the methods referred to in the preceding sentence (see *infra*, paragraph 16).

PRINCIPLE 1
Scope of the Principles

(1) These Principles deal with the operation of close-out netting provisions that are entered into by eligible parties in respect of eligible obligations.

(2) Except as otherwise expressly indicated in these Principles, the term 'operation' encompasses the creation, validity, enforceability, effectiveness against third parties and admissibility in evidence of a close-out netting provision.

Explanation and commentary

14. For the determination of the scope of the Principles, *Principle 1(1)* refers to three core terms the content and meaning of which are defined in other provisions of the Principles: 'close-out netting provision' *(Principle 2)*, 'eligible parties' *(Principle 3(1))* and 'eligible obligations' *(Principle 4(1))*.

15. Within the scope of application so defined, the Principles follow a broad and functional approach concerning the various aspects of the taking of effect of a close-out netting provision, as is evident from the broad scope of the term 'operation' as defined in *Principle 1(2)*. All aspects, from creation and validity, to effectiveness against third parties, admissibility in evidence and enforceability, especially in insolvency, are covered by the Principles. Where the Principles seek to ensure the enforceability of close-out netting provisions, this concerns all these aspects, which can be summed up as the operation of the close-out netting provision. The term 'operation' of a close-out netting provision is therefore used throughout the Principles as a functional, shorthand reference to the various aspects described above and replaces the need to refer to the more specific terms which are not necessarily defined sufficiently precisely in an international context.

16. Concerning the limitations of the scope of the Principles, it should be noted that the Principles propose a minimum scope of harmonisation, where the enforceability of close-out netting provisions within the scope of the Principles should be ensured, whereas they acknowledge, without precluding further

harmonisation, that beyond this minimum scope, each implementing State may regard the enforceability of close-out netting provisions as an issue of its public policy. The Principles do not impose a maximum scope of harmonisation and therefore do not prevent or restrict an implementing State from having a legal framework (whether by means of legislation or otherwise) that goes beyond the Principles in the recognition of close-out netting provisions and the protection of their operation.

17. In view of the preceding paragraph, the Principles allow for a certain measure of discretion (see *Principle 4(2)*) in determining the scope of netting-specific legislation or of the application of other general rules protecting the operation of close-out netting provisions beyond the minimum scope of harmonisation suggested by the Principles. Factors that each implementing State may wish to take into consideration in the exercise of its discretion notably include:

- the importance of protection against systemic risk and the relevance for the functioning of the respective markets of the use of close-out netting provisions as an instrument of counterparty risk management;
- the relationship between close-out netting and the system of insolvency priorities in the implementing State in general;
- the need for predictability of results and certainty in commercial transactions;
- the general principle that the law should not treat similar situations differently without justification, and the specific principles against discrimination between domestic and foreign creditors in insolvency (see UNCITRAL Model Law on Cross-Border Insolvency, Art. 13); and
- whether this discretion is exercised for the purposes of the application of all or only some of the provisions of the Principles, or for their application in general or in situations outside insolvency only.

18. The Principles leave it up to implementing States to consider the desirability of extending the scope of application of

their laws and regulations protecting the operation of a close-out netting provision to any specific parties or obligations beyond the minimum scope of harmonisation under the Principles. Likewise, the Principles provide guidance to national legislators only with regard to the operation of close-out netting provisions falling under the definition in *Principle 2*. This does not encompass certain other clauses that are often included in master agreements in relation to a close-out netting provision but do not strictly speaking form part of the latter (see *infra*, paragraphs 41 and 43).

PRINCIPLE 2
Definition of 'close-out netting provision'

'Close-out netting provision' means a contractual provision on the basis of which, upon the occurrence of an event predefined in the provision in relation to a party to the contract, the obligations owed by the parties to each other that are covered by the provision, whether or not they are at that time due and payable, are automatically or at the election of one of the parties reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other.

Key considerations in respect of this definition

- The definition of 'close-out netting provision' should be broad so as to encompass different types of provision which achieve a functionally identical result.
- It should be neutral with respect to the various legal methods available to achieve the result that may exist in different jurisdictions and in different standard market contracts.
- The definition exclusively relates to contractual close-out netting, including bilateral netting within the context of central clearing systems. It does not address close-out

netting to the extent that its functionalities are achieved under statutory provisions, nor does it address truly multilateral netting.

Explanation and commentary

'Close-out netting'

19. Close-out netting is best described in functional terms, i.e., by reference to a result. The process, in practical terms, is the following. A bundle of transactions with mutual obligations between the parties is contractually covered by a netting provision. Upon the occurrence of a predefined event, all outstanding obligations covered by the netting provision cease to be treated individually and their aggregate value is computed so as to result in a single net payment obligation. This obligation is owed by the party which is 'out of the money' to the party which is 'in the money'. This obligation remains the only obligation (which, depending upon the terms of the relevant provision, may include incidental fees, costs or other expenses) to be settled and is generally due and payable shortly after being determined.

'Contractual provision'

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

21. In practice, a clause allowing for close-out netting between the parties may be included in standard master documentation, be part of a tailor-made framework agreement, or be an entirely self-standing agreement. The Principles therefore refer to the term 'close-out netting provision' rather than to 'arrangement' or 'agreement', so as to encompass these various possibilities. However, the term 'close-out netting provision' covers only those parts of an agreement that actually implement the close-out netting mechanism itself, and nothing else. Definitions, schedules and annexes that the parties may have related to their agreement are covered only to the extent that their content is necessary for the proper operation of the close-out netting mechanism. For instance, certain clauses (walk-away clauses, wait-and-see periods)

that are often used in connection with close-out netting provisions are not covered by the Principles (see *infra*, paragraphs 41 and 43).

22. Where the result of close-out netting is achieved through a combination of statutory rules and contractual provisions (e.g., the right to terminate is statutory, while acceleration, valuation and aggregation are arranged for contractually), the Principles only cover the contractual part. To the extent that the parties have relied upon the application of statutory rules, the operation of the close-out netting mechanism under those statutory rules is not an issue of the enforcement of the contractual agreement that would be covered by the scope of the Principles.

23. The internal rules of clearing, settlement and payment systems, as well as central counterparties are also contemplated by this definition. Despite the fact that they are usually approved by the relevant regulatory authority, the character of the relationship between the system and its participants is, or in any case is treated by this instrument as, one of commercial law (membership agreement, by-laws) as regards the treatment of the assets to be settled in the system. Thus, the close-out netting operation takes effect 'on the basis of' a contractual provision as envisaged by this definition.

24. The definition also covers contractual provisions that are not contained in the clauses of a single agreement, but in several interrelated arrangements, especially master-master agreements (to the extent that the underlying obligations covered by the various master agreements are eligible obligations under *Principle 4*, see *infra*, paragraph 81).

'Obligations owed by the parties to each other'

25. Transactions concluded between two parties may be settled either bilaterally, between the parties themselves, or through a central entity interposed between the parties. Close-out netting is *equally important* in both scenarios.

26. Bilateral settlement between the parties is the standard case and covered by the Principles.

27. The Principles also cover 'central clearing' mechanisms which are ultimately also built on bilateral relationships. Central

clearing is used as a collective term for the functionalities of central counterparties, net payment systems and certain clearing and settlement systems. Central clearing applies by virtue of contractual agreements between market participants or as a legal requirement. The arrangement usually works by interposing a central entity between the parties to every transaction that is concluded between the members of a clearing system, so that the central entity becomes 'buyer to every seller and seller to every buyer'. In other words, the bilateral settlement obligations that exist between the system's participants are entirely replaced by bilateral obligations between each participant and the central clearing entity. As a consequence, the net risk exposure is calculated on a bilateral basis, so that each participant's exposure exists exclusively against the central entity. Thus, given that, from a legal point of view, central clearing breaks down into strictly bilateral relationships, considerations in respect of bilateral close-out netting generally apply to central clearing. This applies both inside and outside the insolvency of the participants and the system. Therefore, legal certainty also requires that the conversion of the original contractual relationships between the central clearing participants into bilateral relationships between each participant and the central clearing entity is insolvency-proof.

28. Truly multilateral close-out netting is not as common as bilateral netting. Under a multilateral close-out netting scheme, more than two parties compute their mutual exposure on a multilateral basis, employing functionalities similar to those used in close-out netting. A mechanism similar in concept to multilateral netting is sometimes used as a tool to circumscribe the exposure of one market participant *vis-à-vis* several other market participants, typically a bank managing its risk exposure under a single netting provision against several entities belonging to the same group of companies (hence this form of netting is also called 'cross-affiliate netting'). The recognition of a multilateral netting provision by the applicable insolvency law depends in part on whether the law is able to accommodate the lack of mutuality of the relevant obligations or on whether the 'mutuality' created through cross-guarantees, cross-collateralisation agreements or similar arrangements is recognised. Truly multilateral close-out netting is *not* covered by the definition in *Principle 2*.

'Occurrence of an event predefined in the provision'

29. The event that triggers the application of the netting provision (the occurrence of the event that is 'predefined in the provision') is commonly referred to in the relevant documentation as the 'termination event', 'enforcement event', 'specified event', or 'default event'. Close-out netting can occur both in situations where both parties are solvent and in the event of the insolvency of either, since it is the parties to the netting provision themselves that determine the trigger for the operation of the mechanism. This event may consist, for example, in one of the parties defaulting on one or more of its obligations, or in its filing for insolvency, in the appointment of a State administrator or a similar intervention by the public authorities, or in the opening of an insolvency proceeding or an administration or restructuring procedure. Often, parties additionally agree to include external circumstances as termination events, such as the objective impossibility of performing an obligation under one of the transactions due to a circumstance beyond the control of a party, or the downgrading of one of the parties' credit rating following its merger with another company.

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

'Reduced to or replaced by a single net obligation'

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

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

– Termination of each transaction; valuation of each obligation; aggregation of all values to form one net payment obligation.

– Acceleration of each transaction, valuation of each obligation, aggregation of all values to form one net payment obligation.

– Termination of each transaction; valuation of each obligation; aggregation of all values to form one net payment obligation; acceleration of the net obligation.

– Termination of each transaction; valuation of each obligation; creation of a new (immediately due and payable) payment obligation representing the overall value.

– Etc.

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

34. Termination is a term used to express the functional result of the relevant open transactions being put to an end. National laws achieve this result by legal mechanisms called cancellation, close-out, rescission, termination, *etc.*

35. Acceleration is a term used to express the concept that an obligation becomes due and payable before the contractually

agreed date; there might be other legal concepts and terms to achieve an identical functional result such as the replacement of the original and as yet unmatured obligation with a new obligation ('novation'). It should be noted that, while the legal technique of novation is covered by the Principles as one of the methods that may be used to replace the original obligations with the single net obligation under the close-out netting provision, the type of transaction commonly referred to as 'novation netting' (or 'settlement netting') is not addressed by the Principles. 'Transformation' is another term that might be used in this context.

36. The aggregation element collapses all relevant transactions or the value resulting therefrom so as to produce a single obligation. This is functionally the same as a set-off of all due and payable obligations in the classical sense. Also, novation (i.e., the parties' agreement that, upon termination of all open transactions, a *new* obligation arises representing the relevant aggregate value) is a suitable concept to achieve the effect of aggregation.

37. The valuation of the terminated transactions or the entire (aggregate) contractual relationship generally seeks to establish compensation for the party that was 'in the money'. This means that the single net obligation is intended to 'represent the value of the combined obligations' that were covered by the close-out netting provision. Whereas the original obligations may include obligations for the payment of money or indeed any other performance (such as the delivery of securities or commodities), the resulting single net obligation must represent the 'value of the combined obligations' as an obligation for the payment of money or having a monetary value.

38. The Principles do not establish any specific requirements for the process of valuation. Usually (but not necessarily), valuation is effected by the non-defaulting party under a mechanism which has been pre-defined in the agreement. The parties are free to define the valuation mechanism and may use concepts such as replacement or market value or any other mutually accepted method of valuation.

39. As regards the substantive result of the valuation, *Principle 2* requires that the resulting net obligation must 'represent the aggregate value of the combined obligations'. No specific

additional criteria are laid down in the definition of the term 'close-out netting provision' and the implementing States retain some discretion as to the precise conditions to be fulfilled by a valuation mechanism in order to satisfy this requirement. Some legal systems, for instance, require an element of commercial reasonableness for the enforceability of close-out netting provisions. However, implementing States that currently do not apply such a commercial reasonableness requirement when determining whether the resulting net obligation can be regarded as representing the value of the combined obligations are not bound by the Principles to introduce such a criterion. Moreover, implementing States obviously remain free to recognise the enforceability of close-out netting provisions even if these are not covered by the definition of *Principle 2*.

'Payable by one party to the other'

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

41. However, parties may have agreed on a clause that allows a non-defaulting party which is 'out of the money' to refuse payment to the defaulting party ('walk-away clause'). Such clauses may have various justifications, for example, that a defaulting party should not benefit from its own default. However, not all jurisdictions permit such clauses because of their potential effect on systemic stability and for reasons of equal treatment of creditors. There is a regulatory debate as to whether they should be valid in the event of insolvency of the defaulting party. In order to take advantage of close-out netting for purposes of calculating required capital under the regulatory capital adequacy standards of the *Basel Committee on Banking Supervision*, parties may not

rely on a walk-away clause.[9] This is a regulatory and policy decision on which the Principles do not reflect a position. Walk-away clauses are not immediately linked to the enforceability of close-out netting provisions, since they do not affect the steps of termination, acceleration, valuation and aggregation under a close-out netting provision as defined in *Principle 2*. Rather, they constitute a type of clause which merely affects the payability of the obligations covered by the close-out netting provision or of the single net obligation resulting from its operation. Thus, where parties have concluded a master agreement that contains a close-out netting provision and a walk-away clause, the walk-away clause falls outside the scope of the Principles, while the protection of the operation of the close-out netting provision as such under the Principles is not affected.

'Automatically or at the election of one of the parties'

42. Depending on the specific contractual agreement, close-out netting either occurs automatically, by operation of the contractual agreement ('automatic termination', which is not allowed in a number of jurisdictions), or it may occur at the discretion of the party which is not the party to which the predefined event relates. Close-out netting provisions employing either elective or automatic termination are covered by the Principles.

43. The extent to which the non-defaulting party should be able to suspend or wait for a period of time or for an indefinite period of time to exercise its rights to close-out is currently under discussion among market participants and regulatory authorities, particularly where the defaulting party is in resolution or insolvency. One concern is that a non-defaulting party which is 'out of the money' may be entitled, under the terms of the master agreement, not to make any payments to the defaulting party after the occurrence of the event of default even though the non-defaulting party refrains from terminating and exercising close-out. Thus, the non-defaulting party may through inaction – by

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[9] Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (2006) Annex 4 para.96(iii), available under http://www.bis.org/publ/bcbs128.pdf.

refraining from the exercise of its rights under the close-out netting provision - avoid having to perform under its obligations to the defaulting party. Several different courts with jurisdiction over recent cross-border insolvency proceedings of large financial institutions have come to different conclusions in this respect. The Principles do not take a stand concerning these issues. The question of whether or not to impose a time limit for the exercise of the right to termination and close-out is regarded as a policy issue of the implementing State. Similarly, any suspension of the non-defaulting party's payment obligations after the termination event has occurred, but before the actual termination itself, does not affect the operation of the close-out netting provision as defined in *Principle 2* and is therefore an issue that is not addressed by the Principles.

PRINCIPLE 3
Definition of 'eligible party' and related notions

(1) 'Eligible party' means any person or entity, other than a natural person who is acting primarily for personal, family or household purposes, and includes a partnership, unincorporated association or other body of persons.

(2) 'Qualifying financial market participant' means any of the following:

(a) a bank, investment firm, professional market maker in financial instruments or other financial institution which (in each case) is subject to regulation or prudential supervision;

(b) an insurance or reinsurance company;

(c) an undertaking for collective investment or an investment fund;

(d) a central counterparty or a payment, clearing or settlement system, or the operator of such a system which (in each case) is subject to regulation, oversight or prudential supervision;

(e) a corporation or other entity that, according to criteria determined by the implementing State, is authorised or supervised as an important participant in the implementing State's markets in contracts giving rise to eligible obligations.

(3) 'Public authority' means any of the following:

(a) a governmental or other public entity;

(b) a central bank;

(c) the Bank for International Settlements, a multilateral development bank, the International Monetary Fund or any similar entity.

Key considerations in respect of this definition

- The definition of 'eligible parties' determines and restricts the scope of the Principles, in conjunction with the definition of 'eligible obligation'. Therefore, the application of the Principles to a legal relationship between two parties depends on whether both are eligible parties, and whether the relevant legal relationship represents an eligible obligation.
- The minimum scope of harmonisation as suggested by the Principles reflects different types of risk that are relevant in the various situations in which close-out netting provisions can be applied. The different categories of eligible parties as defined in *Principle 3* are the core factor for this distinction as applied under the minimum harmonisation approach of the Principles.
- *Principle 3* contains separate definitions for two sub-groups of eligible parties both involving increased risk. *Paragraph (2)* concerns 'qualifying financial market participants', i.e., parties where the enforceability or non-enforceability of close-out netting provisions may give rise to issues of systemic risk; *paragraph (3)* covers 'public authorities', where the enforceability or non-enforceability of close-out netting provisions may affect issues of public interest in the general sense, systemic risk or other. Under

the minimum harmonisation approach taken by the Principles (see *Principle 4(1)*), the scope of application of the Principles requires that at least one of the parties to the contracts from which the obligations covered by close-out netting provision arise must belong to one of these sub-groups.

- Apart from these sub-groups, the term 'eligible parties' is the general criterion for determining the personal scope of application of the Principles. It is defined in a broad and comprehensive manner, but acknowledges the need to protect natural persons acting primarily for personal, family or household purposes.
- Implementing States are free to extend the personal scope of application of the Principles beyond the minimum scope of harmonisation as suggested by the Principles; this discretion is dealt with in more detail in the commentary to *Principle 4*, see *infra*, paragraphs 56 *et seq*.

Explanation and commentary

Paragraph (1) – 'Eligible party'

44. The term 'eligible party' is defined in the broadest possible terms, reflecting the reasoning that it is well-nigh impossible properly to classify the different types of actor that might make use of close-out netting provisions in the financial or other markets.

45. The personal scope of application of the Principles covers both parties with legal personality and other entities, including trusts or partnerships, unincorporated associations or other bodies of persons, the latter being expressly referred to in *paragraph (1)*. All legal persons are covered by the definition in *paragraph (1)* and thus, reflecting the general systematic concept of *Principles 3 and 4*, 'qualifying financial market participants' and 'public authorities' as defined in *paragraphs (2) and (3)* are as sub-groups of 'eligible parties' always also covered by *paragraph (1)*.

46. The only exception provided for in *paragraph (1)* concerns natural persons acting primarily for personal, family or household purposes. This exception reflects the concerns of many legal systems regarding specific protection for consumers in connection

with the operation of close-out netting provisions. Since the scope of the legal category of 'consumer' varies as between the different legal systems, however, the text of *Principle 3* intentionally avoids the use of this term and the scope of the exception is defined in functional terms by reference to the primary purposes of the relevant transaction.

47. It should be noted that under the minimum harmonisation approach as suggested by the Principles, it is not sufficient for both parties to be eligible parties. Instead, at least one of the parties to the close-out netting provision must be a qualifying financial market participant or a public authority as defined in *paragraphs (2) and (3)*. On the other hand, *Principle 4(2)* allows implementing States to extend the scope of their protection of the operation of close-out netting provisions beyond the minimum scope of harmonisation as suggested by the Principles. This may include the extension of the personal scope of application to situations where neither party to the close-out netting provision is a qualifying financial market participant or a public authority as defined in *paragraphs (2) and (3)* or even to parties not covered by *paragraph (1)* - see the commentary to *Principle 4*, *infra*, paragraphs 82 *et seq*.

Paragraph (2) – 'Qualifying financial market participant'

48. The term 'qualifying financial market participant' encompasses all those parties active on the financial markets in relation to which the non-enforceability of a close-out netting provision might not only raise concerns regarding the individual credit risk management, but also issues of systemic risk.

49. In the interests of legal certainty as to the personal scope of application of the Principles, the definition in *paragraph (2)* is not based upon a direct reference to a requirement of systemic risk, but instead, in *sub-paragraphs (a) to (d)*, contains an enumeration of certain parties that are defined as being covered by the term 'qualifying financial market participant'.

50. *Sub-paragraph (e)* introduces an element of discretion for the implementing State into the definition of the term 'qualifying financial market participant' by extending the definition to corporations or other entities that, according to criteria

determined by the implementing State, are authorised or supervised as important participants in the implementing State's markets with regard to contracts giving rise to eligible obligations. The purpose of this provision is to include also certain non-financial corporate parties within the scope of the term 'qualifying financial market participant' under the law of each implementing State. The reasoning is that in some cases at least, certain parties participate in the relevant markets and make use of close-out netting provisions in a manner equivalent to financial entities and raising similar issues of systemic risk.

51. *Sub-paragraph (e)* does not specify any requirements as to the conditions, manner or content of the authorisation or supervision of such an important participant in the relevant markets. Instead, the intention is to allow implementing States to take into account the characteristics of their domestic markets in determining which entities should be allowed to take advantage of close-out netting provisions. Just as implementing States are free to extend the scope of application of the Principles under their own laws beyond the minimum scope of harmonisation suggested by the Principles by whatever measure, they may under *sub-paragraph (e)* follow both a general approach, authorising general classes of parties as being eligible for close-out netting (as a 'qualifying financial market participant' in the sense of this provision), or an entity-specific approach, authorising or supervising individual entities. Also, the decision as to whether ongoing supervision is required or whether a – general or specific – authorisation is sufficient, is left to each implementing State.

52. The implementing State may use various criteria in deciding whether or not to include certain entities within the scope of the parties covered by *sub-paragraph (e)*, such as, for instance, the size of the corporation or entity (measured by reference to assets, revenues, or otherwise) or the scale of its dealings in the relevant markets. Establishing such uniform criteria in these Principles for all States would not be appropriate nor indeed feasible. However, the criteria chosen by an implementing State should offer all guarantees of legal certainty and predictability to counterparties while ensuring that systemically-important entities are not excluded (see the general reasoning *supra*, paragraph 17).

Paragraph (3) – 'Public authority'

53. *Paragraph (3)* covers 'public authorities' as another sub-group of eligible parties. The underlying reasoning is that where one of the parties to a close-out netting provision is a public authority, the enforceability of the close-out netting provision is likely to raise issues of public interest. Often, this public interest might refer to issues of systemic risk; another specific concern might be the issue whether claims for the repayment of public funds made available to a private market participant can be protected in the event of the insolvency of the latter.

54. The aforementioned specific reasoning is especially evident in relation to the types of public authorities enumerated in *sub-paragraphs (b) and (c)*, i.e., central banks, the Bank for International Settlements, a multilateral development bank, the International Monetary Fund, or any similar entity.

55. *Sub-paragraph (a)* extends the definition of the term 'public authority' to governmental or other public entities. These broad terms should be interpreted in the light of the objectives of *paragraph (3)*, also taking into consideration the nature of the other instances of public authorities covered in *sub-paragraphs (b) and (c)*. Thus, the term 'public entity' encompasses, at least in certain cases and depending upon the local framework of the law of the implementing State, private entities providing public services. However, minor public involvement in an entity would not necessarily be sufficient to regard that entity as a 'public entity'.

PRINCIPLE 4
Definition of 'eligible obligation'

(1) 'Eligible obligation' means:

(a) an obligation arising under a contract of any of the following kinds between eligible parties at least one of which is a public authority or a qualifying financial market participant:

(i) Derivative instruments, that is to say, options, forwards, futures, swaps, contracts for differences and any other transaction in respect of an underlying or reference asset or a reference value that is, or in future becomes, the subject of recurrent contracts in the derivatives markets;

(ii) Repurchase agreements, securities lending agreements and any other securities financing transaction, in each case in respect of securities, money market instruments or units in an undertaking for collective investment or an investment fund;

(iii) Title transfer collateral arrangements related to eligible obligations;

(iv) Contracts for the sale, purchase or delivery of:

a. securities;

b. money market instruments;

c. units in an undertaking for collective investment or an investment fund;

d. currency of any country, territory or monetary union;

e. gold, silver, platinum, palladium or other precious metals;

(b) an obligation of an eligible party (whether by way of surety or as principal debtor) to perform an obligation of another person which is an eligible obligation under sub-paragraph (a);

(c) a single net obligation determined under a close-out netting provision entered into by the same parties in respect of obligations under sub-paragraph (a) or (b).

(2) An implementing State may elect to broaden the scope of paragraph (1)(a) in one or both of the following ways:

(a) by providing that it is to extend to obligations arising under contracts between parties neither of whom is a public authority or a qualifying financial market participant;

(b) by providing that it is to extend to obligations not limited to those listed in paragraph (1);

subject, in either case, to such limitations or exceptions as the implementing State may specify.

Key considerations in respect of this definition

- While *Principle 3* defines the notions of 'eligible party' and related terms that are relevant for the determination of the personal scope of application, *Principle 4* is the core expression of the minimum harmonisation approach as suggested under the Principles. Under *Principle 4(1)*, the scope of application of the Principles is restricted to obligations to which at least one public authority or a qualifying financial market participant is a party. *Principle 4(2)*, however, recognises that implementing States remain free to extend their protection of the enforceability of close-out netting provisions beyond the minimum scope of harmonisation suggested by the Principles.
- Close-out netting would be possible from the perspective of the purely legal mechanisms involved in respect of all mutual contractual relationships the value of which can be expressed in an amount of currency. However, in the event of default of one of the parties, close-out netting offers special treatment of the non-defaulting party in relation to the insolvent's general creditors. Therefore, under the minimum harmonisation approach suggested by the Principles, there is not only a limitation of the personal scope of application of the Principles as referred to in the preceding paragraph, but the substantive scope of application, i.e., the scope of eligible obligations, is likewise restricted to certain types of obligation. Therefore, there need to be elements justifying a contractual

relationship being covered by a close-out netting provision. There are three such elements.

- *Single relationship*: contracts entered into on the understanding that each as a practical matter affects the others should be covered. A first such case is the quasi 'natural' category of transactions in which the single relationship is directly implied. For example, swaps or repurchase transactions are entered into on the understanding that the mutual rights and obligations (which are legally distinct from one another) within a single transaction cannot be separated by the parties and should not be looked at separately in the event of one of the parties becoming insolvent (i.e., no cherry picking should apply in relation to only one leg of these transactions). In a second category of cases, this single relationship is wider and created contractually by the parties. However, given that close-out netting leads to special treatment in the event of insolvency, this contractual single relationship can only be established where there are good objective reasons to deal with a multitude of transactions on a collective basis. The main reasoning here is that it is more efficient for parties to monitor and manage their mutual risk exposure on the basis of an overall assessment of all transactions outstanding between them.
- *Rapid changes of value*: A second justification for applying close-out netting to certain of the parties' mutual rights and obligations stems from the fact that the volatility of the value of certain financial transactions would expose parties to considerable market and credit risk which they would have difficulty managing if they were not allowed to terminate such transactions upon the occurrence of one of the predefined termination events, in order to determine gains and losses and to re-hedge their portfolio. Rapid and significant changes in the contract value might expose the non-defaulting party to a multiple of the anticipated counterparty and market risk which can no longer be appropriately hedged.

- *Systemic risk*: A third justification is the avoidance of systemic risk. This element flows partly from the second justification. In deteriorating market conditions, the ability to terminate contracts and thus to limit exposures is important in guarding against the situation where the failure by one of the parties to perform its obligations causes its counterparty likewise to become unable to perform its obligations *vis-à-vis* third parties.

Explanation and commentary

General remarks on the scope of application and the minimum harmonisation approach under Principle 4

56. By defining the obligations eligible for inclusion in a close-out netting provision, *Principle 4* addresses the substantive scope of application of the Principles. It should be noted that *paragraph (1)(a)*, as the core element of the definition of the term 'eligible obligation', contains a reference to the definitions in *Principle 3*. Therefore, in order to be eligible, obligations must not only belong to one of the types of obligation enumerated in *sub-paragraph (a)*, *nos. (i) to (iv),* but the creditor and the debtor of the obligation must also be eligible parties as defined in *Principle 3*. Additionally, one of them must be a public authority or a qualifying financial market participant. Under *sub-paragraphs (b) and (c)*, there are equivalent restrictions of the personal scope of application on the basis of the references to the secured obligation (*sub-paragraph (b)*) or to the obligations covered by the master agreements (*sub-paragraph (c)*), see *infra*, paragraphs 80 *et seq*. The scope of protection of the operation of close-out netting provisions is limited to such situations in which, at least on the basis of a generalised characterisation, the enforceability of a close-out netting provision not only raises issues as to the relevant parties' individual credit risk management, but also concerns public interests such as, primarily, protection against systemic risk in financial markets (see *supra,* paragraphs 48 and 53).

57. Under *Principle 4(2)*, however, implementing States may, at their discretion, extend the scope of application of their protection of the operation of close-out netting provisions to situations beyond the minimum scope of harmonisation suggested under the

Principles, both in respect of the personal scope of application (eligible parties, *Principle 4(2)(a)*) and the substantive scope of application (eligible obligations, *Principle 4(2)(b)*). See *infra*, paragraphs 82 *et seq*.

Paragraph (1) - 'Eligible obligation'

58. The term 'eligible obligation' is defined in *paragraph (1)* as covering three sub-groups of types of obligation. First, *sub-paragraph (a)* covers obligations arising under certain types of contract enumerated in that paragraph. In this regard, the term 'contracts' is to be understood in a broad sense, also including contracts that might be categorised as 'commercial' contracts. It is impossible to make a neat distinction between financial contracts, on the one hand, and commercial contracts, on the other hand. For instance, futures and forwards are both used by industrial and commercial companies to hedge price swings in relation to raw materials, etc. Application of these rules to contracts entered into by energy traders, airlines and similar businesses, provided they fulfil the requirements regarding the personal scope of application of the Principles, would be beneficial as these face similar exposures to rapid price swings as those affecting financial firms. In *sub-paragraph (b)*, the scope of the term 'eligible obligation' is extended to obligations securing another eligible obligation and in *sub-paragraph (c)*, to obligations arising under master agreements covering other eligible obligations.

Paragraph (1)(a)(i) – 'Derivative instruments'

59. The term 'derivative instruments', refers to contracts in respect of an underlying or reference asset or a reference value. The reference value may consist of rates or indices, or of any other measure of economic value, or of factual events. In today's markets, the reference value usually consists of a rate, yield, price or index relating to interest rates, currencies, transferable securities, money market instruments, commodities, precious metals, credit risk, energy, emissions, economic or monetary statistics, actuarial or other insurance-related data, meteorological data, freight forward rates, bandwidth or property. However, other reference values are also conceivable. Regardless of whether the transaction is concluded in respect of an underlying or reference

asset or a reference value, the term 'derivative instrument' requires that the transaction is, or in future becomes, the subject of recurrent contracts in the derivatives markets. Thus, individual one-off transactions are not covered by *paragraph (1)(a)(i)*.

60. Derivative instruments will typically fulfil both criteria (*cf.* key considerations, *supra*) for inclusion in the list of contracts. First, two typical financial market participants such as banks, merchant banks, funds, insurance companies, *etc.* will ordinarily regard the multitude of their open derivative instruments with each other as a single relationship. Risk monitoring and assessment will usually be effected by the parties on an aggregate basis.

61. Derivative instruments also pass the test of the second criterion, i.e., exposure to considerable market and credit risk. They are often highly volatile transactions with rapid and significant price movements. Rapid price movements combined with large outstanding counterparty credit exposures and transaction volumes could also increase the danger of systemic risk.

62. Financial markets subdivide derivatives contracts into a number of categories, notably options, forwards, futures, swaps, contracts for differences, and their respective subcategories. The boundaries between these categories are not always clear-cut. Moreover, the list of derivatives categories can never be exclusive, in view of the need to cater for future market developments and differences in categorisation. Therefore, the underlying consideration is that the Principles apply to all derivatives covered by the definition in *paragraph (1)(a)(i)*, regardless of which category market practice may attribute to them.

63. Depending on the provisions of the relevant contracts, derivatives can be either physically settled or cash settled. Both are included within the scope of the Principles.

64. For the purpose of the Principles, it is immaterial whether the relevant contracts are entered on-exchange or off-exchange, or whether they are settled 'over-the-counter' or through a clearing mechanism or central counterparty (*n.b.* that in the latter cases, a bilateral close-out netting provision between the central entity and the system participant emerges (*cf. supra*, paragraph 27)).

Paragraph (1)(a)(ii) – 'Securities financing transactions'

65. *Paragraph (1)(a)(ii)* covers three methods of securities financing: repurchase agreements, securities lending agreements, and other securities financing transactions. In all three cases, transactions are covered if they have been concluded in respect of securities, money market instruments or units in an undertaking for collective investment or an investment fund.

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

67. Securities lending entails that the securities are made available to the counterparty with a simultaneous agreement to retransfer or return these, or equivalent securities, at a predetermined point in time. The borrower must provide collateral (e.g., in the form of cash) to the lender for the duration of the arrangement. Securities lending is mostly driven by the borrower's need for a certain types of securities.

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

69. The main example of another securities financing transaction that would be covered by *paragraph (1)(a)(ii)* is a margin loan. In much the same way as under the transactions referred to in the preceding paragraphs, under a margin loan money is advanced by a bank to its customer to purchase

securities on condition that the bank can subsequently regard these securities as collateral securing the loan. Again, the two prongs of such arrangements are (i) a flow of cash in one direction and (ii) the provision of rights over securities (collateral) in the other direction. The collateral can be provided under a title transfer arrangement or a non-title transfer arrangement (*cf. infra*, *sub-paragraph (a)(iii)*), i.e., depending on the arrangement, ownership of the securities is transferred to the bank.

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

Paragraph (1)(a)(iii) – 'Title transfer collateral arrangements'

71. *Paragraph (1)(a)(iii)* extends the definition of the term 'eligible obligation' to obligations arising under title transfer collateral arrangements related to eligible obligations. There are title-transfer collateral arrangements and non-title transfer collateral arrangements. They differ as to their nature, and the analysis as to whether and to which extent they are suitable for inclusion in a netting provision differs accordingly.

72. Under a title transfer collateral arrangement, full legal title is passed to the collateral taker and the collateral provider receives a claim for transfer of the identical sum or asset at a later stage. No property interest is retained on the provider's side. As a consequence, valuation and inclusion in the net amount of both legal positions are possible because there are claims for retransfer on both sides (a claim for repayment/retransfer of the value of the transaction, and a claim for retransfer of the collateral).

73. A non-title transfer collateral arrangement involves traditional security agreements such as pledge or charge. These are characterised by the fact that they are proprietary in nature and both the collateral provider and the collateral taker have proprietary interests in the encumbered asset. In particular, the collateral provider will usually retain legal title to the asset. This

type of arrangement is not generally susceptible to close-out netting as commonly understood, since a proprietary interest cannot be combined with, or netted against, a claim of a monetary character. Instead, enforcement of the rights of the pledgee is by way of sale of the pledged property and discharge of the secured obligations out of the proceeds of sale. Where both close-out netting and a traditional security interest apply under the parties' agreement, close-out netting operates under exclusion of the security interest. Rather, the security interest, in a second logical step, secures the net amount.

74. An important sub-category is the non-title transfer collateral arrangement which includes a right of use. In these cases, the parties agree, generally or in effect, that the proprietary right may be replaced, at the election of the collateral taker, by a right to the return of identical or equivalent assets. This is the case, in particular, where the agreement, sanctioned by the relevant law, permits the collateral taker to use the encumbered asset for its own purposes, in particular to 'rehypothecate' it, and subsequently to return not the *same* asset but an *equivalent* one. In this instance, the residual property interest originally vested in the collateral provider may cease to exist and be replaced by a contractual claim for re-transfer or the equivalent thereof. As a consequence, again, there are claims of an obligatory nature on both sides. Therefore, such an arrangement, if allowed under the relevant law, is generally capable of being included in a netting provision, the effect of which is, broadly, that the pledged property remains with the pledgee but a claim equal to its value is included in the netting calculation. *Principle 4(1)(a)* does not cover non-title transfer collateral arrangements with a right of use, but implementing States may decide under *Principle 4(2)(b)* to extend the scope of the protection to such non-title transfer collateral arrangements.

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

76. It is important to note that repurchase, securities lending as well as title transfer-collateral agreements may be collectively managed and monitored from the perspective of counterparty risk. Parties often cover all those types of transactions by a close-out netting provision.

Paragraph (1)(a)(iv) – Contracts for the sale, purchase and delivery of certain assets

77. *Paragraph (1)(a)(iv)* relates to contracts for the sale and delivery of certain assets against payment in so far as they are not covered by the definition of derivative instruments, in particular futures and forwards. For example, on the spot market, prices are agreed and paid immediately, whereas delivery occurs within a time frame of less than one month.

78. The relevant contracts are regularly entered into on the basis of a single relationship, and are subject to the same type of credit risk and change in value as other types of eligible obligation. In addition, they may be subject to settlement risk.

79. It should be noted that *paragraph (1)(a)(iv)* contains an exhaustive list of contracts giving rise to eligible obligations under this provision. This list does not, for example, include spot contracts for crude oil or transactions concerning emission allowances. Implementing States may, however, decide to extend their protection of the operation of close-out netting provisions to obligations arising from such transactions under *paragraph (2)(b).*

Paragraph (1)(b) – Surety agreements and other personal security

80. *Paragraph (1)(b)* ensures that not only the obligations of the (direct) parties to one of the contracts enumerated in *paragraph (1)* come within the scope of the Principles but also the obligations of other eligible parties that assume a liability of their own (whether by way of surety or guarantor, or as principal debtor) for the performance of the obligation of one of the parties to that contract. The most prominent such arrangements are guarantee and indemnity arrangements or other types of personal security that may exist in different jurisdictions, regardless of the wording employed. If the secured obligation is not an eligible obligation

under *paragraph (1)(a)*, the obligation of the third party security provider likewise cannot be eligible under *paragraph (1)(b).*

Paragraph (1)(c) – Master-master agreements

81. *Paragraph (1)(c)* provides that obligations arising as single net obligations under the close-out netting mechanism of a master agreement are likewise eligible obligations, thereby allowing close-out netting to take effect under master-master agreements, i.e., agreements under which there are several master agreements covered by another master agreement providing for the netting of the single net obligations arising under the covered master agreements (see also *supra*, paragraph 24). Such obligations arising under the master agreements covered by the close-out netting provision in a master-master agreement are eligible obligations under *paragraph (1)(c)* only to the extent that the covered master agreements have been concluded by the same parties and in respect of obligations covered by *paragraphs (1)(a) and (b)*, i.e., eligible obligations between eligible parties, at least one of which is a public authority or a qualifying financial market participant, or obligations assumed by eligible parties under a suretyship agreement as security for such an obligation.

Paragraph (2)(a) – Extension of the personal scope of application to other parties

82. In suggesting a minimum scope of harmonisation, the Principles are not intended to restrict the possibility for implementing States to extend the scope of their protection of the operation of close-out netting provisions to situations not falling under this minimum scope. *Paragraph (2)(a)* addresses the extension of the personal scope of application of the protection under the Principles.

83. First, it is left to implementing States's discretion whether to broaden the scope of *paragraph (1)(a)* by removing the limitation contained in *paragraph (1)(a)* that the obligations must arise under contracts to which at least one public authority or a qualifying financial market participant is a party.

84. Secondly, implementing States may decide to extend the scope of protection under the Principles to close-out netting provisions covering obligations arising from contracts that have been concluded by parties other than eligible parties in the sense of *Principle 3(1)*. Such an extension might especially be useful in respect of natural persons that participate in the financial markets to a certain extent and in relation to whom it might otherwise be unclear whether they act for personal, family or household purposes. Each implementing State is free as regards the extent of the protection and in defining the relevant group of natural persons.

85. Generally, the Principles do not take a stand concerning the issue as to whether implementing States should, in the interests of the protection of the parties' reliance on close-out netting provisions as a credit-risk management technique, decide in favour of such an extended scope of the enforceability of such provisions or not. The general criteria that could be taken into consideration in exercising this discretion are referred to above (paragraph 17). Implementing States are also free to decide upon the legal technique to be applied when extending the scope of protection of close-out netting provisions. *Principle 4(2)* allows the implementing States to specify any limitations or exceptions to such an extension of the scope of application of the Principles.

Paragraph (2)(b) – Extension of the substantive scope of application to other obligations

86. *Paragraph (2)(b)* provides that the implementing States may also extend the substantive scope of application of protection under the Principles. Implementing States may decide that their protection of the operation of close-out netting provisions under the Principles should, under their national law, also apply to obligations not covered by *Principle 4(1).*

87. The question as to whether loans and deposits should be included may be particularly relevant (see the following paragraphs). However, there might be other types of contract which States may decide to include, such as transactions concerning the sale, purchase or delivery of fungible commodities in general, non-title transfer collateral arrangements (see *supra* paragraph 74) or contracts for the clearing of obligations covered

by *Principle 4(1)(a)*. Implementing States may even decide to extend the scope to any contracts giving rise to a cash or physical settlement where both parties are public authorities or qualifying financial market participants or even to all types of contract in general.

Extension to loans and deposits

88. The inclusion of loans and deposits in the list of contracts is controversial because, although several arguments may be advanced for their inclusion, other aspects militate against such inclusion. From the outset, 'consumer' deposits and loans are left out of this discussion, since consumers are generally excluded from the minimum scope of harmonisation suggested by the Principles (see *Principle 3(1)*) and may be included only at the discretion of the implementing State under *Principle 4(2)(a)*.

89. Loans and deposits are closely related to one another from a functional perspective. Both are technically an advance of money (the principal) by one party to another, entailing a promise to return the principal at some point. Both generally, but not necessarily, carry the obligation to pay interest. A more superficial difference concerns the parties' motivation. It is assumed that a borrower accepts the principal from the lender in order to satisfy its own funding needs, whereas the depositary rather plays the role of safe-keeper of the money in the depositor's interest. However, in practice, banks' traditional sources of financing have been their clients' deposits, a fact which rather blurs that distinction. From a functional and legal point of view, therefore, loans and deposits are akin to one another. From a regulatory point of view, on the other hand, deposits enjoy specific protection, most particularly the circumstance that deposits receive special support under national legislation and traditionally, only licensed credit institutions ('banks') are able to take deposits.

90. It might be argued that neither loans nor deposits pose a particular risk or threat to systemic stability that can be best prevented by the application of close-out netting. They are not necessarily subject to rapid changes in value or to the volatility of markets. They are not used for hedging but rather for funding and they are not traded in large volumes. However, a number of

factors suggest that the inclusion of loans and deposits might be worth considering in certain circumstances.

- Loans mainly consist of a transfer and retransfer of cash. This functionality is identical to the cash leg of a number of transactions used by banks and central banks, notably repurchase agreements, securities-lending agreements and cash-title transfer collateral agreements. The latter are all undoubtedly within the scope of close-out netting. Carving out loans generally would mean that a clear distinction would have to be made between (ineligible) loans and the cash leg of the aforementioned (eligible) transactions. This might be difficult, particularly in a cross-jurisdictional situation, and thereby create legal uncertainty and provoke regulatory arbitrage. On the other hand, the presence of a non-cash leg in the eligible transactions might substantially mitigate the potential uncertainty and arbitrage.

- Banks regularly post deposits with and give loans to one another. Such deposits may be very short term and thus quite volatile as a funding source, as volumes may change from day to day according to the relevant needs, and because they are often provided in different currencies. Such arrangements expose the parties to credit risk and market (currency) risk. Banks might wish to calculate their mutual risk exposure flowing from these operations on a net, rather than a gross basis.

- Central banks take deposits from banks (in fulfilment of their minimum reserves policy) and extend loans to banks (in the framework of their monetary operations). A central bank will have an interest in being able to manage the risk exposure to each of the relevant banks on a net basis, i.e., in being able to apply close-out netting. Therefore, many central banks apply close-out netting to such loans and deposits.

- Furthermore, the phenomenon of ‘cash-pooling’ benefits from close-out netting. Cash pooling occurs where member companies of the same group manage their cash reserves collectively. Typically, the positive credit balance of one member of the group is made available to any others members that are in need of cash, through a common master cash account held by the parent company. A deposit (alternatively: loan) arrangement comparable to a revolving account facility exists between each member of the cash pool and the parent company, under which mutual repayment obligations are expressed as a net credit balance. Legally, mutual payment obligations are not settled until the member in question exits the cash pool arrangement (despite the fact that the current exposure is expressed as a net balance). However, the parties would not enter into such agreement if their exposure were not limited to the net exposure in the event of the counterparty's insolvency. If the insolvency administrator were able to cherry pick those deposits/loans that were favourable to the insolvent estate, and if it could at the same time set aside those that were unfavourable, the risk to the solvent party would be considerably increased.

91. On the other hand, there are arguments against making loans and deposits eligible for close-out netting. In addition to the reasons articulated above:

– including loans and deposits would mean that that part of a bank's balance sheet that was subject to close-out netting would be considerably increased.

– excluding deposits and loans from the scope of application of close-out netting would not necessarily mean that set-off was equally excluded. Many of the aforementioned arguments put forward in favour of the eligibility of loans and deposits for close-out netting could probably be addressed by set-off.

PRINCIPLE 5
Formal acts and reporting requirements

(1) The law of the implementing State should not make the operation of a close-out netting provision dependent on:

(a) the performance of any formal act other than a requirement that a close-out netting provision be evidenced in writing or any legally equivalent form;

(b) the use of standardised terms of specific trade associations.

(2) The law of the implementing State should not make the operation of a close-out netting provision and the obligations covered by the provision dependent on the compliance with any requirement to report data relating to those obligations to a trade repository or similar organisation for regulatory purposes.

Key considerations in respect of this Principle

- Formal requirements that impinge on the legal enforceability of close-out netting provisions have considerable potential to create legal uncertainty in a cross-jurisdictional context. Accordingly, the operation of close-out netting provisions should not depend on requirements such as prior registration with a public register or notarisation.
- The operation of close-out netting provisions should not depend on the use of standard documentation so as to allow for tailor-made close-out netting provisions and framework agreements, for individual changes to existing standard documentation or for market-led changes of standard documentation itself. The regulatory framework may impose restrictions in this regard; however, these must not hamper enforceability in commercial and insolvency law terms.

- The reporting of data in relation to certain financial transactions to trade repositories and similar organisations is an important feature of the supervisory framework. However, non-compliance with the duty to report such data should not entail the non-enforceability of the relevant contracts and the close-out netting provision which covers them.
- The principle that the operation of close-out netting provisions should not be made subject to formal acts and reporting requirements does not restrict the implementing State's power to provide for administrative, regulatory or penal sanctions for non-compliance with formal requirements and reporting requirements. Moreover, it is only the operation of the close-out netting mechanism that is not to be made subject to requirements of form. Where and to the extent that the parties include an agreement on the provision of security in the same contractual (master) agreement, form requirements of secured transactions law may apply, which can result in the ineffectiveness of purported security interests.

Explanation and commentary

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

Paragraph (1)(a) - Formal acts

93. For the above reasons, in a cross-border context, any requirements as to formal acts other than writing (or equivalent forms) appear to create additional risk. The main, but by no means only examples of such formal acts are requirements of prior registration with a public register and notarisation. Other requirements such as a mandatory notice period or prior approval by a competent court arguably are more closely related to enforcement and are therefore dealt with *infra*, paragraph 118. There are two strands of such potential risk caused by requirements of formal acts other than writing.

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

95. Secondly, even if such formal requirements are initially complied with under the first law, any possibility of transferring a close-out netting provision (including the transactions covered) to a new, foreign entity would be in jeopardy since it is unlikely that the law of the acquirer would require compliance with exactly the same formal steps.[10]

- This aspect is particularly relevant where a holding company re-integrates with a hitherto legally independent foreign subsidiary, in which case some or all contractual agreements entered into by the subsidiary might from that point on be subject to a different insolvency law, i.e., the law applicable to the parent company. It is unclear whether a contract transferred in this manner would be upheld in the event of the parent company's insolvency if the formal requirements regarding the close-out netting provision differed.

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[10] Cf. UNIDROIT 2011, Study LXXVIII C - Doc. 2, p. 37 (Example 7), p. 71 (Example 17).

– It is equally relevant in the context of resolution powers concerning banks or other financial institutions, which usually include the possibility of transfer, by regulatory order, of part or all of the financial institution's business to a second (solvent) institution. If the receiving second institution is subject to a different insolvency law, and if that law imposes formalities on close-out netting provisions, it is very unlikely that the formalities (if any) under which the close-out provision was originally entered into would suffice.

96. The registration of close-out netting provisions (and in some cases, the obligations covered by them) is required in certain jurisdictions as a condition for the creation, validity, enforceability, effectiveness against third parties, or admissibility of the close-out netting provision. In some cases, this requirement has a deterrent function against fraud, e.g., to exclude fraudulent backdating of close-out netting provisions prior, but close to insolvency. However, this means that all domestic and foreign parties, including those acting in good faith and in the absence of any fraudulent behaviour, as well as in the absence of insolvency of one of the parties, would be hit by the unenforceability of the close-out netting provision as a consequence of non-compliance with the registration requirement, e.g., due to a simple operational mistake. This situation might potentially create great legal uncertainty, and this is why registration should not be linked to the unenforceability of the close-out netting provision. However, there is nothing in the Principles to prevent courts from sanctioning fraudulent behaviour: *Principles 6(2) and 7(2)* leave open the possibility for the applicable law to treat close-out netting provisions as unenforceable as a consequence of fraudulent behaviour.

Paragraph (1)(b) - Use of standardised terms of trade associations

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

in standard documentation, individual amendments would imperil enforceability.

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

Paragraph (2) - Reporting requirements

99. In attempting to render the derivatives market more transparent, many jurisdictions have recently introduced or are about to introduce a duty to report data (parties, volume, type of transaction, date) relating to certain types of standardised derivatives to a trade repository. This measure serves prudential/supervisory purposes and the Principles do not intend to restrict the application of such regulatory requirements. However, while other potential sanctions are not affected (see *infra*, paragraph 101), a failure to report should not have as a consequence the restriction of the operation of a close-out netting provision. Should reporting be a prerequisite for the enforceability of the close-out netting provision, any non-compliance would actually *create* risk, since it would endanger the enforceability of the risk management mechanism agreed by the parties in situations which the parties (and possibly also their regulator) might not have anticipated since the failure will, in most cases, be a consequence of unintentional operational failure. This result would be clearly disproportionate and dangerous.

100. This reasoning also underlies the extension of *Principle 5(2)* to the obligations covered by the close-out netting provision. The regulatory reporting requirements typically have the objective of ensuring transparency and monitoring the market in order to control risks that may be building up. If a failure to report an underlying obligation were to result in the ineffectiveness of this obligation, this sanction would create additional risks if both parties had relied on this transaction in their risk-management. In order to avoid such unforeseen risks it would appear preferable to

allow the parties to rely on the effectiveness of the transaction and on its valid inclusion in the close-out netting provision. Of course, this does not rule out any other consequences of the failure to comply with the reporting requirement concerning the obligations covered by the close-out netting provision.

Consequences other than the restriction of the operation of a close-out netting provision or obligations covered by that provision: administrative, regulatory or penal sanctions

101. The reasoning in the preceding paragraphs argues against the restriction of the operation of a close-out netting provision (and of the obligations covered by that provision in the situation described in *paragraph (2)*) as a consequence of the failure to comply with formal and reporting requirements. Other sanctions, especially administrative, regulatory or penal consequences of such non-compliance, are not affected by *Principle 5*. It should also be noted that this Principle regulates the consequences of a failure to comply with formal requirements in relation to the close-out netting mechanism only. Where the parties agree on a close-out netting provision and on the provision of security in the same contractual (master) agreement, the validity of the security agreement may be subject to formal requirements of secured transactions law notwithstanding *Principle 5*. This may result, for instance, in the ineffectiveness of the provision of collateral as security for the obligations of the parties under the close-out netting provision.

PRINCIPLE 6
Operation of close-out netting provisions in general

(1) The law of the implementing State should ensure that a close-out netting provision is enforceable in accordance with its terms. In particular, the law of the implementing State:

(a) should not impose enforcement requirements beyond those specified in the close-out netting provision itself;

(b) should ensure that, where one or more of the obligations covered by the close-out netting provision are, and remain, invalid, unenforceable or ineligible, the operation of the close-out netting provision is not affected in relation to those covered obligations which are valid, enforceable and eligible.

(2) These Principles do not render enforceable a close-out netting provision or an eligible obligation that would otherwise be unenforceable in whole or in part on grounds of fraud or conflict with other requirements of general application affecting the validity or enforceability of contracts.

PRINCIPLE 7
Operation of close-out netting provisions in insolvency and resolution

(1) Subject to Principle 8 and in addition to Principle 6, the law of the implementing State should ensure that upon the commencement of an insolvency proceeding or in the context of a resolution regime in relation to a party to a close-out netting provision:

(a) the operation of the close-out netting provision is not stayed;

(b) the insolvency administrator, court or resolution authority should not be allowed to demand from the other party performance of any of the obligations covered by the close-out netting provision while rejecting the performance of any obligation owed to the other party that is covered by the close-out netting provision;

(c) the mere entering into and operation of the close-out netting provision as such should not constitute grounds for the avoidance of the close-out netting provision on the basis that it is deemed inconsistent with the principle of equal treatment of creditors;

(d) the operation of the close-out netting provision, and the inclusion of any obligation in the calculation of the single net obligation under the close-out netting provision, should not be restricted merely because the close-out netting provision was entered into, an obligation covered by the provision arose or the single net obligation under the close-out netting provision became due and payable during a prescribed period before, or on the day of but before, the commencement of the proceeding.

(2) These Principles do not affect a partial or total restriction of the operation of a close-out netting provision under the insolvency law of the implementing State on grounds which include factors other than, or additional to, those referred to in sub-paragraphs (c) and (d) above, such as knowledge of a pending insolvency proceeding at the time the close out netting provision was entered into or the obligation arose, the ranking of categories of claims, or the avoidance of a transaction as a fraud of creditors.

Key considerations in respect of Principles 6 and 7

- *Principles 6 and 7* aim at protecting the operation of close-out netting provisions from the effect of the application of domestic laws and regulations that may hinder the operation of close-out netting provisions whenever the application of such rules would be in conflict with the objectives of the Principles.
- Close-out netting provisions should be enforceable between the parties and against third parties. In the event of the commencement of insolvency proceedings in relation to one of the parties, this includes the insolvency administrator and the general insolvency creditors of the defaulting party.
- The operation of close-out netting provisions should be governed by the terms agreed by the parties, both before and after the commencement of insolvency proceedings and also in the context of a resolution regime. As a general rule, implementing States should not impair the operation of close-out netting provisions by imposing restrictions under national laws and regulations, neither in the form of general rules nor through specific rules directed against close-out netting.
- However, close-out netting is not shielded against *every* rule of commercial or insolvency law. The demarcation between those legal rules that should not apply to close-out netting and other legal provisions that should continue to apply requires careful consideration, in relation to laws and regulations of a general nature as well as in relation to restrictions specific to situations of insolvency or in the context of a resolution regime. As a general rule, provided that the general requirements for the valid creation of contracts are fulfilled, the sole fact of entering into a close-out netting provision should not be subjected to additional conditions under contract or commercial law and likewise should not trigger the application of insolvency avoidance rules. However, if a situation involves qualifying elements (for example, fraud *vis-à-vis* other creditors), the relevant

contract law and insolvency law tools (remedies for fraud, avoidance, *actio pauliana*) should continue to apply.

- For purposes of international compatibility, a common standard in this regard is of utmost importance.

Explanation and commentary to Principles 6 and 7

Systematic structure of Principles 6 and 7

102. The common objective of *Principles 6 and 7* is the comprehensive protection of the operation of close-out netting provisions, covering all aspects from the creation and formal validity (see also the specific rule in *Principle 5*), to the effectiveness against third parties, admissibility in evidence and enforceability, both before and upon the commencement of insolvency proceedings and within and outside the context of resolution regimes.

103. *Principle 6* sets out the general rules on the protection of the operation of close-out netting provisions. This general standard of protection applies both before and upon the commencement of insolvency proceedings and within and outside the context of resolution regimes.

104. Rules that are specific to situations of insolvency and resolution regimes are contained in *Principle 7*. As is made clear in the text of the chapeau of *Principle 7* by the words 'in addition to Principle 6', the protective rules of *Principle 6* remain applicable even after the commencement of insolvency proceedings and in the context of resolution regimes and are complemented under *Principle 7* by additional rules that are directed against a number of typical specific restrictions of the operation of close-out netting provisions in the latter types of situation.

105. *Principles 6(2) and 7(2)* both allow exceptions to the general rules on the protection of the operation of close-out netting provisions, allowing restrictions under the laws and regulations of the implementing State that do not limit the operation of close-out netting provisions as such, but that constitute requirements of general application or are triggered by the presence of other factors, especially fraud.

106. *Principles 6 and 7* are not intended to impinge upon the particular rules applicable in the context of the resolution of banks or other financial institutions which, under certain conditions, may supersede close-out netting provisions. The relationship of the Principles to those rules is addressed in *Principle 8*, which provision takes precedence over the resolution-specific rules in *Principle 7*, as is made clear by the words in the chapeau of *Principle 7* 'subject to Principle 8'.

Principle 6(1) sentence 1 - Enforceability of a close-out netting provision according to its terms

107. *Principle 6(1) sentence 1* is a 'catch-all' provision addressing all rules under national law that might potentially conflict with close-out netting provisions but should not (reservations apply, *cf. infra*).

108. The wording 'enforceable in accordance with its terms' is the core idea of the Principles. It relates to the challenge posed to close-out netting provisions by some quasi-universally recognised legal rules. The best example is probably the insolvency administrator's right to 'cherry pick' (*cf. infra*), but there are others. However, the diversity of legal systems and of the rules within them makes it very difficult to find a general, international formula that precisely describes which insolvency or commercial law rules and principles cause problems. Such a description is possible only in relation to the most obvious rules, which are here captured under *Principle 6(1)(a) and (b)* and *Principle 7(1)(a) to (d)*. However, as close-out netting provisions are embedded in commercial and insolvency law in much the same way as any other contract, many other legal obstacles are capable of rendering a close-out netting provision unenforceable. These are potentially numerous, but difficult to describe.

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

110. A telling example of a conflict that might hamper the enforceability of close-out netting would be its assimilation to statutory set-off rights under commercial law and the resulting

application of the requirements for set-off to close-out netting. Despite the fact that statutory set-off is more limited than close-out netting, in the absence of any clarifying legal rule courts and insolvency administrators might apply its requirements by analogy to close-out netting provisions, thus potentially distorting the enforceability of close-out netting. In particular, set-off traditionally applies only to mutual obligations of the same kind that are due and payable and that are legally distinct; in some jurisdictions, set-off traditionally is restricted to obligations flowing from the same agreement, or that are very closely connected to each other (for the delimitation between set-off and close-out netting see also *supra*, *paragraph* 3). As these requirements will rarely be complied with by a close-out netting provision, there is a real risk that the provision will be unenforceable.

111. Similar impediments to the enforceability of close-out netting provisions might stem from their perceived similarity to such known concepts as, for example, novation, and the subsequent application of the enforceability requirements of a novation agreement to a close-out netting provision. However, as analogies like these are probably very diverse, there is a need for a 'catch-all' rule. This is why *Principle 6(1) sentence 1* prescribes that a close-out netting provision, as defined in functional terms in *Principle 2*, should be generally enforceable.

112. It is obvious, however, that close-out netting provisions would never be allowed to trump certain other fundamental rules, such as the rules relating to misrepresentation and fraud to the detriment of the counterparty, its creditors or the insolvent estate. In certain cases, the distinction may be quite difficult to make. This is why *Principle 6(1)(a) and (b)* and *Principle 7(1)(a) to (d)* set out the most typical challenges to close-out netting provisions that should be disapplied in order to guarantee the enforceability of close-out netting, while exceptions to this general rule apply under *Principles 6(2) and 7(2)*.

Enforceability of a close-out netting provision within and outside insolvency and resolution

113. The systematic structure of *Principles 6 and 7* as set out above ensures that the scope of the principle on the enforceability of a close-out netting provision according to its terms as laid down

in *Principle 6(1) sentence 1* covers situations both before and upon the commencement of insolvency proceedings and within and outside the context of resolution regimes.

114. The background is as follows. A close-out netting provision is a provision within a bilateral contractual relationship. Outside insolvency proceedings or resolution regimes, such a close-out netting provision rarely clashes with policy considerations so that there is scant reason to prohibit or limit its use. As a consequence, a close-out netting provision should generally be effective and enforceable as between the parties outside the context of insolvency proceedings or resolution regimes.

115. The role of a close-out netting provision in reducing counterparty and systemic risk becomes dominant in particular in the event of the commencement of insolvency proceedings in relation to one of the parties. However, rules of insolvency law that are generally intended to preserve the insolvency estate for distribution to creditors and to ensure equal treatment of the latter could potentially be incompatible with the essential features of close-out netting. One of the primary purposes of insolvency law is to determine the question as to which creditors' claims should take precedence over which other creditors' claims. Insolvency law traditionally provides for tools such as 'cherry picking' and avoidance of contracts to put its insolvency policies into practice (*cf. infra*), and the application of such rules may render close-out netting provisions meaningless. However, the enforceability of close-out netting is crucial not only outside insolvency but within insolvency and resolution as well, since the purpose of close-out netting is to reduce counterparty and systemic risk. If this is not recognised in the latter situations, the value of close-out netting provisions would be seriously disturbed. Accordingly, the purpose of *Principles 6 and 7* is to clarify that the law should protect the enforceability of a close-out netting provision throughout its lifetime, namely both before and upon the commencement of insolvency proceedings and within and outside the context of resolution regimes.

116. For the purpose of the Principles, the definition of 'insolvency proceeding', i.e., which 'insolvency' procedures should accommodate close-out netting, should be very broad, and the Principles duly target the law governing a great variety of

different procedures. Reference is made to Article 1(h) of the Geneva Securities Convention[11]: '*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.* Both judicial and administrative proceedings are covered, aiming at both liquidation and reorganisation, these terms being defined in the UNCITRAL Legislative Guide on Insolvency Law as follows: *'Liquidation': proceedings to sell and dispose of assets for distribution to creditors in accordance with the insolvency law;*[12] *'reorganization': the process by which the financial well-being and viability of a debtor's business can be restored and the business continue to operate, using various means, possibly including debt forgiveness, debt rescheduling, debt-equity conversions and sale of the business (or parts of it) as a going concern.*[13]

117. As a factual situation of particular interest as regards the enforceability of close-out netting provisions, resolution regimes are expressly mentioned in *Principle 7*, emphasising that – subject to *Principle 8* – the protection of the operation of close-out netting provisions under *Principle 7* also covers the newly developed and still developing 'resolution regimes for financial institutions', as described in the *Financial Stability Board*'s Key Attributes of Effective Resolution Regimes for Financial Institutions, which – depending on the national legislation in the different jurisdictions – may or may not fall within the definition of the term 'insolvency proceeding' as referred to in the preceding paragraph. Under such resolution regimes, a national authority (typically the central bank or the financial services authority, or both) takes appropriate measures in respect of a financial institution that is no longer viable, such as, in particular, transferring the failed firm's assets and liabilities to a bridge institution, overriding shareholders' rights, conducting a 'bail-in', *etc*. It follows from the Key

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11 UNIDROIT Convention on Substantive Rules for Intermediated Securities, adopted in Geneva, on 9 October 2009.

12 UNCITRAL, 2004 Legislative Guide on Insolvency Law, Glossary (w) (p. 5).

13 UNCITRAL, 2004 Legislative Guide on Insolvency Law, Glossary (kk) (p. 7).

Attributes, para. 4.1 that, first, the legal framework for close-out netting during a crisis should be clear and that close-out netting should be enforceable. Accordingly, the Principles should, in general, also apply to administrative procedures aiming at the resolution of financial institutions. Secondly, however, close-out netting should not hamper the effective implementation of resolution measures: in particular, the early termination of large volumes of assets under close-out netting provisions has the potential of undermining the effectiveness of the authority's measures since such termination might occur before the appropriate measures can be taken. That is why the *Financial Stability Board* requires, *inter alia*, that the regulator be given the right temporarily to stay early termination and acceleration rights (Key Attributes, para. 4.3). This issue is addressed separately in *Principle 8*.

Principle 6(1)(a) – Additional enforcement requirements

118. Whereas *Principle 5* deals with the formal acts which should not be required for the operation of a close-out netting provision, *Principle 6(1)(a)* relates to additional conditions for the enforcement of a close-out netting provision. The practical value and effect of close-out netting would be significantly diminished or even rendered void if the law were to impose any additional requirements as conditions for the enforcement of close-out netting provisions that went beyond those that the parties might have contractually agreed. In particular, the requirements traditionally imposed on the realisation of security interests such as pledges, charges and mortgages should not be made to apply to close-out netting. Such specific requirements may include, for example,

- prior notice to the defaulting party that the close-out netting provision may be put into operation;
- approval of the terms of the realisation or operation of the close-out netting provision by a court or other public authority; or that
- the realisation be conducted by public auction or in any other prescribed manner; or that

– the close-out netting provision be operated in a legally prescribed manner; or that
– the close-out netting provision be subject to the requirements that may apply in the context of enforcing set-off.

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

Principle 6(1)(b) – Invalid/unenforceable/ineligible obligation included

120. Another group of potential obstacles to the enforceability of netting provisions relates to the obligations covered. One or several of the obligations covered might flow from a particular type of transaction which is invalid, unenforceable or ineligible. Since the close-out netting provision and all the obligations to which it applies are often regarded as *one* contract, general principles of commercial law could hamper the enforceability of the bundle as a whole. This might endanger the enforceability of the netting provision as a whole, i.e., with respect to all remaining obligations. A better solution would be to ensure that the netting mechanism is not affected in relation to the other obligations that are valid, enforceable and eligible.

121. An obligation is ineligible if it is not of a type covered by *Principle 4*. Ineligible obligations should simply be severed from the bundle of obligations covered by the close-out netting provision and continue their separate lives under the applicable regime of their governing law, whereas the remaining obligations can be netted.

122. Even if in principle eligible, an obligation may be unenforceable for various reasons. A prominent case relates to wagering or gaming prohibitions which might apply in relation to certain derivatives transactions in some jurisdictions. The fact that one or more of the obligations covered by the close-out netting provision are unenforceable should not have any impact on the netting of the remainder of the bundle of obligations covered by the close-out netting provision.

Principle 7(1)(a) – Stay

123. Insolvency rules often impose a stay on all transactions with the insolvent estate as from the moment of the commencement of the proceeding. Such a stay would traditionally also inhibit the operation of set-off and is sometimes expressly extended to netting mechanisms. The reasoning is that any further outflow of assets must be stopped and the insolvency administrator given the right to repudiate all unfavourable contracts. However, a stay imposed on the close-out netting of eligible obligations leads to a situation in which it becomes impossible effectively to manage the credit *and* market risk associated with the bundle of obligations covered. During the stay, their value might fluctuate considerably and cause much greater potential damage to the solvent party than would have occurred had termination been possible at the moment of insolvency. Furthermore, from a conceptual angle, a stay appears unnecessary since the insolvency administrator should not have the right to choose among unperformed contracts (no cherry picking, *cf. infra*). This is why *Principle 7(1)(a)* suggests that the operation of the close-out netting provision should not be stayed upon the commencement of an insolvency proceeding in relation to a party to a close-out netting provision. It should be emphasised that this provision is only intended to address stays ordered as a general measure based upon the commencement of an insolvency proceeding alone, while a restriction of the operation of a close-out netting provision in more specific circumstances would be subject to the other provisions of *Principle 7*, notably *Principle 7(2)*.

124. The prohibition of stays under *Principle 7(1)(a)* applies in the context of resolution regimes as well (*cf.* also *supra*, paragraph 117), but in this context it is subject to the exception in *Principle 8*, which accommodates stays that are necessary in the context of resolution of financial institutions.

Principle 7(1)(b) – Cherry picking

125. In an insolvency proceeding, the insolvency administrator or court may have the right to 'cherry pick' from the insolvent party's non-performed contracts. This refers to the right to require any counterparty to perform those contracts that are favourable to

the insolvent estate while rejecting those that are unfavourable to it.

126. If it were possible to cherry pick among a netting set, the bundle of transactions would be disassembled and the solvent party would be required to perform its obligations under all the transactions that were unfavourable from its perspective, whereas the insolvency administrator would not perform the obligations under the favourable transactions – ultimately, the solvent party would be exposed to the full counterparty risk.

127. Cherry picking is essentially contrary to the characteristics of a single relationship as set out *supra* (*cf.* key considerations in respect of *Principle 4*). Furthermore, cherry picking disproportionately increases the counterparty risk for the other party and should not, therefore, be available to the insolvency administrator.

128. Those jurisdictions that accommodate close-out netting tend to solve the conflict between cherry picking and enforceability of close-out netting provisions by disallowing the selection of isolated obligations. The insolvency administrator may not demand performance under transactions covered by the close-out netting provision whilst rejecting any of the obligations owed to the other party. The right of the insolvency administrator, to the extent that this right exists under the applicable insolvency law, to reject *all* transactions covered by the close-out netting provision is not affected. Thus, either *all* transactions must be performed, or *none.*

129. Obviously, the rule in the preceding paragraph is subject to the qualification that the underlying transactions may not be unenforceable for any other reason. The insolvency administrator is not prevented from demanding performance under other obligations covered by the master agreement merely by reason of having refused to perform an obligation that is not enforceable as such. In such situations, *Principle 6(1)(b)* protects the operation of the close-out netting provision only as regards the other obligations covered that are valid, enforceable and eligible (for a specific application of this rule as regards the time-based avoidance of obligations covered by the close-out netting provision, see *infra*, paragraph 141) Moreover, no performance may be demanded once the obligations covered by the close-out

netting provision are terminated under the close-out mechanism and reduced to or replaced by a single net obligation representing the value of the combined obligations.

130. The same principles apply where close-out netting provisions and their underlying obligations are again bundled by an 'umbrella' close-out netting provision (in practice, several master agreements are bundled by a 'master-master agreement', see *supra*, paragraph 24). To the extent that the various master agreements are validly included in the close-out netting mechanism provided for under the master-master agreement, the insolvency administrator should not be allowed to require performance on just one of them.

Principle 7(1)(c) – No conflict with equal treatment of creditors

131. This paragraph suggests that under the domestic law, the mere entering into and operation of a close-out netting provision as such should not constitute grounds for the avoidance of a close-out netting provision on the ground that it is deemed inconsistent with the principle of equal treatment of creditors of the insolvent estate by favouring one creditor to the detriment of the other creditors.

132. First, this rule is particularly relevant since the effects of a close-out netting provision often occur at the moment of, or shortly before, the insolvency proceedings are opened. As a consequence, conflicts with the so-called 'anti-deprivation' principle, the *pari passu* principle, or the unenforceability of *ipso facto* clauses might otherwise arise.

133. Secondly, this Principle addresses the concern that the mere inclusion of a close-out netting provision in the contractual documentation might be deemed inconsistent with the principle of equal treatment of creditors to the detriment of other creditors of the insolvent estate. In the absence of any qualifying facts, the conclusion of a close-out netting provision is neutral, as it is not clear which party, if any, will default. Furthermore, parties do not, at the time of entering into the close-out netting provision, know who will be 'in the money' or 'out of the money' at any given point in time in the future.

134. However, the domestic law can impair the operation of a close-out netting provision should there be qualifying elements, going beyond the *mere* fact of entering into the close-out netting provision (*cf. Principle 7(2)*, with references to some examples of such qualifying factors).

Principle 7(1)(d) – Suspect periods and zero-hour rules

135. National insolvency laws often contain rules avoiding (or allowing the administrator or court to avoid) the entering into agreements or the taking effect of close-out netting mechanisms, transfers, payments and provision of collateral which have occurred during a prescribed period prior to insolvency. Such a period is either defined as a fixed period prior to the commencement of insolvency proceedings (e.g., the three months preceding the date of commencement), or it may be defined by the insolvency court, counting, in particular, from the point in time when the over-indebtedness or similar indicator first occurred. The reasoning underlying such rules is to increase the pool of assets available for distribution amongst general creditors and to avoid unjustified preference of one or more creditors over the remaining creditors by 'clawing back' the relevant payments or property.

136. Neither the close-out netting provision nor, to the extent that they are included into the calculation of the single net obligation under the close-out netting mechanism, any obligations covered by the close-out netting provision should be subject to such avoidance rights.

In relation to the close-out netting provision

137. The close-out netting provision itself is protected under *Principle 7(1)(d)* against time-based avoidance in two separate respects. First, the mere fact that the close-out netting provision took effect, i.e., that the single net obligation representing the aggregate value of the combined obligations covered by the close-out netting provision became due and payable, during a suspect period should not justify any restriction of the operation of that provision. This principle is of key importance in protecting the enforceability of close-out netting provisions, since it is often the application for the commencement of insolvency proceedings

itself that triggers the close-out netting mechanism. This means that such provisions would be largely devoid of effect if they could be avoided on the grounds of the close-out netting mechanism having taken effect within the suspect period.

138. Secondly, in some jurisdictions, there might be uncertainty as to whether entering into a close-out netting provision during the suspect period might justify an avoidance action. Therefore, there is a risk that an insolvency administrator or court would attempt to halt, avoid or otherwise render unenforceable a close-out netting provision entered into during the suspect period. However, the parties are in no position, at the time of entering into a netting provision, to know which of them, if any, might subsequently default. Equally, they cannot know with any certainty which party will be 'in the money' at the time of the potential subsequent default of one of the parties. Thus, entering into a close-out netting provision is neutral from the outset and equally beneficial or disadvantageous as to the risk borne by both sides. This situation is different from that of receiving payments or property or taking new or additional collateral, which decreases the credit risk of only one of the parties. As a result, entering into a close-out netting provision should not be subject to avoidance merely on the grounds that it took place before insolvency proceedings commenced.

In relation to the obligations covered

139. In so far as this concerns the operation of the close-out netting provision, this Principle also extends to the obligations covered by the close-out netting provision: To the extent that such obligations are included in the calculation of the single net obligation under the close-out netting provision, no obligation should be subject to avoidance solely on the grounds that it arose during the subject period.

140. The reasoning behind this Principle is that an insolvency administrator would typically avoid only those obligations falling within the suspect period and favourable to the solvent party. The result would be comparable to that described above (*cf. Principle 7(1)(b)* – 'cherry picking'). As a consequence, the solvent party would be burdened with a considerably increased credit risk which could not be foreseen at the time of entering into the

contract or at any other point in time when the relevant obligation arose. On the other hand, the issue of the enforcement of the relevant obligation as such, where it is not included in the calculation of the single net obligation under the close-out netting mechanism, falls outside the scope of the Principles. Thus, where the solvent party does not trigger the close-out netting mechanism and does not rely on its rights under the close-out netting provision, the application of national insolvency avoidance provisions based on the fact that the obligation in question arose during a suspect period is not restricted.

141. It should also be noted that the limited protection afforded under *Principle 7(1)(d)* in respect of the obligations covered by the close-out netting provision has the consequence that where the national insolvency law allows such obligations to be avoided on the grounds that they arose during a suspect period, the insolvency administrator is not prevented, either under *Principle 7(1)(b)* or under *Principle 7(1)(d)*, from refusing performance of those obligations while demanding performance of other obligations owed by the solvent party that are covered by the close-out netting provision.

Zero-hour rules

142. For the same reason, the enforceability of close-out netting provisions should not be impaired by the application of 'zero-hour rules', i.e., rules that by way of legal fiction bring forward the commencement of insolvency proceedings to 0:00h of the day of the decision to open them.

Safeguard against fraud or transactions with knowledge of a pending insolvency proceeding, etc.

143. The aforementioned applies only to the extent that there are no other qualifying elements present (*cf.* the wording 'merely because'). As a consequence, and in accordance with *Principle 7(2)*, the law remains free to determine the consequences of fraud, knowledge of a pending insolvency proceeding at the relevant moment, or similar factors.

Principles 6(2) and 7(2) – Exceptions

144. *Principles 6(2) and 7(2)* refer to various national laws and regulations that are not to be affected by the Principles. These rules of national law are acknowledged as providing for exceptions to the general principle on the enforceability of a close-out netting provision according to its terms under *Principle 6(1) sentence 1* and to the more specific sub-rules in *Principle 6(1)(a) and (b)* and *Principle 7(1)(a) to (d).*

145. *Principle 6(2)* addresses rules on fraud or conflict with other requirements of general application affecting the validity or enforceability of contracts and provides that neither close-out netting provisions nor, as a matter of course, the obligations covered by those provisions are exempted from the application of such general rules.

146. *Principle 7(2)* is directed more specifically at national insolvency law provisions which could restrict the operation of a close-out netting provision on the basis of factors other than, or additional to, those referred to in *Principle 7(1)(c)* and *(d)*, such as knowledge of a pending insolvency proceeding at the time the close-out netting provision was entered into or the covered obligation arose, the ranking of categories of claims, or the avoidance of a transaction as a fraud of creditors.

147. *Principle 7(2)* provides a non-exhaustive list of examples of factors that might allow the operation of a close-out netting provision to be restricted under the insolvency law of an implementing State, but does not specify further conditions in this regard. *Principle 7(2)* is specific only insofar as it is expressly spelt out that the elements mentioned in *Principle 7(1)(c)* and *(d)* cannot justify the restriction of the operation of a close-out netting provision, not even on the basis of the rules mentioned in *Principle 7(2)*, unless additional factors are present. Moreover, the nature of the examples given in *Principle 7(2)* and the nature of this provision as an exception to the general rule on the enforceability of close-out netting provisions suggests that there should be a rather high threshold for the restriction of the operation of a close-out netting provision under the national insolvency law. For instance, mere knowledge of a pending insolvency proceeding at the time the close-out netting provision

was entered into or the covered obligation arose, should not necessarily justify restricting the operation of that provision under the national insolvency law in cases where the parties pursued legitimate intentions.

148. It should be noted that *Principles 6 and 7* are concerned only with such restrictions under national law as impair the operation of the close-out netting mechanism, as defined in *Principle 2* as such. The Principles do not address the enforceability of other clauses that are merely ancillary to a close-out netting provision, such as walk-away clauses and provisions on wait-and-see periods (see *supra*, paragraphs 41 and 43). Similarly, the rules of some legal systems which subject the operation of a close-out netting provision to standards of commercial reasonableness are not regarded as restrictions that might run counter to *Principles 6 and 7* to the extent that the definition in *Principle 2* covers only such close-out netting provisions under which the resulting single net obligation is calculated so as to 'represent the aggregate value of the combined obligations' (see *supra*, paragraph 38).

PRINCIPLE 8
Resolution of financial institutions

These Principles are without prejudice to a stay or any other measure which the law of the implementing State, subject to appropriate safeguards, may provide for in the context of resolution regimes for financial institutions.

Key considerations in respect of this Principle

- The Principles should assist in shaping domestic legal rules on close-out netting that also accommodate 'resolution regimes' for financial institutions. The current international consensus on the standards for such resolution regimes is laid down in the Key

Attributes of Effective Resolution Regimes for Financial Institutions developed by the *Financial Stability Board*.[14]

- The first aspect is that the legal framework governing close-out netting should be clear and transparent and that close-out netting should be enforceable also within the context of resolution regimes for financial institutions. This aspect is covered by *Principles 6 and 7*.
- The second aspect is that despite the above, close-out netting should not hamper the effective implementation of resolution measures. In particular, the competent authority should, under certain conditions and to a certain extent, have the right to delay the operation of a close-out netting provision by means of a stay of the termination or acceleration rights occurring under such provision. As such a right would be contrary to *Principle 7(1)(a)*, there should be an express exception in this sense.
- While stays are of particular relevance for the operation of close-out netting provisions, national resolution authorities might have a variety of other types of resolution powers besides stays (see the *Financial Stability Board's* Key Attributes, part 3). The exception contained in *Principle 8* is therefore extended to any measure which the law of the implementing State, subject to appropriate safeguards, may provide for in the context of resolution regimes for financial institutions.
- 'Appropriate safeguards' refers to measures to protect the valid interests of the counterparty to the financial institution that is being resolved, while ensuring the effective resolution of the failed institution. The reference to 'appropriate safeguards' in *Principle 8* is to be understood as subjecting the exception contemplated in this Principle to international standards on the appropriate treatment of close-out netting in the context of resolution regimes for financial institutions. Thus,

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[14] Cf. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.

Principle 8 is oriented at and should be interpreted in the light of the *Financial Stability Board's* Key Attributes parts 4 and 5.

- It should be noted that international standards on the appropriate treatment of close-out netting in the context of resolution regimes for financial institutions and their implementation under national law are still evolving. The policy underlying such resolution regimes is still subject to changes in the future and the references in *Principle 8* and the commentary should therefore be understood as being dynamic and contingent.

Explanation and commentary

149. The Principles ensure the enforceability of close-out netting provisions – including within the context of resolution regimes for financial institutions (*cf. supra*, paragraph 117). However, the *Cross-border Bank Resolution Group*[15] has shown that the unrestricted exercise of termination rights on the occasion of a financial institution's entry into resolution proceedings, in particular the simultaneous close-out of high volumes, has the potential of harming the competent authority's aim of orderly resolution of the relevant institution.

150. *Principle 8* provides that stays or other measures restricting the operation of close-out netting provisions should be subject to 'appropriate safeguards', i.e., measures to protect the valid interests of the counterparty to the financial institution that is being resolved, while ensuring the latter's effective resolution. The use of the term 'appropriate safeguards' is to be understood as a reference to the international standards with regard to special resolution regimes for financial institutions which are implemented under the various national resolution regimes and which include standards for the protection of close-out netting provisions in the context of such resolution regimes.

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[15] Bank for International Settlements/Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, Recommendation 9, p. 40 *et seq.*

151. The reference to 'appropriate safeguards' underscores the rule that close-out netting provisions should be generally enforceable and that a stay or any other measure taken by the relevant authority to restrict the operation of such provisions should be strictly limited to the effective implementation of the resolution regime. As regards such stays and the question as to whether the entry into resolution and the exercise of any resolution powers can be validly agreed in the close-out netting provision as a trigger for a close-out netting mechanism, the *Financial Stability Board* has set the current international standard for the interplay between resolution measures and appropriate safeguards in the Key Attributes part 4 and the relevant Annex IV, in particular by requiring that –

- 'subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed' (Key Attributes, para. 4.2); and
- 'should contractual acceleration or early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers. The stay should:

(i) be strictly limited in time (for example, for a period not exceeding 2 business days);

(ii) be subject to adequate safeguards that protect the integrity of financial contracts and provide certainty to counterparties (see Annex IV on Conditions for a temporary stay); and

(iii) not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to entry into resolution or the exercise of the relevant resolution power occurring before, during or after the period of

> the stay (for example, failure to make a payment, deliver or return collateral on a due date)' (Key Attributes, para. 4.3).

152. Reference is made to Annex IV to the *Financial Stability Board's* Key Attributes for further details.

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