



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

Second Meeting

Rome, 13 – 15 September 2011

UNIDROIT 2011
Study LXXVIII C - Doc. 9
December 2011

REPORT

(prepared by the UNIDROIT Secretariat)

Abbreviated report	2
Introduction	5
I. Basic assumptions for the future instrument	6
A. The form of the Draft Principles	6
B. The personal scope of the instrument	7
C. The material scope of the Draft Principles	9
D. Possible extensions of the material scope of the Principles	14
E. Interplay with crisis management powers	17
F. Payment and settlement systems.....	18
G. Netting in multilateral structures.....	18
H. Collateral arrangements.....	20
II. Consideration of the Second Preliminary Draft of Principles on Close-out Netting of Financial Instruments (UNIDROIT Study LXXVIII C – Doc. 6)	21
A. The introduction	21
B. Definitions (Draft Principles 1-5).....	22
C. Formal requirements for Close-out Netting Provisions (Draft Principles 6-9)	25
D. The enforceability of close-out netting (Draft Principles 10-16)	26
III. Planning of further work	30
A. Conflict of laws	30
B. The third meeting of the Study Group.....	30
APPENDIX I List of participants	31
APPENDIX II Agenda (UNIDROIT – Study 78C – Doc. 5)	34
APPENDIX III Revised Preliminary Draft of Principles regarding the Enforceability of Close-out Netting Provisions (UNIDROIT – Study 78C – Doc. 6)	36
APPENDIX IV ISDA definition of eligible contracts (UNIDROIT – Study 78C –Doc. 8)	44
APPENDIX V Alternative Draft on definitions	47

Abbreviated report**I. Basic assumptions for the future instrument****A. The form of the Draft Principles, p. 6-7 [6-7]**

The Study Group reaffirmed its preference for a soft law instrument in the form of Principles. Varying views were expressed regarding the drafting style to adopt for these Principles. Some participants favoured short provisions with very generic formulations. Others preferred more precise and specific legal language to promote clarity and uniformity. A third group of participants proposed to strike a balance between these two poles.

B. Personal Scope of the Principles, p. 7-9 [8-16]

A majority of opinion favoured covering all legal persons, unincorporated firms and partnerships. With view to natural persons, the Study Group did not take a position but agreed to leave it to national legislators to determine whether the Principles should apply to individuals, maybe to restricted classes of individuals (e.g. to professional, sophisticated or high-net-worth-individuals). The Study Group welcomed the 'Alternative Draft on definitions'¹ as a good basis for discussion but saw room for refinement in particular regarding subpara. (b). The definition of eligible parties should be kept in the black letter rules of the Principles.

C. Material scope, p. 9-14 [17-35]

The Study Group agreed that the next draft of Principles should contain a definition of eligible (financial) contracts in the black letter rules based on the 'Alternative Draft on definitions' and the discussions of the Study Group. The definition of eligible contracts should be followed by a general comment containing the explanation given at the end of the 'Alternative Draft on definitions'. Also each of the categories of the definition would have specific comments. The definitions provided in the 'ISDA definition of eligible contracts'² would appear in the comments.

D. Possible extensions of the material scope of the Principles, p. 14-17 [36-51]

The Study Group discussed an extension of the scope of the Principles to the protection of underlying contracts and obligations against typical obstacles to the enforceability of netting (1), to other (ancillary) provisions of a master agreement or contract document between the parties (2) and to statutory provisions that provided for an autonomous netting or set-off mechanism in insolvency proceedings by operation of law (3). The Study Group did not take a decision on any of the amendments proposed. A majority of opinion favoured however an extension of the protection granted by Draft Principle 11 to regimes that disallowed set-off and netting arrangements for reasons of equal treatment of creditors in a pre-insolvency situation or outside of insolvency (4).

E. Interplay with crisis management powers, p. 17 [52-53]

The Study Group reaffirmed the view that certain crisis management powers should prevail over the ability of a counterparty to exercise and trigger its close-out netting rights. It agreed to defer a decision on these powers to await clarifications of the Financial Stability Board (FSB).

F. Payment, clearing and settlement systems, p. 18 [54-56]

The Study Group decided to postpone a decision on payment, clearing and settlement systems. It agreed that it would focus its attention on operations that were based on a close-out netting mechanism which corresponded to the bilateral close-out netting mechanism defined in Draft Principle 1.

¹ Cf. Appendix V, p. 47.

² Drafting proposal of the International Swaps and Derivatives Association (ISDA), cf. Appendix IV, p. 44.

G. Netting in multilateral structures, p. 18-20 [57-63]

The Study Group stressed that the Principles should apply to any form of bilateral netting even if it occurred in a multilateral context. Several participants concluded that close-out netting mechanisms in CCP structures fell into the scope of application of the Principles. The Study Group decided to defer the discussion on CCPs to consider the findings of other international working groups in order to ensure consistency of the international instruments. The Study Group also deferred discussions on netting in multi-branch structures.

H. Collateral arrangements, p. 20 [64-66]

The Study Group welcomed the 'Alternative Draft on definitions' as a great step in advancing the discussions on collateral and expressed the view that the commentary to item (c) of that Draft seemed to address the main concerns regarding the protection of pledge collateral. Until the next meeting, it would focus its analysis on whether that commentary covered all relevant situations.

II. Consideration of the Second Preliminary Draft of Principles on Close-out Netting of Financial Instruments (UNIDROIT Study LXXVIII C – Doc. 6)**A. The introduction, p. 21-22 [67-72]**

The Study Group agreed to reform the introduction to better reflect the ongoing debate of regulators in the financial crisis.

B. Definitions (Draft Principles 1-5), p. 22-24 [73-84]

Draft Principle 1. The Study Group did neither take a final decision regarding drafting alternatives (a) and (b) nor regarding the brackets in the close-out netting definition.

Draft Principle 2. Some participants advocated merging the definition of enforcement event with Draft Principle 1 since the term was not reused in the document. Others favoured keeping both provisions separate to clarify that the enforcement event contained a separate idea.

Draft Principle 3. Some participants proposed to delete the definition of insolvency proceedings. Others felt that it should be supplemented by a definition of crisis management powers. They suggested using the definition of insolvency proceedings in footnote 27 and the definition of reorganisation measures of Art. 2(1)(k) of the Financial Collateral Directive as a starting point for discussions.

C. Formal requirements (Draft Principles 6-9), p. 25-26 [85-90]

With respect to every Draft Principle of this section, a proposal was made by different participants to extend the scope of the provision to the underlying contracts. The Study Group did not take a decision to extend the scope.

Draft Principles 6 and 7. A majority of opinion endorsed Draft Principles 6 and 7. Some participants recommended adopting a stricter approach to avoid fraudulent backdating.

Draft Principle 8. Some participants wondered whether legislators would follow any recommendation not to sanction the noncompliance with formal requirements by invalidity or voidness of the relevant contract. A majority of participants felt that the provision was reasonable. They argued that the breach of formal requirements could be sanctioned by any other consequence except for invalidity or voidness (fines, regulatory sanctions, imprisonment, actions for compensations for damages).

Draft Principle 9. One participant wondered whether the substance of Draft Principle 9 was implied in Draft Principle 6, at least if the provision was redrafted to speak of "formal requirement" instead of "formal act".

D. The enforceability of close-out netting (Draft Principles 10-16), p. 26-30 [91-108]

Draft Principle 10. The Study Group discussed whether Draft Principle 10 should remain a stand-alone provision or whether it should be merged with Draft Principle 11, possibly 13. Even though the participants saw a need for clarifying the contents within which Draft Principle 10 operated, there was no majority of opinion favouring a merger.

Draft Principle 11. The Study Group decided to recommend to national legislators that the following obstacles to the enforcement of netting should be disapplied: restrictions to set-off applied to netting (including automatic stay), cherry-picking provisions, the prohibition of early termination and acceleration as well as preferences and suspect periods. Further, a majority of participants decided that Draft Principle 11 should be extended to cover situations of *concursum creditorum*, pre- and outside insolvency.

Draft Principle 12. A majority of the participants opted for deleting Draft Principle 12 and dropping the subject of walkaway clauses altogether. A strong minority opinion favoured explaining walkaway clauses in a commentary and argued that those provisions were for good reasons controversial. The Study Group should explain the functioning and implications of these provisions and provide expressly that the Principles left the decision about the validity and enforceability of these provisions to policy makers.

Draft Principle 14. The Study Group came to the understanding that it was not in the position to determine a reasonable timeframe for closing out. Some participants advocated therefore deleting the provision on the 'power to wait and see'³. A majority felt however that the issue should be addressed somewhere in the Principles and explained to the national legislators. In any event, a separate provision should deal with the reasonableness of the valuation.

Draft Principle 15. The Study Group agreed that Draft Principle 15 should be accompanied by an explanatory note clarifying that fraudulent preferences were not covered by the provision. It acknowledged further that Draft Principle 15 was an exceptional provision because it clearly included the underlying obligations. The Study Group agreed to maintain Draft Principle 15 as it was but to have further discussion on it in future meetings.

III. Planning of further work**A. Conflict of laws, p. 30 [109]**

The Secretariat conducted an in-depth study of conflict-of-law issues as they relate to netting. Based on the findings of the Study, the Secretariat will, in consultation with the Hague Conference, submit to the group a revised set of provisions for discussion at a later stage.

B. The third meeting of the Study Group, p. 30 [110-111]

The third meeting of the Study Group will be held on 7-9 February 2012 at the seat of UNIDROIT in Rome.

³ Certain netting agreements allow a party to withhold payments upon the default of its counterparty while not forcing it to close-out Cf. Below, Sect. II.D.4, paras. 100 f., p. 28f.

Introduction

1. The Study Group on principles and rules on the netting of financial instruments met in Rome at the seat of UNIDROIT from 13 to 15 September 2011.
2. Before opening the discussions, Mr Devos from the Bank for International Settlements (BIS) and Mr Wezenbeek from the European Commission (Commission) were invited to give a brief report on the proceedings and debates relating to close-out netting in their institutions.
3. Mr Devos presented the interim report of the Cross-border Bank Resolution Group (CBRG) on key findings of its survey on the resolution of financial institutions, published by the Basel Committee on Banking Supervision early July 2011⁴. In line with its previous recommendations, the report confirmed the need to promote close-out netting arrangements but also stressed that netting should not hamper the effective implementation of resolution measures.⁵ It noted that only few countries had empowered resolution authorities so far to temporarily delay the operation of early termination as recommended by a previous report of the CBRG⁶.
4. Mr Devos then gave an account of the consultative document of the Financial Stability Board (FSB) on “Effective Resolution of Systemically Important Financial Institutions” that was issued in July 2011.⁷ The FSB recommended that the legal framework governing netting should be clear, transparent and enforceable and should not hamper the effective implementation of resolution measures⁸. The FSB noted that close-out netting rights might result in a disorderly rush for the exit of assets of the failing or distressed institution and thereby jeopardise the implementation of resolution measures, such as the transfer of critical operations to a bridge bank. To prevent these effects, the FSB recommended that close-out netting might be restricted by either providing resolution authorities with a discretionary power to impose a stay, or by way of a statutory rule that would prevent automatically the exercise of close-out rights⁹. The FSB proposed safeguards to protect the non-defaulting counterparty which was affected by a stay¹⁰ and raised questions for public consultation.¹¹ Mr Devos announced that the FSB would draft new recommendations by early October and circulate the final proposal to the G20 Leaders Summit in November.¹²

⁴ Bank for International Settlements/Basel Committee on Banking Supervision, Resolution policies and frameworks – progress so far, July 2011, p. 23 f. (available under <http://www.bis.org/publ/bcbs200.pdf>).

⁵ Bank for International Settlements/Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, www.bis.org/publ/bcbs169.pdf (hereinafter: CBRG Report), Recommendation 8, p. 35-38.

⁶ CBRG-Report (cf. above fn. 5), Recommendation 9, p. 39 f.

⁷ FSB, Consultative Document: Effective Resolution of Systemically Important Financial Institutions – Recommendations and Timelines (cf. http://www.financialstabilityboard.org/publications/r_110719.pdf) of 19. July 2011. The overview of responses “Effective Resolution of Systemically Important Financial Institutions” http://www.financialstabilityboard.org/publications/r_111104dd.pdf) was published on 4. November 2011. The FSB had received from the G20 a mandate to develop a proposal how to organise and to enhance the financial soundness of systemically important financial institutions.

⁸ Cf. p. 27, Section 5.1 of Annex 1 to the FSB Consultation paper (cf. above, fn. 7).

⁹ Cf. Section 8 of Annex 2, p. 39 and Annex 8, p. 71 ff to the FSB-Consultation paper (cf. above, fn. 7).

¹⁰ A stay should be temporary (max. 24-48 hours), should only concern clauses triggered by virtue of the initiation of resolution proceedings, not by clauses linked to a default of performance and should not impede the rights of the non-defaulting parties to close-out after the period of stay. Resolution authorities should not cherry-pick (i.e. transfer all of the contracts with a particular counterparty). Cross-border issues should be mitigated by national recognition of foreign stays on a case-by-case basis.

¹¹ The questions dealt with adverse outcomes of regulatory stays, the scope of the stay (counterparties, type of contracts and provisions), the safeguards, the duration and cross-border issues, cf. p. 21 of the FSB-Consultation paper (fn. 7).

¹² Cf. The “Key Attributes of Effective Resolution Regimes for Financial Institutions” of October 2010, published on 4 November under http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

5. Mr Wezenbeek informed the Study Group about the proceedings on the European level. He informed the Study Group that the Commission planned to further harmonize its close-out netting provisions in the first half of 2012. The Commission's main concern was however the crisis-management framework that was subject of discussion between the Commission and Member States. Also, the negotiations of the European Market Infrastructure Regulation (EMIR)¹³ kept the Commission occupied. Mr. Wezenbeek informed the Study Group that there would be a mandatory clearing of OTC derivatives but that certain aspects had not been determined yet: First the delimitation of powers between the national supervisors and the European Securities and Markets Authority (ESMA), second, whether Central Counterparties (CCPs) had to have a banking license, third how to deal with pension funds. Another important question was how to ensure that equivalent rules applied with regard to third countries. Further work of the Commission included the capital requirement package¹⁴, a review of Directive 2004/39/EC (MIFID)¹⁵ and legislation on central securities depositories¹⁶. For these reasons, Mr. Wezenbeek estimated that the legislative initiative on close-out netting¹⁷ would start a bit later than originally envisaged.

I. Basic assumptions for the future instrument

A. The form of the Draft Principles

6. The Study Group did not take a final decision regarding the form of the instrument although the Study Group reaffirmed a preference for a soft law instrument in the form of Principles accompanied by extensive explanatory material.

7. Varying views were expressed on how the nature on the instrument should be reflected in the wording. The Study Group was invited to consider the broad and more generic principles of the Committee on Payment and Settlement Systems (CPSS)¹⁸, the crisp and prescriptive UNIDROIT

¹³ Cf. The Commission's proposal Com(2010)484 of a Regulation on OTC derivatives, central counterparties and trade repositories (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0484:FIN:EN:PDF> and the accompanying impact assessment http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_impact_assessment_en.pdf). On 4 October 2011, the Council of the European Union set out its position with a view to negotiations with the European Parliament on the draft regulation (<http://register.consilium.europa.eu/pdf/en/11/st15/st15148.en11.pdf>).

¹⁴ Proposal COM(2011)452 for a Regulation on prudential requirements for credit institutions and investment firms Parts I-III (available under http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0452%2801%29:FIN:EN:PDF; http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0452%2802%29:FIN:EN:PDF and http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0452%2803%29:FIN:EN:PDF).

and Proposal COM(2011) 453 for a Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC, available under <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0453:FIN:EN:PDF>, both discussed in the Council of the EU on 18. November 2011 (cf. <http://register.consilium.europa.eu/pdf/en/11/st17/st17166.en11.pdf>).

¹⁵ Proposal for a Directive on markets in financial instruments repealing Directive 2004/39/EC of 20.10.2011 (COM(2011) 656, http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf) and Proposal for a Regulation on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories of 20.10.2011 (COM(2011) 652, available under http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_652_en.pdf).

¹⁶ Cf. The public consultation of 13. January 2011 by DG Markt (DG Markt G2 D(201)8641), available under http://ec.europa.eu/internal_market/consultations/docs/2011/csd/consultation_csd_en.pdf) and the CSD site http://ec.europa.eu/internal_market/financial-markets/central_securities_depositories_en.htm.

¹⁷ http://ec.europa.eu/governance/impact/planned_ia/docs/2011_markt_013_close_out_netting_en.pdf.

¹⁸ Cf. the Core Principles for Systemically Important Payment Systems published by the Committee on Payment and Settlement Systems (CPSS) in 2001 under <http://www.bis.org/publ/cpss43.pdf>.

Principles of International Commercial Contracts¹⁹ and the UNCITRAL Legislative Guide on Insolvency Law²⁰ as drafting examples. Some participants favoured the CPSS-approach of few short principles with generic formulations. They argued that countries were supposed to be guided by the principles which implied some discretion at the implementing stage. Others expressed a preference for more precise and specific legislative language, which could best promote clarity and uniformity. A third group of participants proposed to strike a balance between these poles.

B. The personal scope of the instrument

1. General discussion

8. Varying views were expressed regarding the definition of eligible parties. Some participants advocated excluding natural persons from the personal scope of the instrument. Amongst those, some proposed to limit the scope of application even more to legal person that were typically active on the financial market like credit institutions or major corporates. Others favoured covering all legal persons. Both groups of participants argued that netting tended to be seen as a privilege and an exception to fundamental principles of insolvency law such as the *pari passu* treatment of creditors. Any exception to those principles needed to be justified by reasons related to systemic risk. Transactions of natural persons generally did not imply enough systemic risk to justify netting protection²¹. They added that any individual who wanted to manage risks through netting was free to incorporate.

9. Other participants argued that derivatives transactions of natural persons could involve considerable systemic risk. History had proven the systemic importance of some high net-worth individuals, of certain families and groups of individuals²² and there was no reason to believe that the future would be any different. They explained that the trustees of some important trusts, many hedge funds and in several jurisdictions private partnerships were in fact natural persons. Since individuals were capable of dealing in the market, the financial infrastructure should apply also to them. They concluded that the Principles should not exclude natural persons. The delimitating factor for the application of the Principles should better be sought in the definition of eligible contracts. Amongst the proponents of this wider approach, the opinions varied regarding the inclusion of consumers. All participants agreed that consumer protection was an important policy objective which should be respected, but they expressed varying opinions on whether netting was beneficial or possibly disadvantageous for consumers. Some participants felt that it would be detrimental for consumers if their contracts were less clearly legally enforceable and less legally certain than the contracts of other market participants. Others saw potential pitfalls and detriments for consumers resulting from netting.²³

¹⁹ The newest 2010 version of the Principles adopted at the 90th session of the Governing Council is available under <http://www.unidroit.org/english/principles/contracts/principles2010/blackletter2010-english.pdf>.

²⁰ The UNCITRAL Legislative Guide on Insolvency Law of 2005 is available under www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.

²¹ One participant gave the example of the implementation of the Financial Collateral Directive 2002/47/EC in Belgium: The Belgian Ministry of Justice fiercely rejected including natural persons since that would considerably impair the effect of principles of insolvency law, in particular the *pari passu* treatment.

²² A large investor cornered the silver market in the 1970s and was one of the largest individual bankrupts in the history of the financial market. Also the Herstatt bank from Cologne was organised as a partnership. When it went bankrupt in 1974, the general partner lost all his money (and thereby gave its name to the cross-currency settlement risk that arose in the inter-bank fund transfer systems when the banking hours did not overlap).

²³ One participant gave the example of a Spanish bank that had sold derivatives without explaining the risks attached. When the contract was out of the money and the bank needed to collect money from its clients, it used the deposits of the clients. The participant explained that the problem was that the bank simply used the money of its clients who would then have to try to recollect it in court.

10. To mediate between these views, one participant remarked that an exclusion of parties from the Principles did not necessarily imply that that party was excluded from netting: A national legislator would be free to extend the personal scope of the instrument. Another participant pleaded for an open formulation which would give national legislators some leeway to adopt also a more restrictive approach regarding eligible parties.

11. In the course of the discussions, the majority of the participants came to pronounce themselves in favour of a pragmatic and flexible middle approach: The Principles should cover legal persons as well as unincorporated firms and partnerships. The Principles should however not take a position on natural persons. The Principles should rather leave it to national legislators to determine whether the Principles should apply to individuals, maybe to restricted classes of individuals. The Principles should however present arguments that speak for or against the inclusion of natural persons in the explanatory material. As such criteria, the Study Group discussed:

- One of the parties was a financial or credit institution
A majority of participants spoke in favour of applying netting in that case - the legal form of the counterparty would then be irrelevant. This approach would cover most of the situations involving single net-worth individuals.
- Consumers
A majority of participants favoured excluding consumers. The participants could however not agree on a common definition of consumers. Several participants cautioned that the definitions proposed in Draft Principle 5, which made reference to the purpose of a transaction²⁴, were to a large extent subject to interpretation and created thereby legal uncertainty. To reduce that uncertainty, one participant proposed to amend Draft Principle 5 by stating that a person needed to act "ostensibly" for personal, family or household use. Another participant proposed to cover only sophisticated natural persons that had proven that they understood the complex financial products. Another participant proposed drawing inspiration from the work of the FSB and the Organisation for Economic Co-operation and Development (OECD) on consumer finance protection²⁵. Other participants proposed that the definition of consumers could be left to each jurisdiction to define consumers.

12. With respect to the structure of the Principles, the Study Group expressed itself in favour of keeping the definition of eligible parties in the black letter rules of the Principles rather than relegating it into a commentary.

2. The 'Alternative Draft on definitions'

13. In the course of the discussions on the scope of the Principles, three participants of the Study Group submitted an alternative draft on definitions regarding the personal and material scope of the Draft Principles ("The Alternative Draft on definitions")²⁶. The Study Group welcomed

²⁴ Cf. Draft Principle 5 of the Second Revised Draft of Principles (UNIDROIT Study 78C – Doc. 6, attached hereto as Appendix III, p.39) based on Art. 2(a) of the United Nations Convention on contracts for the international sale of goods of 1980 (CISG) referring to acts „for purposes other than for their personal, family or household use“ or the alternative in Footnote 27 of the Second Revised Draft for Principles that referred to acts „for purposes which are outside that person’s trade, business, craft or profession“ and was adapted from Art. 2(a) from Directive 2005/29/EC and Art. 2(1)(f) of Directive 2008/122/EC.

²⁵ "At the Seoul Summit in November 2010, the G20 asked the FSB to work in collaboration with the Organisation for Economic Co-operation and Development (OECD) and other international organisations to explore, and report back by the November 2011 Summit, options to advance consumer finance protection". On 26 October 2011 the FSB and OECD have issued a report and principles on Consumer Finance Protection with particular focus on credit (available under www.financialstabilityboard.org/publications/r-1110126a.pdf).

²⁶ 'Alternative Draft on definitions', attached hereto as Appendix V, p. 47).

the proposed definition of eligible parties as a good basis for discussion but saw some room for refinement.

14. Some participants made alternative suggestions regarding policy decisions: One participant proposed to remove single unincorporated entrepreneurs and merchants that behaved and had powers like incorporated companies from category (c) to (b). This implied adapting the wording of category (b) since a private person could never be an “association”. With regard to the wording of category (c), another participant drew attention to the fact that not all emerging countries had specific legislation on netting or on payment systems which could be amended to authorise the participation of individuals in netting agreements. The definition of category (c) should therefore be broadened to encompass also regulatory authorisations. A third participant proposed to give national legislators some leeway not only to expand but also to limit the list of eligible parties. He proposed to add the following paragraph *„Any national legislator can limit the eligible parties for instance by a statement that at least one party must be a financial institution.“*

15. Other proposals dealt with drafting techniques. It was proposed to replace the formulation “a person other than a natural person”²⁷ in category (a) by the term “a legal person” and the wording “any other person designated [...]” in category (b) by the formulation “any natural person designated [...]” to facilitate the understanding of the definition.

16. On more general terms, one participant encouraged the Study Group to make sure that the overall concept was coherent and fully understandable from the terms of the definition itself. He suggested that the Study Group should in particular try to find more precise terminology for the entities covered by category (b) “partnership or unincorporated association”. He explained that the current wording “unincorporated associations” would encompass some loose forms of non-commercial associations like betting or car sharing pools, which would give rise to controversies. Though the practical relevance of the problem could be mitigated by restrictions brought through the definition of eligible contracts and assets, he assumed that it could be crucial for the public perception to have clear and understandable criteria for the types of entities covered. Such a criterion could be that the association runs a business or acts as an entrepreneur or merchant. He further suggested setting forth the interaction of the eligible parties with the definition of eligible contracts and eligible assets.²⁸

C. The material scope of the Draft Principles

1. The ISDA Drafting proposal on eligible financial contracts (UNIDROIT Study LXXVIII C – Doc. 8)

17. The International Swaps and Derivatives Association (ISDA) had kindly agreed to prepare a drafting proposal on eligible financial contracts (UNIDROIT Study LXXVIII C – Doc. 8; “ISDA Draft”)²⁹ responding to a request uttered by participants during the first meeting. Its drafting proposal had been distributed to the Study Group before the meeting. ISDA explained that the proposal might look like an enumerative approach but in fact, it had attempted to identify the genera of a definition. For that reason it had chosen very broad definitions: the definition of derivatives and reference values were intended to encompass anything anyone could do for the foreseeable future in derivatives, even if the financial instrument was not yet subject to recurrent transactions. ISDA

²⁷ The formulation was adapted from Art. 1(2)(e) of the Financial Collateral Directive 2002/47/EC of 6 June 2002 (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>).

²⁸ The explanatory note to eligible financial contracts used the notion of “major market participants”. The Study Group was invited to elaborate whether this had an impact on the definition of eligible parties.

²⁹ ISDA “Note for the Study Group on Netting re eligible financial contracts”, attached hereto as Appendix IV, p. 44 (UNIDROIT Study LXXVIII C – Doc. 8).

stated that it had drawn inspirations from MiFiD³⁰ but had tried to avoid those limitations which were due to the fact that the directive was designed for licensing and similar regulatory purposes.

18. The Study Group welcomed the ISDA Draft as a great contribution that advanced the discussions on eligible parties considerably. Going through the list of items proposed in the ISDA Draft, one participant concluded that the following elements were missing: securities financing transactions, payment netting, netting under master-master agreements and netting of claims based on unjust enrichment. Another participant considered that the definition of reference value on the second page was still too narrow: it should encompass anything that could fluctuate.

19. Several participants raised doubts whether holding a single security could constitute an eligible contract. They recommended striking that element from the list of financial instruments defined on page two of the ISDA Draft and argued that shares were sufficiently covered by subpara. (d)(i) of the definition. In respect of the definition of transferrable securities on pages two and three of the ISDA Draft, one participant proposed to replace the reference to “normal” trading on the market³¹ by a reference to economic characteristics.

20. Varying views were expressed regarding items (b) and (c) of the list, eligible deposits and loans. Some participants cautioned that deposit netting could undermine deposit guarantee schemes³². Hence, deposits covered by a guarantee scheme should not be eligible for netting. Moreover, these participants argued that there was no need to net deposits because banks could apply other techniques such as pledges or set-off. They acknowledged that alternative techniques were not exempted from insolvency laws (i.e. from automatic stays) but felt that deposits and loans did not merit the same level of protection as derivatives or contracts for the sale of financial instruments. Other participants argued that the possibility to use deposits as a pledge or for set-off spoke on the contrary for their inclusion since it showed that deposits would be used by the bank anyhow. In addition, some deposits and loans constituted an important means of risk-mitigation and needed to be covered. One participant gave the example of deposits netted in cash-pooling arrangements and margin lending. Some participants proposed a middle solution: the Study Group should analyse in more detail to what extent certain forms of deposits and loans should be available for netting. One solution regarding deposits might be to exclude insured deposits – an idea that was reflected by text in the square brackets in the ISDA Draft, referring to deposits “other than a deposit that is insured under a state deposit guarantee scheme”.

21. With regard to drafting, one participant wondered why the ISDA Draft used the terms ‘CCP’ instead of ‘clearing house’ and ‘authorisation’ instead of ‘recognition’, thereby deviating from the terminology of the EU EMIR-legislation³³. Another participant proposed to merge the definition of ‘financial instruments’ of the second page of the ISDA draft with the definition of eligible financial contracts and argued that many items of the definition were financial instruments. Yet another participant suggested distinguishing between the financial contracts and the underlying transactions.

22. Several participants felt that the list of categories proposed by ISDA should be accompanied by policy considerations why these items merited protection. The Study Group discussed the following criteria:

³⁰ Directive 2004/39/EC on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC and repealing Directive 93/22/EEC (available under <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>)

³¹ The wording was adapted from Art. 4(1)(19) of MIFID 2004/39/EC (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>).

³² One participant explained that many countries applied particular practices to insured deposits, e.g. in principle, set-off was available only for loans that were non-performing.

³³ Cf. Above, fn. 13, p. 6.

- The risk a party faces;
- Whether a contract involved trading or not;
- Whether the contract was part of a series of contracts (combination of a multitude of transactions) that were subject to market evaluation (market valuation mechanism) and thereby created an unjustified exposure of the nondefaulting party to the credit risk of the other party;
- Whether the contract constituted in substance an indivisible asset that should not be divided artificially and that was by nature moving;
- Indivisibility of the contracts based on party autonomy. The parties should be free to combine several products to an indivisible asset if the combination could be justified. A possible justification could be seen in the trading strategy, the lack of efficient risk-mitigation alternatives or the reliance on criteria of fair value and volatility in the market.

23. The Study Group considered that it might end up with two or three different categories of eligible contracts rather than with one all-encompassing generic definition. It agreed that the important element of all the transactions was that they ultimately created systemic risks: The rationale for netting protection was not primarily the concern that one counterparty might fail, but the systemic risk of such a failure for the market.

2. The Alternative Draft on the definition of eligible contracts

24. The authors of the Alternative Draft on definitions³⁴ explained that their definition of eligible financial contracts was based on the ISDA Draft³⁵ and therefore cross-referred to the definitions given by ISDA, which should continue to apply with the exception of the definition of financial instruments (f) and of surety transactions. The authors drew attention to the fact that they had changed the order of the items to cite the most important contracts first: derivatives and repo transactions. The authors further noted that they had amended the definition of Draft Principle 1 by adding “relating to obligations outstanding under” [an eligible financial contract]. They explained that their intention had been to emphasise that the Draft Principles applied to obligations outstanding at the moment of default. Thereby they had tried to reflect the distinction drawn in the list of eligible contracts between contracts which created obligations – such as derivatives repos – and instruments that were subject to contracts of sale and delivery under which those obligations arose (i.e. the list of items under subpara. (f)).

25. The explanation following category (g) revealed the underlying concept of the drafting proposal, which was based on a special, favourable treatment of certain contracts. The eligible contracts under the definition were characterised by three elements:

- The contracts were exposed to fluctuation/volatility in the market.
- It was therefore reasonable to manage risks on a net basis.
- If the net treatment was not available, this would produce legal uncertainty and thereby systemic concerns.

The authors noted that those criteria revealed why loans and deposits were controversial instruments: Traditional loans and deposits – those that were neither negotiable nor transferrable – were not exposed to volatility and could therefore make use of traditional arrangements such as set-off.

26. Going through the categories, the authors mentioned that the category of subpara. (a) should be renamed “derivatives instruments” instead of “derivatives”. They further drew attention to the commentary to title-transfer arrangements: traditional security interests were usually

³⁴ Alternative Draft of definitions, attached hereto as Appendix V, p. 47 f.

³⁵ ISDA Definition of eligible contracts, attached hereto as Appendix IV, p. 44 f.

proprietary in character and thus not eligible for netting. Only if they were converted into obligations, they could be subject to netting arrangements. With view to the enumeration of assets under subpara. (f), the authors underlined that the word “fungible” was the key notion for a correct understanding: the underlying asset could be any fungible asset that was sold or delivered.

27. The authors acknowledged an overlap between the category (a) “derivatives” and (f) “contracts for the sale and delivery of” [the listed assets]. The sale or delivery of assets enumerated in (f)(1)-(f)(6) could itself constitute a derivative and thus fall already under subpara. (a). The authors explained that they had consciously taken abroad this overlap since their primary intention had been to avoid gaps. They would however be open to suggestions to refine the categories.

28. The Study Group welcomed the Alternative Draft on definitions as a good basis for discussion and was especially appreciative of the commentaries and explanations. In particular the introduction to the definition of eligible contracts and the commentary under subpara. (c) – title transfer collateral arrangements – were favourably received. The commentary explained the types of collateral arrangements that could and should fall under close-out netting provisions. The new introduction solved problems and gave clarity in particular regarding unpaid amounts or default interests.

29. The Study Group agreed that the definition needed to be amended to cover also obligations arising under **Master-Master Agreements** and under the regime of **unjust enrichment**.

30. Some participants advocated either to delete the term “**financial**” in Draft Principle 1 and in the heading of the definition of eligible “financial” contracts or to add the terms “commercial contracts” or “physically-settled transactions” to encompass also netting in energy trades. They argued that the Study Group had expressed its intention to cover also physically-settled transactions regarding fungible commodities (i.e. of delivery obligations regarding the same underlying commodity). The term “financial” would however go directly against that intention: Energy traders did not consider their transactions to be “financial contracts”. Also legislators had shown in the transposition of the Markets in Financial Instruments Directive 2004/39/EC (MIFID)³⁶ that they distinguished between commercial and financial transactions and since they had excluded commercial transactions from the regime established by MIFID. Other participants considered that the term “financial” might be important in the communication with the audience which consisted mainly of financial institutions. The term should therefore only be replaced if the Group had found a better name. Otherwise, it should be clarified that a “financial” contract could be an energy trade and that energy could be an underlying asset.

31. The Study Group analysed the Alternative Drafting proposal in more detail and started with the notion of subpara. (a) “**derivatives**”. It noted that the definition of derivatives on page two of the ISDA Definition of eligible contracts was based on the enumerative definition of “reference values” on the same page of the ISDA Definition.³⁷ With regard to the definition of “reference values”, one participant pointed to a mismatch between the ISDA definition and the Alternative Draft: The ISDA definition mentioned commodities as separate products next to emissions and energy, whereas the Alternative Draft on definitions used the wording “any other [fungible] commodity” in category (f)(6). The participant invited the Study Group to clarify whether

³⁶ Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC and repealing Council Directive 93/22/EEC (available under <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>).

³⁷ Cf. Appendix IV, p.45: “Reference value” means 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, property or other measures of financial, commercial or economic risk or value.

emissions and energy constituted commodities or were separate products for the purpose of the Draft Principles. One participant proposed to analyse the definition provided by ISDA against enumerative definitions adopted in some jurisdictions. With view to the enumeration of possible “reference values” provided by ISDA, another participant suggested to draw inspiration from legislative acts that combined an enumerative approach with an open generic element (catch-all) intended to preserve flexibility for new products.³⁸ The Study Group appreciated the idea of an open generic element to adapt to evolutions on the market. One participant cautioned that a generic formulation implied also a limiting element alongside its self-updating nature: it set a criterion to determine the nature of reference values. On more general terms, one participant proposed to restrict subpara. (a) to “derivatives on financial instruments” or “financial derivatives” while a majority advocated keeping the definition of derivatives instruments as broad as possible, including also emission trades, weather derivatives or precious metal options.

32. The Study Group agreed to keep the categories (d) **deposits** and (e) **loans** in brackets because most deposits and loans did not fulfil the criteria for an eligible contract defined in the explanatory note³⁹. The brackets were supposed to indicate the Study Group’s intention to come back to the categories at a later stage and to discuss whether certain types of deposits and loan instruments fulfilled the criteria (e.g. credit default swaps on a loan or margin loans).

33. One participant pointed to the fact that an elimination of categories (d) deposits and (e) loans would have implications for the sureties in **subpara. (g)**, which referred back to the previous subparagraphs. If the Study Group decided to delete deposits and loans, a guarantee on a loan would only be covered by the Principles if it fell under (f): if it was a bond, it would be a transferrable security covered by (f)(1), if it was a short-term loan, it would fall under subpara. (f)(2) money market instruments. A longer loan would not be covered. The participant proposed to use broad generic terms in subpara. (g) rather than a reference to previous categories to avoid (future) gaps.

34. Another participant raised the question whether all forms of transferrable securities that should be covered would fall into the current category (f)(1). He cited surety certificates and deposits as relevant instruments and invited the Study Group to discuss those at a later stage.

35. The Study Group decided that the next draft of the Principles should contain a definition of eligible (financial) contracts in the black letter part of the Principles. The definition would be followed by a General Comment containing the explanation given at the end of the Alternative Draft on definitions. Each of the categories of the definition would have specific comments. The

³⁸ For instance, in 11U.S.C. § 101(53B)(ii), the term swap agreements is defined by reference to recurring dealings in the swap or other derivative market:

The terms “swap agreement” – (A) means –

(i) any agreement including the terms and conditions incorporated by reference in such agreement which is (I) an interest rate swap [... enumeration of contracts until...] (X) an inflation swap, option, future or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives market (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(iii) any combination of agreements or transactions referred to in this subparagraph; [...]. Text available under http://www.law.cornell.edu/uscode/usc_sec_11_00000101----000-.html.

³⁹ Cf. the explanatory note under subpara. (g) of the Alternative Draft on definitions referring to the three characteristics of eligible contracts, described above in para. 25, p.11; cf. also the discussion on deposits and loans under para. 20, p.10.

current ISDA definitions would appear in those comments to avoid burdening the text with too many definitions.

D. Possible extensions of the material scope of the Principles

36. The Study Group noted that the scope of the current Draft Principles was limited in four regards:

- First, it was limited to protecting the close-out netting agreement itself as opposed to the underlying contracts and obligations (with the exception of Draft Principle 15, which applied expressly also to the underlying obligations).
- Second, it was limited to protecting the enforcement of the close-out netting mechanism as defined in Draft Principle 1⁴⁰. The Draft Principles took no position regarding other provisions contained in a same master agreement or contract document between the parties.
- Third, the Principles were drafted to protect contractual netting provisions, not statutory provisions that provide for a netting⁴¹ or set-off⁴² mechanism in insolvency proceedings by operation of law.
- Fourth, the protection of the contractual agreement against overriding statutory provisions provided by Draft Principle 11 applied to insolvency situations only. Yet, the enforcement of netting could be impeded by similar (statutory) obstacles outside of insolvency.

37. Under the current draft, all aspects excluded from the scope of application were to be dealt with by the law of the governing jurisdiction. The Study Group discussed whether and under what circumstances it was justified to expand the scope of the Principles to any of those aspects.

1. Possible extension to the underlying contracts and obligations

38. Varying views were expressed as to whether the Draft Principles should be extended to protect also the underlying contracts and obligations against certain typical obstacles to the enforcement of netting. Some participants cautioned against broadening the scope of the Draft Principles to the underlying contracts and obligations. Even though personally in favour of protecting the underlying contracts and obligations, they expressed themselves against any expansion of the Draft Principles to issues which were not integral to the protection of close-out netting. They argued that a minimalist approach that focussed on protecting the netting provision itself and preventing contagion between one invalid or avoided underlying obligation towards the netting set⁴³ was ambitious enough. In view of previous considerations to expand the personal scope of the Draft Principles to natural persons, to commodities, possibly also to loans/deposits, and to deal with issues such as choice of law, some participants argued that any further expansion of the protective shield implied that the Study Group adopted a maximalist approach. This might have adverse consequences for the public acceptance of the Draft Principles.

39. Other participants recommended that the Principles should protect the underlying contracts and obligations against certain, clearly defined obstacles that typically jeopardised both the netting agreement and the underlying contracts and obligations. As such obstacles they cited

⁴⁰ Except if otherwise provided (e.g. in Draft Principle 12 and 16 of the Revised Preliminary Draft for Principles (Unidroit, Study 78C, Doc. 6), attached hereto as Appendix III., p. 41 f).

⁴¹ E.g. § 104 of the German Insolvency Act (Insolvenzordnung).

⁴² E.g. Rule 4.90 of the UK Insolvency Rules 1986.

⁴³ Cf. Draft Principle 16 of the Revised Preliminary Draft (Unidroit, Study 78C, Doc. 6), attached hereto as Appendix III, p. 42.

- gaming and gambling provisions,⁴⁴
- provisions on insurance contracts,
- form requirements,
- governing law/governing language issues,⁴⁵
- suspect periods.

Inspired by Art. 3 of the ISDA Model Netting Act of 2006⁴⁶, one participant suggested to formulate “A qualified financial contract shall not be and shall be deemed never to have been void or unenforceable [solely because mutuality was established by novation in a multilateral netting system], by reason of [legal provisions] relating to games, gaming, gambling, wagering or lotteries [or by being qualified as an insurance contract]”.⁴⁷

40. The participants who advocated an expansion of the scope of the Principles to the protection of the underlying contracts and obligations against the cited obstacles argued that the protection of close-out netting would be flawed without the specified amendments: A typical defence of a receiver to avoid the enforcement of netting was to plead that all underlying contracts or obligations were invalid for identical reasons as addressed in the Principles regarding the netting agreement. If all underlying contracts were void or voidable, this would undermine the effectiveness of netting and might, for several reasons, have serious consequences for the financial stability: First, due to its character as a risk mitigation instrument, credit managers used close-out netting functionally as financial collateral which implied great economic importance and thus systemic risks. Second, in CCP structures, the unbundling of mirroring transaction after a failure of a participant risked endangering the entire structure. The participant explained that instead of closing out, CCP’s generally entered into mirroring transactions to close down the prop book of a clearing member which was ailing or about to fail. A CCP would always try to have other general clearing member assume the positions of the ailing or failing member to avoid a reduction of liquidity in the system. This economic close-out took place through bilateral agreements until the latest hour prior to insolvency. If a receiver could unbundle this package and challenge certain transactions for being made in a suspect period, this would create much systemic risk. The participant added that the same rationale applied to OTC derivatives markets that were not cleared in CCP’s. In those structures, parties agreed to reduce their risk by entering into offsetting transactions. In response to concerns that an extension of the scope might be detrimental for the perception of the Principles, the participants argued that they proposed only a limited extension of the protection of underlying contracts and obligations to specific, clearly defined obstacles but did not aim at exempting the underlying contracts and obligations from all (public policy) requirements under national laws.⁴⁸ One could therefore not speak of a maximalist approach.

41. One participant stated that an expansion of the scope of the Draft Principles would require the Study Group to examine each Draft Principle to evaluate whether it was necessary to add a reference to the underlying contracts or obligations.

42. Several participants favoured to address the obstacles and controversies regarding the underlying contracts and obligations in a commentary. They maintained that controversial issues should not be avoided. The Study Group should rather explain them to policymakers.

⁴⁴ Several participants explained that there was uncertainty in many jurisdictions on the effect of gaming and gambling statutes or statutes prohibiting speculations.

⁴⁵ One participant explained that certain jurisdictions excluded particular transactions from the netting set by way of choice of governing law or language.

⁴⁶ 2006 ISDA Model Netting Act, available under <http://www.isda.org/docproj/pdf/Model-Netting-Act101007.pdf>.

⁴⁷ The text passages in brackets are added to the wording of the ISDA Model Netting Act.

⁴⁸ Capacity, consumer protection and short-selling prohibitions were cited as examples for legal provisions that should not be disapplied.

43. The Study Group did not take a decision to extend the protection of the Principles against typical obstacles to the enforceability of netting to underlying contracts and obligations. Yet, it would welcome a drafting proposal for their protection in square brackets to facilitate the discussion at the next meeting⁴⁹.

2. Extension to certain other provisions of master agreements

44. The Study Group discussed whether the Principles should address certain provisions of master agreements which did not refer directly to the close-out netting mechanism as defined in Draft Principle 1 (by termination/acceleration, valuation and determination of the net sum) but were so closely related to that mechanism that they would be mainly included in master agreements or other contracts containing a close-out netting provision (e.g. walkaway clauses and clauses conferring upon the nondefaulting party a power to wait and see⁵⁰).

45. Several participants took the view that the Principles should remain restricted to a protection of the close-out netting mechanism itself as defined by Draft Principle 1. They argued that they had conceived the project to deal with one modality of financial market transactions, not with close-out netting 'and beyond'. They acknowledged however that Draft Principle 10 might easily be misunderstood to protect also ancillary provisions to the close-out netting provision in a master agreement. To avoid those misunderstandings, the participants proposed to clarify the limited scope of the Principles in a commentary.

46. Other participants recommended addressing those typical provisions of a (master) agreement in the Principles that would seriously harm the close-out netting mechanism if they were not enforceable and which had occupied the minds of policy makers for some time. They proposed to at least identify and explain the functioning and implications of these provisions in a commentary. In view of the risk that the scope of Draft Principle 10 could be misunderstood, some participants suggested to provide expressly that it was not against the rationale of the Principles if jurisdictions declared such ancillary provisions invalid, void or voidable.

3. Extension of the Principles to statutory close-out netting provisions

47. Several participants advocated extending the scope of the Principles to apply also to statutory provisions that provided for an autonomous netting⁵¹ or set-off⁵² mechanism irrespective of the stipulations of the netting agreement. One participant made the following drafting proposal to expand the definition of close-out netting in Draft Principle 1 to statutory netting provisions: "*Close-out Netting is the legal consequence of either a contractual clause or a statutory provision whereby, on the occurrence of a certain event, these consequences follow [...]*". The proponents of this view argued that the Principles were supposed to facilitate the recognition and legal protection of close-out netting under a functional approach, no matter if the operation was stipulated in a contract or regulated by a statutory provision. The Study Group should seek to provide useful guidance also for these mechanisms.

48. Other participants felt that the enforceability of statutory provisions was self-evident and did not need the support of Principles which state that statutory provisions should be enforceable in accordance with their terms.

⁴⁹ The proposal should be made in square brackets to indicate that no agreement has been reached to expand the scope of the instrument.

⁵⁰ Cf. Below, Sect. II.D.3 paras. 98 f., p. 27 f. and Sect. II.D.4, paras. 100 f., p. 28f.; Special considerations were uttered regarding each of these powers. They are presented in more detail below in the relevant section.

⁵¹ E.g. § 104 of the German Insolvency Act (Insolvenzordnung).

⁵² E.g. Rule 4.90 of the UK Insolvency Rules 1986.

4. Extension of the protection of Principle 11 to situations outside insolvency

49. The Study Group noted that Draft Principle 11 applied to obstacles to the enforcement of netting in insolvency proceedings only. Participants then stressed that a party could face the same problems with the enforcement of a close-out netting provision as in insolvency proceedings also in a pre-insolvency stage or completely outside of insolvency. They gave the example of regimes that provided for an equal treatment of creditors outside insolvency (e.g. *Concursus creditorum/Concours des créanciers*). The Study Group agreed that those obstacles should be disapplied as well.

50. Varying views were expressed regarding the way in which these obstacles to the enforcement of netting should be eliminated. Some participant proposed to address obstacles based on equal treatment outside insolvency in Draft Principle 10, others suggested that the definition of reorganisation measures which had yet to be formulated might be the right place. These views did not find the support of a majority. To explain their objections against the last proposal, participants argued that reorganisation measures were only one of the regimes that might require an equal treatment of creditors. Requirements to treat creditors equally could also apply in other situations where assets were seized. Therefore, a proposal based on the definition of reorganisation measures would be incomplete.

51. Several participants proposed to expand the carve-out under Draft Principle 11 to all regimes that commanded an equal treatment of creditors. They argued that the carve-out of statutory impediments to the enforceability of netting should not be split up into two separate provisions - one for insolvency in Draft Principle 11 and one elsewhere for outside-insolvency situations. Two distinct Principles would create the impression that different regimes should apply to those obstacles where in fact, the Study Group was of the view that the same regime should apply to both the *conkursus creditorum* and to insolvency proceedings.

E. Interplay with crisis management powers

52. The Study Group confirmed its view that certain special crisis management powers of regulators or other governmental authorities should prevail over the ability of a counterparty to exercise and trigger its close-out netting rights. It took note of the fact that the FSB intended to clarify by November 2011⁵³ what kind of supervisory measures could be taken in a financial crisis and should prevail over the enforcement of close-out netting. The participants came therefore to the understanding that it was yet too early to identify these measures and agreed to defer the discussion on the interplay between netting and crisis management powers to await the outcome of the discussions in the FSB. In the meantime, the Draft Principles should recognise the priority of these powers in a footnote. Footnote 39 needed to be enlarged for that purpose to encompass all crisis management powers – whether they were taken by regulator or by any other governmental authority and whether the decision was taken by an administrative body or in a statute⁵⁴.

53. Several participants proposed to bear in mind and to explain in a commentary that there was always a trade-off in terms of both legal certainty and systemic disruption when pre-existing third-party rights were overridden. The Study Group should therefore not blindly carve out all regulatory measures but try to define the areas and likely manners in which they might occur. Several participants felt that it might be useful to provide guidance on these powers particularly for jurisdictions which were not closely involved in the work of the FSB.

⁵³ Key Attributes of Effective Resolution Regimes for Financial Institutions of October 2011 (published on 4 November 2011 under http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

⁵⁴ E.g. nationalisation/temporary ownership of a bank, temporary stays/moratoria or the transfer of assets to another legal entity such as. a bridge bank.

F. Payment and settlement systems

54. The Study Group noted that payment, settlement and clearing systems applied a great diversity of structures and methods. It agreed to focus its attention on operations that were based on a close-out netting mechanism which corresponded to the bilateral close-out netting mechanism defined in Draft Principle 1.

55. The participants noted that most payment systems applied a net settlement mechanism to their daily transactions that differed considerably from the close-out netting mechanism defined in Draft Principle 1. These operations should therefore not be in the focus of this project. On the contrary, the mechanisms prescribed for the default of one participant often implied elements of close-out netting in the operation which determined the position of the defaulting participant vis-à-vis the operator and sometimes also with respect to the positions towards other participants. There were also netting-relevant aspects in ancillary services⁵⁵, which might inform the discussion on the inclusion of certain forms of deposits or credit positions within the scope of protection of the Principles. The key attention should however be on the protection of close-out netting arrangements that were applied in CCPs.

56. The participants noted that the legal framework and legislative development regarding payment, settlement and clearing systems was rather complex and agreed that the issue should remain under consideration.

G. Netting in multilateral structures

57. A majority of participants reiterated the view that the Principles should not cover truly multilateral netting – netting between multitudes of parties that did not create mutuality in a first step.⁵⁶ Others considered that there might be merit in addressing multilateral netting⁵⁷ but agreed that the issues raised complexities that should await a later point in time.

58. The Study Group stressed that the Principles should by contrast apply to any form of netting that created mutuality in a first step and thus cover any form of bilateral netting even if it occurred in a multilateral context. One participant proposed to clarify this expressly and to draw drafting inspirations from the recent legislation of some jurisdictions.⁵⁸

⁵⁵ E.g. specific forms of triparty arrangements or the liquidity pooling mechanism of TARGET2.

⁵⁶ Cf. the Report first meeting, paras. 8-10, p. 3 (UNIDROIT – Study LXXVIII C - Doc. 4, available under <http://www.unidroit.org/english/documents/2011/study78c/s-78c-04-e.pdf>).

⁵⁷ They considered that some parts of the CHIPS were based on purely multilateral netting. CHIPS, the Clearing House Interbank Payments System is an „*electronic credit transfer systems payment systems [... that offers...] real-time final settlement for payment orders. [...] Payment instructions submitted to the payment queue that remain unsettled at the end of the day are tallied and funded on a multilateral net basis prior to releasing the payments*“, cf. Payment and settlement systems in selected countries, The Payment System in the US (CPSS - Red Book – 2003), <http://www.bis.org/cpss/paysys/UnitedStatesComp.pdf>). Also the Euro1 Single Obligation Structure seemed to imply multilateral netting. But like other payment and settlement systems, these structures had tailor-made underpinnings.

⁵⁸ The UK Finance Act 2011, for instance, provides in (c. 11), Schedule 19 – The bank levy, Part 4 – Chargeable equity and liabilities that:

16 (1) *This paragraph applies for the purposes of paragraph 15(2) if—*

[...]

(c) there is in place an agreement which makes provision for there to be a single net settlement of all M's liabilities, and liabilities of other members of the group to N or another entity which is not a member of the group, (so far as covered by the provision) and all N's liabilities (so far as covered by the provision) if the netting event occurs, and

(d) the provision mentioned in paragraph (c) is legally effective and enforceable.

(2) For the purposes of sub-paragraph (1)—

59. The participants concluded that close-out netting mechanisms in CCP structures fell into the scope of application of the Principles because CCPs operated on the basis of bilateral relationships to their participants. To avoid misunderstandings, one participant suggested mentioning in a commentary that from a legal perspective, CCPs applied bilateral netting.

1. Netting in CCP structures

60. The Study Group took note of the fact that CCP structures were currently under consideration in a number of bodies, including the FSB, the CPSS-IOSCO⁵⁹, the CBRG⁶⁰ and the ESMA (former CESR)⁶¹. It agreed that the conclusions of those bodies on risk reduction and risk allocation in CCPs would have considerable impact on the shape of an appropriate close-out netting mechanism. For this reason, the Study Group decided to defer the discussion on CCPs and to consider the findings of other fora currently working on the matter before further deliberating on CCPs in order to ensure consistency of the international instruments. One participant proposed that the Study Group should pay special attention to the question whether a participant was entitled to close out its positions against an ailing CCP.⁶²

61. On more general terms, the Study Group noted that two steps had to be distinguished regarding netting in CCP structures: First, the creation of a bilateral obligation between the CCP and the participant⁶³ and second the close-out netting of that obligation. The Study Group discussed whether it should take a position on the first step. On the one hand, the first step did not imply the netting mechanism as defined in Draft Principle 1, on the other hand the close-out netting of the second step presupposed that the obligations were created validly. The participants agreed that some entity should address the uncertainties and obstacles of the first step but expressed doubts as to whether UNIDROIT was the right forum for these discussions.

2. Netting in multi-branch structures

62. The Study Group considered whether to address netting agreements within multi-branch structures. One participant held the view that the issue was covered – though not explicitly mentioned – by Draft Principles 10 and 11 (party autonomy): if the parties were free to determine the application of the netting agreement, they could also stipulate that the agreement should apply to their branches. Other participants feared that Draft Principles 10 and 11 alone would be

(a) "agreement" includes an agreement which forms part of a multilateral agreement, arrangement or trading facility, [...]

(cf. http://www.legislation.gov.uk/ukpga/2011/11/pdfs/ukpga_20110011_en.pdf, p. 315).

⁵⁹ "Recommendations for Central Counterparties" of November 2004 (www.bis.org/publ/cpss64.pdf) and "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs", Consultative report of May 2010 (<http://www.bis.org/publ/cpss89.pdf>).

⁶⁰ "Report and Recommendations of the Cross-border Bank Resolution Group" of March 2010, www.bis.org/publ/bcbs169.pdf (CBRG Report), Recommendations 8 and 9, p. 36 ff.

⁶¹ Draft recommendations for securities settlement systems, and draft recommendations for central counterparties (CESR/ESCB Consultation paper) of October 2008 (www.esma.europa.eu/data/document/08_749.pdf) - The former Committee of European Securities Regulators (CESR) has become the European Securities and Market Authority (ESMA) (www.esma.europa.eu).

⁶² One participant raised concerns whether a close-out of participants should be allowed and argued that this would imply major systemic risks. Other participants explained that many CCPs currently had no provisions for a close-out of the participants in their rules but that they would have been persuaded to amend their rulebooks. This followed from the Basle III requirements: any bank that wanted to calculate its outstanding obligations vis-à-vis the CCP on a net amount needed to be able to demonstrate that they had a legally enforceable right to close out.

⁶³ The Study Group understood that the first step of centralising the obligation at the CCP was achieved mainly through novation, sometimes through representation. This step might give rise to problems in the cross-border context since the legal formulation or characteristics of the transfer might vary from jurisdiction to jurisdiction.

insufficient to deal with the particular problems raised by multi-branch netting. They drew attention to the problems of parallel insolvency proceedings in jurisdictions that permitted territorial liquidation proceedings⁶⁴. They cautioned that the abstract wording of the Draft Principles 10 and 11 as currently drafted was insufficient to balance rights and obligations in parallel insolvency proceedings.

63. The Study Group agreed that the issue required more consideration and should be addressed during the next meeting. One participant suggested taking into account the ongoing discussions of UNCITRAL on enterprise groups⁶⁵. Due to the complexity of the matter and the necessity for a discussion, the Study Group would welcome a proposal of the Secretariat. For the time being, the current draft of the Draft Principles should not be altered.

H. Collateral arrangements

64. The Study Group came to a general understanding that the Principles could not apply to proprietary rights to the return of collateral. Arrangements under which the full ownership of the financial collateral remained with the collateral provider⁶⁶ ("pledge collateral") should generally not be covered. Pledge collateral would traditionally rather apply to the result of the operation of netting. By contrast, arrangements under which a collateral provider transferred full ownership of the collateral to the collateral taker ("title transfer collateral arrangements"⁶⁷) should be included.

65. The Study Group proceeded to discuss whether it was justified to include the right to the return of pledge collateral into a netting set in particular circumstances. Participants identified a rehypothecation of the pledge collateral⁶⁸ as such an exceptional circumstance. They argued that proprietary interests were less significant after a transfer of the collateral to an onward third party.⁶⁹ Under the same rationale, one participant proposed that pledge collateral should be included if it was given under an agreement that the collateral could remain with the collateral taker upon closing out while its market value should be taken into account in an overall net-settlement. The participant explained that such provisions were used in the market to make a rather artificial and sometimes quite difficult stage of selling the collateral unnecessary in what might be a thin market.

66. The Study Group has not taken a final decision on collateral arrangements yet. It welcomed the Alternative Draft on definitions as a great step in advancing the discussions and expressed the view that the commentary to item (c) of the Alternative Draft on definitions addressed the main concerns regarding the protection of pledge collateral. The Study Group would focus its analysis on the concept of collateral protection put forth in the commentary to item (c) of the Alternative Draft on definitions.

⁶⁴ One participant stressed that these problems could not only arise in the US but also in the EU if the financial institution was established in a EU jurisdiction but a branch is a non-EU-bank: despite the universality approach, most EU countries would then retain some authority to initiate a host insolvency proceeding (cf. the CBRG-Report of March 2010, p. 23, available under <http://www.bis.org/publ/bcbs169.pdf>).

⁶⁵ <http://daccess-dds-ny.un.org/doc/UNDOC/GEN/V11/872/54/PDF/V1187254.pdf?OpenElement>.

⁶⁶ E.g. pledges, charges, liens.

⁶⁷ This category is understood to include repos. Other examples: deposits, credit support arrangements. The right to the return of capital is of contractual nature under those arrangements.

⁶⁸ E.g. under Art. 9 of the UCC.

⁶⁹ Art. 5 of the EU Financial Collateral Directive 2002/47/EC (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>) provided that the obligation to return the collateral changed into an open redelivery obligation in case of rehypothecation. Thereby the proprietary rights of the collateral provider rescinded.

II. Consideration of the Second Preliminary Draft of Principles on Close-out Netting of Financial Instruments (UNIDROIT Study LXXVIII C – Doc. 6)

A. The introduction

67. The Study Group agreed that the introduction needed to be further reformed to reflect the ongoing debate of academics and regulators in the financial crisis. The introduction should offer a brief analysis of the status quo of netting legislation and practice, reflecting the interplay of the Principles with crisis management powers. In order to explain the added value of the Principles, the introduction needed to answer the question why further harmonisation was desirable in spite of the level of protection that existed today. One participant invited the Study Group to give examples of real cases where netting had or could have had a beneficial influence in the cross-border context to demonstrate the benefits of netting to those countries that had no experience with this instrument.

68. The introduction should further expose possible frictions with insolvency laws: It should acknowledge that Close-out Netting might be seen as an exception to certain principles of insolvency law and discuss critical opinions on key policy issues between netting protection and principles of insolvency laws. In particular, footnote 7 should be revised regarding the powers of insolvency administrators which have greater powers than the insolvent debtor. A justification of these deviations from insolvency laws should be another important element of the introduction. The Study Group agreed that systemic stability was the key argument. With a view to the expected addressees, several participants suggested that the Principles should focus on stability in financial markets. Others favoured a broader approach aiming also at stability on energy markets.

69. Some participants advocated outlining the single agreement concept as a second line of justification in the introduction. Under the single agreement concept, a netting provision was understood to bundle a set of cash-flows into a single contract. Thereby it precluded the powers of insolvency administrators to cherry-pick among that single contract according to the same rationale that prohibited cherry-picking among a single interest swap. In this perspective, netting did not constitute an exception to *pari passu*-treatment. The proponents of this view acknowledged that the concept was subject to debate. The wider and more diverse the set of underlying obligations was, the greater was the controversy.

70. One participant pointed to the fact that the justification depended on the overall approach towards netting. If the Study Group decided to adopt Principles that granted certain (financial) contracts a special beneficial treatment⁷⁰, it would have to justify the netting protection with reasons relating to the stability of the relevant (financial) market. If the Study Group decided to adopt the view that netting was available to (almost) every type of contract and party but that only few legal provision should be disapplied, then every exemption itself needed to be justified by reasons underlying the particular legal regime. The participant suggested that an exemption from *pari passu* provisions could be justified by drawing a parallel to statutory set-off, which constituted one of the recognised traditional exception to *pari passu*.

71. Another participant proposed to outline the history of netting recognition for regulatory purposes and to explain the underlying policy considerations in the introduction. He explained that netting recognition had its roots in netting by novation. Originally, institutions were required to demonstrate that their netting system and practice reflected in real time the legal position which legitimately stemmed from the netting agreement. Over the years, Courts and modern statutes

⁷⁰ Cf. para. 108, p. 21 of the Report of the First Meeting (UNIDROIT Study S78C - Doc. 4, <http://www.unidroit.org/english/documents/2011/study78c/s-78c-04-e.pdf>): The approach implied a broad protection of the netting agreements from substantive law (i.e. netting was exempted from the entire insolvency law).

had softened this rigid test by applying the maxime "*Id certum est quod certum reddi potest*" ("That is certain which may be rendered certain") pursuant to which it was sufficient that an institution was able to determine its legal position upon the occurrence of an enforcement event.

72. Some participants advocated explaining the role of netting for the payment systems. They argued that many countries had been assessed under the Financial Sector Assessment Program⁷¹ undertaken by the International Monetary Fund (IMF) and the World Bank to determine whether their payment system provided sufficient protection from insolvency and complied with the CPSS standards⁷². Many of those countries were currently in the process of adopting laws on payment systems and wondered about the role of this project in the overall context. One participant proposed to expressly state in the introduction that payment systems might overlap with the scope of the Principles but were not the primary focus of the Principles since they had specific protection imperatives.

B. Definitions (Draft Principles 1-5)

1. Draft Principle 1 (Close-out Netting Provision)

73. The Study Group discussed drafting alternatives (a) and (b) of Draft Principle 1 and concluded that it was too early to make a decision. Being inspired by the European Financial Collateral directive 2002/47/EC⁷³ and the Geneva Convention⁷⁴, alternative (a) had the advantage that it had been tested for almost ten years. It had proven to work well and to embrace all netting mechanisms. At the same time, however, alternative (a) implied within both its subparagraphs a number of concepts which were difficult to understand. Alternative (b), in turn, unbundled these elements since it described the three steps of the netting mechanism and clarified the concepts behind those steps. It was therefore more easily accessible and transparent for an audience which consisted of a great variety of countries from developed and emerging markets. In a preliminary vote, a slight majority of participants opted for alternative (a). Some participants favoured neither option and proposed to merge both alternatives to have an easier but comprehensive text than alternative (a) with a more general formulation than alternative (b) which would therefore encompass the main elements of both definitions.

74. Stimulated by the differing wording of the valuation in draft alternative (a) ("to pay an amount representing their estimated current value") and (b) ("close-out value, market value or replacement value"), the Study Group discussed drafting options regarding the valuation. One participant suggested replacing the wording "representing the estimated current value" under alternative (a) by "representing the value" or "representing the amount owed". In the same line of thought, another participant proposed to reduce the different values enumerated in alternative (b) ("close-out value, market value or replacement value") to one term, "fair value"⁷⁵. He argued that the reference to a "fair value" might help clarifying that netting was not about exploiting the insolvency estate but was designed to simply attribute to each party what it had on the books according to market prices. Thus, the term might build the bridge to the justification of the Principles before the public. Some participants raised concerns that the term "fair value" was less

⁷¹ Cf. <http://www.imf.org/external/NP/fsap/fsap.aspx>.

⁷² Report of the Committee on Payment and Settlement Systems (CPSS) on Core Principles for Systemically Important Payment Systems of January 2001 and joint-Report with the Technical Committee of the International Organisation of Securities Commissions (IOSCO) on Securities Settlement Systems of January 2001 (available under <http://www.bis.org/publ/cpss42.pdf>) and Recommendations for Central Counterparties of November 2004 (available under <http://www.bis.org/publ/cpss64.pdf>).

⁷³ Art. 2(1)(n) of the EU Financial Collateral Directive 2002/47/EC (available under <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>).

⁷⁴ Art. 31(3)(j) of the Geneva Securities Convention (available under <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/convention.pdf>).

⁷⁵ The term „fair value“ is defined in IAS 32.11 and 39.9.

clear than the classical concepts of "market value" or "replacement value" and might thus give rise to controversies. The proponent of using the "fair value" replied that the valuation of financial instruments always implied uncertainty, even under the standard of the "estimated current value" since the determination of the "estimated value" depended upon the perspective, namely whether the evaluation was looked at from the bid or the offer side. Picking up the problem of uncertainty in the valuation of obligations, one participant raised the question of how to attribute a value to assets that were not traded on regulated markets. Several participants considered that the parties could provide for a valuation method in their contract and that such a provision should apply and prevail over other methods provided for in statutes. Only if the valuation method was one-sidedly favouring one party, namely if the input parameters were not taken from objective sources but from the sphere of the determining party, for instance, this provision would be inapplicable.

75. The Study Group further discussed the drafting options in brackets in Draft Principle 1.

76. It did not take a final decision in respect of the first bracket relating to [agreement/provision]. A slight majority of participants favoured the term "provision" while some participants cautioned that the term might be misunderstood in the context of Draft Principles 10 and 11. They voiced the concern that the term "provision" could imply that all provisions of a master agreement should be covered by the protective shield of Draft Principle 10. Other participants cautioned that the term "provision" could lead to a misunderstanding in Draft Principle 11: Draft Principle 11 stated that a Close-out Netting Provision should be enforceable notwithstanding the commencement or continuation of insolvency proceedings "except as otherwise provided in a Close-out Netting [Agreement/Provision]". If the Study Group opted for the more generic term "provision", the cited phrase could be understood to include statutory provisions that limit the enforcement of close-out netting. For these reasons, some participants favoured the term "agreement". They could not see the problems with the term "agreement" raised at the first meeting regarding general terms and conditions or provisions in rulebooks of infrastructures.⁷⁶ The acceptance of those legal texts would always constitute an agreement. An term "provision" would only be better suited if the Study Group decided to broaden the scope of the Draft Principles to close-out netting provisions in statutes.⁷⁷ One participant proposed as an alternative the term "arrangement". The proposal was welcomed by some participants who considered that this term was more generic and therefore better suited for the soft nature of Principles, but did not find the support of a majority of participants.

77. With reference to the previous discussion on the material scope of the Draft Principles⁷⁸, several participant proposed to delete the term "financial" in the second bracket ["relating to eligible financial contracts"] to encompass also netting on the energy market.

78. Concerning the third bracket "two [or more]", the Study Group reiterated its intention to cover only netting agreements that created mutuality as a first step.⁷⁹ To reflect this idea, some participants advocated deleting the words "or more" and clarifying in an explanatory note that the Draft Principles should apply to bilateral netting even if it occurred in a multilateral context. Other participants favoured a more general formulation to avoid a decision on the issue. They suggested replacing the formulation "two or more parties" by the wording "the parties".

79. Regarding the next bracket "[either or both]", which was relevant only for alternative (a) of the definition, several participants advocated keeping both options.

80. Varying view were expressed in respect of the last bracket ["whether through the operation of set-off, novation or otherwise"]. Some participants welcomed that amendment because it

⁷⁶ Report on the Second meeting, UNIDROIT Study S78C - Doc. 4, para. 42, p. 9, (available at <http://www.unidroit.org/english/documents/2011/study78c/s-78c-04-e.pdf>).

⁷⁷ Cf. Section, I.D.3. above, paras. 47 f., p. 16.

⁷⁸ Cf. Section I.C.2. above, para. 30, p. 12.

⁷⁹ Cf. Section I.G. above, paras. 57 f, p. 18 f.

reflected that netting could be realised through different legal techniques, while others considered that it would be sufficient to have this statement somewhere in the explanatory material.

81. Some drafting proposals related to one of the alternatives for the definition of the netting mechanism only: With view to alternative (a), it was suggested to reconsider the wording “an account is taken”. In alternative (b), the Study Group decided to delete the term “entitlements” because entitlements were already encompassed by the word “obligation”.

82. Last, the Study Group agreed to clarify in an explanatory note that the netting mechanism did not prescribe a logical order between the three elements of Draft Principle 1 (termination/acceleration, valuation and determination of the net sum). The application of the principles should not be locked into a specific approach because different methods existed in practice⁸⁰. However, one participant suggested keeping the issue under consideration. He drew attention to the fact that the logical order of the mechanism might be of relevance for cross-jurisdictional effects of certain regulatory powers which were currently debated and explained that an order by a regulator or other authority might be linked to a particular step of netting.

2. Draft Principle 2 (Enforcement event)

83. The Study Group noted that the term “enforcement event” was used solely in the definition of Draft Principle 1. Several participants proposed therefore to delete Draft Principle. Some participants added that the term “enforcement event” should be replaced with terminology that was less content-laden such as “specified event”, “stipulated event” or “expressed event”. Other participants cautioned that the Study Group might lose any of the ideas embodied in Draft Principle 2 in case of a merger with Draft Principle 1. Among those ideas they cited the clarification that an enforcement or specified event was any set of circumstances the parties had defined in their contract (not an event provided for in a statutory provision) as well as the possibility of opting either for automatic early termination or for termination by notification. Some participants objected to the deletion. They argued that the definition was well recognised and very useful to explain to policymakers and regulators in jurisdictions that were not familiar with the concept of netting that the definition of ‘enforcement event’ contained the separate idea that the parties were free to determine the elements that trigger the closing-out in their contract. They invited the Study Group to discuss certain controversial issues in the commentary such as the question of whether certain events like downgrading could constitute an enforcement event.

3. Draft Principle 3 (Insolvency Proceedings)

84. Several participants raised the question of whether a definition of insolvency proceedings was necessary in Principles and proposed to delete Draft Principle 3 altogether. Others considered that the definition was important and suggested to use the definition of insolvency proceedings of footnote 22, which should be supplemented by a provision or paragraph on crisis resolution measures. In light of the fact that crisis management measures might be discussed in the FSB in November 2011, the Study Group decided to defer the discussion on this definition to the next meeting. In the meantime, a tentative carve-out for crisis management measures should be included into the provision to indicate that the Study Group agreed to disapply netting to certain crisis management measures. One participant proposed to use the definition of reorganisation measures of the Financial Collateral Directive for the tentative carve-out.⁸¹

⁸⁰ The ISDA Master Agreements of 1992 and 2002 did not imply acceleration of the transactions but stipulated that obligations were discharged and set aside. Instead, a single payment obligation arose that looked at the terminated transactions: thus, there was no aggregation but pure calculation. The Global Master Repurchase Agreement of 1992, 1995 and 2000 on the contrary involved acceleration (available under <http://www.icmagroup.org/legal1/global.aspx>).

⁸¹ Art. 2(1)(k) of the Financial Collateral Directive 2002/47/EC provides “‘reorganisation measures’ means measures which involve any intervention by administrative or judicial authorities which are intended to preserve

C. Formal requirements for Close-out Netting Provisions (Draft Principles 6-9)

1. Draft Principles 6 and 7

85. One participant explained that it was very important to exclude any formal requirement except for a possible writing requirement⁸² in the cross-border context. He cited the example of a transfer of business from an ailing bank to a healthy foreign bank⁸³: If there was a notarisation requirement in the healthy bank's jurisdiction but none in ailing bank's jurisdiction, all underlying contracts risked to be invalid after the transfer. One participant suggested replacing the term formal act by the term formal requirement.

86. Some participants suggested that the provision should be enlarged to cover also the eligible contracts to avoid that the netting mechanism was undermined if the writing requirement applied to all the underlying contracts and rendered them void or voidable.⁸⁴

87. Another participant remarked that Draft Principles 6 and 7 were incompatible with certain netting laws⁸⁵, which recognised close-out netting only in three alternative circumstances: The financial contracts were either concluded in a trading system or over an exchange (1), cleared in a clearing house (2) or were part of a recognised Master Agreement between parties that entered into more than one repo or derivative financial instrument or other financial contract (3). He favoured this stricter approach and raised the question as to how to avoid fraudulent backdating under the current draft: How could an insolvency administrator or court control the timing of the agreement and thus prevent an abuse of the netting regime to the detriment of other creditors.

2. Draft Principle 8

88. Several participants expressed their strong support for trade registries but considered that invalidity was an unguided weapon to secure compliance with reporting obligations. Invalidity was considered to be an inefficient and dangerous sanction because it was just as likely to damage the innocent as the guilty. The breach of formal requirements could be sanctioned by any other consequences such as fines, regulatory sanctions such as a closing-down of the business, imprisonment and possibly actions for compensations for damage suffered as a result of breach. This should be clarified in an explanatory note. Other participant cautioned that legislators would not accept any provision that prevented them from sanctioning the noncompliance with formal requirements by invalidity or voidness. They proposed to redraft the provision to state that a governmental approval of the terms of the agreement should not be required and that the use of certain documentation should not be mandatory.

89. Mirroring the debate on the extension of the scope of the Principles to the underlying contracts and obligations⁸⁶, some participants proposed that Draft Principle 8 should address also registration requirements for the financial contracts themselves.

or restore the financial situation and which affect pre-existing rights of third parties, including but not limited to measures involving a suspension of payments, suspension of enforcement measures or reduction of claims;" (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>).

⁸² The wording of Draft Principles 6 and 7 was adapted from Art. 3 of the Financial Collateral Directive 2002/47/EC (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>).

⁸³ E.g. BNP taking over Fortis.

⁸⁴ Cf. the discussion under I.D.1., paras. 38 f., p. 14 f.

⁸⁵ E.g. the new Russian netting legislation: In August 2011, the "Clearing and clearing activity law" and the "Law implementing corresponding amendments to certain existing Russian laws" came into effect, which allowed netting for OTC transactions primarily through amendments to the Securities Market Law and the Bankruptcy Law.

⁸⁶ Cf. above I.D.1., paras. 38 f., p. 14 f.

3. Draft Principle 9

90. One participant raised the question whether the content of Draft Principle 9 was not implied in Draft Principle 6, at least if the provision was redrafted to refer to a “formal requirement” instead of a “formal act”. To avoid misunderstandings, he proposed to clarify in an explanatory note to Draft Principle 6 that the provision applied also to the use of standardised terms. Others proposed to extend Draft Principle 9 to cover also the underlying eligible contracts.

D. The enforceability of close-out netting (Draft Principles 10-16)

1. Draft Principle 10

91. Various views were expressed as to whether Draft Principle 10 should remain a stand-alone provision. Some participants advocated redrafting Draft Principle 10 following the model of Art. 4 of the ISDA Model Netting Act. They proposed to add an immediate reference to the main areas of concern to the general statement that contracts should be enforceable according to their terms.⁸⁷ This could be done by merging Draft Principles 10 and 11, possibly also with Draft Principle 13. These participants expressed concerns that Draft Principle 10 could be misunderstood in two ways: first, to simply reaffirm a general principle of contract law, which would not reflect the full and proper meaning the Study Group attached to the provision. Second, Draft Principle 10 could be misunderstood to stipulate that whatever was written somewhere in an agreement that contained a netting clause should always be valid – regardless of the extent in which it violated public policy.⁸⁸

92. Other participants considered that Principle 10 was quite clear. It protected the validity and enforceability of the private agreement. Remaining doubts could be addressed in the explanatory note. They further argued that the current structure had the advantage of avoiding gaps: a list of the areas of concern might not capture all obstacles to the enforceability of netting. Based on the understanding that the Principles should apply only to the close-out netting mechanism as defined in Draft Principle 1 and not to ancillary provisions of a netting agreement⁸⁹, one participant argued that the very narrow scope of application of the Principles justified a full protection of close-out netting provisions⁹⁰. Even though the participants saw a need for clarifying the contents within which Draft Principle 10 operated, there was no majority of opinion favouring a merger.

93. One participant proposed to replace the entire Draft Principle 10 with the following text:
“For the close-out netting agreements for which the legislator considers a specific protection is needed, the legislator has to ensure the enforcement of netting even in the event of insolvency proceedings disapplying specific provisions which could undermine the effectiveness of close-out netting agreements.”

The participant explained that this proposal intended to recognise the public order of insolvency laws. Those laws were elaborated according to economic and political considerations specific to each jurisdiction. A majority of participants rejected this proposal because it simply reflected the status quo. They argued that the Study Group had been formed expressly to overcome the fragmentation of the various national netting schemes and the problems it created in the cross-border context. The intention of the drafting proposal to leave national jurisdictions leeway to balance the public interest in the enforceability of netting with other public interests should be

⁸⁷ I.E. A Close-out Netting provision should take effect in accordance with its terms regardless of formalities, notwithstanding the opening of insolvency proceedings, etc.

⁸⁸ This reading presupposed that the Principles applied also to clauses that did more than regulate the three-step netting mechanism (cf. the debate on the scope in Section I.D.2 above, paras. 44-46, p.16)

⁸⁹ Cf. Section, I.D.2 above, paras. 44-46., p. 16.

⁹⁰ A close-out netting provision had been filtered first through the definition of close-out netting provisions, then through the list of eligible contracts and parties.

addressed in a more structured and detailed way: when spelling out the interplay of regulatory measures and netting and in the insolvency carve-out.

2. Draft Principle 11 (Insolvency carve-out)

94. Inspired by the list of obstacles to the enforceability of netting laid out on p. 20 f. of the Preliminary Draft Report⁹¹, the Study Group agreed to address the following obstacles in Draft Principle 11:

- The restrictions to set-off applied to netting including automatic stay (The Study Group agreed to revisit this item),
- Cherry-picking,
- Prohibition of early termination and acceleration (Acceleration should be added since it was one of the key concepts) and
- Preferences and suspect periods (currently addressed in Draft Principle 15).

95. A majority of opinion further agreed that Draft Principle 11 should be amended to cover not only obstacles resulting from insolvency laws but all obstacles to the enforcement of netting that were based on the principles of equal treatment of creditors⁹².

96. With view to structure, the Study Group decided that Draft Principle 11 should be amended by a general explanation on the interplay between netting and insolvency. That explanation should be followed – either as a subset or as an independent Draft Principle – by a list of powers that merited special reference. Each of those items should be complemented by explanations on what these powers normally were, for what purposes they existed and why they might create systemic risk and needed to be disapplied.

97. One participant proposed further to consolidate Draft Principles 9 and 11 but the proposal was not echoed by other participants.

3. Draft Principle 12 (Walkaway clause)

98. A majority of participants proposed to delete Draft Principle 12, which dealt with so-called walkaway clauses or limited two-way payment clauses allowing a nondefaulting party not to make payments in the event of default of their counterparty. The participants argued that there was no reason to address walkaway clauses because they did not fall into the scope of the Draft Principles. Even though those clauses were often found in the master agreement with netting provisions, they did not apply to the netting mechanism itself consisting of the three steps defined in Draft Principle 1 (to termination/acceleration, valuation and determination of the net sum).⁹³

99. Other participants⁹⁴ felt that the Principles should address walkaway clauses. They explained that walkaway clauses prevented that the single payment obligation could fall due after closing out and thus seriously undermined the netting mechanism. They further argued that walkaway clauses should be addressed because they had occupied the minds of policy makers for some time. Differing views were expressed however on how to address walkaway clauses. One participant proposed to state explicitly that walkaway clauses should not be enforceable. He

⁹¹ Preliminary draft report on the need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution, UNIDROIT, Study 78C, Doc. 3, (<http://www.unidroit.org/english/documents/2011/study78c/s-78c-03-e.pdf>).

⁹² Cf. Section I.D.4 above, paras. 49-51., p. 17.

⁹³ Cf. Section I.D.2 above, paras. 44-46., p.16.

⁹⁴ Those participants had advocated in general addressing certain provisions that did not refer to the netting mechanism strictu sensu but would seriously harm the close-out netting mechanism if they were not enforceable (Cf. Section I.D.2. above paras. 44-46., p.16).

argued that close-out netting was widely considered to be an advantage for the nondefaulting party because it allowed that party to reduce its risk to a net sum. He wondered why a party in such an advantageous situation should further be allowed to refuse even the payment of the net sum to the insolvency estate. Other participants acknowledged that walkaway clauses were controversial but stated that they were not merely a privilege for the nondefaulting party to the detriment of the general creditors. They explained that there could be good reasons for walkaway clauses and gave the example of a fluctuating swap contract: If the nondefaulting party had set up a hedging strategy which enabled it to match its assumed exposures and thereby neutralise its risks, this party could not pass on the risk to its hedging in case of an early termination caused by a default of the counterparty because the hedging would not fall due. If in this scenario the nondefaulting counterparty was temporarily out of the money at the time of the default, the early termination might attribute windfall benefits to the defaulting party and thereby attribute at least a timing disadvantage - possibly an absolute disadvantage - to the nondefaulting party. They concluded that walkaway clauses were for good reasons controversial. The Study Group should explain the functioning and implications of walkaway clauses but leave the decision on these provisions to policy makers. To avoid misunderstandings, the participants proposed to provide expressly that the Principles took no position on walkaway clauses, thereby clarifying that those clauses should not be protected by Draft Principles 10 f. from overriding provisions of insolvency law.⁹⁵

4. Draft Principle 14 (Power to wait and see)

100. Draft Principle 14, which stipulated a timeframe for close-out, had been introduced to limit a 'power to wait and see' of the nondefaulting counterparty. Such a power arose under certain netting agreements that allowed a party to withhold payments upon the default of its counterparty while not forcing it to close-out⁹⁶. Analysing the drafting proposal, the Study Group came to the conclusion that it would be difficult to determine a specific timeline for closing-out. It also rejected the idea of letting regulators determine the timeframe. The Study Group felt that a regulator's understanding of a reasonable timeframe varied depending on whether it was mainly concerned with the timeline of liquidation or with avoiding the simultaneous close-out of large volumes of financial contracts and the resulting decrease of asset values, which could destabilise markets (fire sales).⁹⁷

101. Some participants favoured deleting Draft Principle 14 altogether because of the difficulty of determining a timeframe and because a contractual provision allowing a party to withhold payments did not fall into the scope of application of the Draft Principles as defined by the definition of close-out netting under Draft Principle 1.⁹⁸ Others recommended that the 'power to wait and see'⁹⁹ should be addressed somewhere in the Principles for several reasons: First, the issue had received much attention amongst regulators and the wider public with the insolvency of Lehman and Enron¹⁰⁰ and continued to be vividly discussed among experts. Therefore, the Study

⁹⁵ The question as to whether such a statement on the enforceability of ancillary provisions would be necessary depended on the decision the Study Group took regarding the scope of the instrument (Cf. Section I.D.2 above, paras. 44-46., p.16).

⁹⁶ cf. Report of the first meeting, p. 14, para. 75-78, UNIDROIT, Study 78C – Doc. 4 <http://www.unidroit.org/english/documents/2011/study78c/s-78c-04-e.pdf>. Examples: Art. 2(a)(iii) of the ISDA MA 1992 and 2002 and Art. 9 of the EFET General Agreement for natural gas trading.

⁹⁷ Cf. CBRG-Report, Rec. 9, para. 115 f, p. 40 (cf. above para. 2, www.bis.org/publ/bcbs169.pdf).

⁹⁸ Cf. The discussion on the material scope of the Draft Principles in Section I.D.2 above, paras. 44-46, p. 16.

⁹⁹ Cf. para. 100 above, p. 28.

¹⁰⁰ Cf. the Report of the first meeting, p. 15, para. 76 ff. (UNIDROIT, Study 78C – Doc. 4 <http://www.unidroit.org/english/documents/2011/study78c/s-78c-04-e.pdf>); *Enron Australia v. TXU Electricity Ltd.* [2003] NSWSC 1169, New South Wales Supreme Court, Decision of 11 February 2005; United States Bankruptcy Court for the Southern District of New York, Bench Ruling of 15 September 2009 ordering

Group should at least identify and explain the issue. Second, there was a risk that the Principles could be misunderstood. If the Principles did not allow a limitation of the 'power to wait and see', a reader might think that Draft Principles 10 f. provided that also ancillary provisions of a the netting agreement like those granting a 'power to wait and see' needed to be enforceable according to their terms where in fact, a limitation of such a power would not run against the intention of the Study Group.

102. Amongst those participants in favour of express statements on the 'power to wait and see', the views varied regarding the approach to adopt. Some participants advocated providing that the close-out had to occur within a "reasonable number of business days". They argued that such a general formulation was acceptable in a soft law instrument like principles and would invite a court or insolvency authority to take into account all the circumstances of a particular case (in particular the complexity of the arrangement). Other participants preferred not to take a position on whether a suspension, if any, should be allowed and if so with what consequences. They proposed to simply clarify that the protection of close-out netting provisions from overriding provisions of insolvency law under Draft Principle 10 should be limited in its extent. This could be done by stipulating that the protection afforded by Draft Principle 10 f. would run out after a certain period of suspension.

103. With regard to the structure of the section, some participants proposed to combine the provision on the 'power to wait and see' with Draft Principle 12 on the walkaway clause and argued that both clauses had similar effects.

104. Regardless of the final decision on the 'power to wait and see', the Study Group agreed that there should be a separate provision on the reasonableness of the valuation like in Draft Principle 14 of the 'First tentative structure for Principles regarding the enforceability of netting agreements'¹⁰¹. The Study Group did not decide whether the provision should indicate criteria to determine the reasonableness (e.g. whether the valuation needed to be based on a "fair value" concept or occur within a particular timeframe) or whether the Draft Principle should simply require that the (aggregation and) valuation needed to be conducted in a reasonable manner, which would leave it to each jurisdiction to determine the reasonableness.¹⁰²

5. Draft Principle 15 (Suspect periods/Zero-hour rule)

105. The Study Group acknowledged that Draft Principle 15 could be misunderstood to disapply laws governing fraudulent evasion of insolvency laws. It stressed that the word "solely" was the key to a correct understanding. Draft Principle 15 was drafted to restrict only one power of liquidators or bankruptcy trustees: The power to avoid past transactions based on the sole reason that the transaction took place at a certain point in time prior to the opening of insolvency proceeding. Thus, the provision applied to zero-hour rules and to suspect periods. To avoid misunderstandings on that scope, the Study Group agreed that Draft Principle 15 should be accompanied by an explanatory note clarifying that fraudulent preferences – transactions entered into for purpose of evading insolvency laws – did not fall under the provision. The avoidance of fraudulent transactions was not based "solely" on the timing of the conclusion of the contract but on a fraudulent motivation of evading insolvency laws.

106. The Study Group acknowledged that Draft Principle 15 was an exceptional provision under the Revised Draft of the Principles because it explicitly referred to the underlying obligations. While an extension of the scope of the Principles to underlying obligations might be questionable in other

Metavante Corporation to make payments to Lehman Brothers Special Financing Inc.; High Court of Justice in London, *Lomas and others v JFB Firth Rixson, Inc and others*² [2010] EWHC 3372.

¹⁰¹ UNIDROIT, Study 78C – Doc. 3, <http://www.unidroit.org/english/documents/2011/study78c/s-78c-03-e.pdf>.

¹⁰² Cf. the discussion on valuation above in para. 74, p. 22 f.

cases¹⁰³, a majority of participants explained that it was the main purpose of Draft Principle 15 to protect also the underlying obligation from zero-hour rules and suspect periods. The Study Group should retain Draft Principle 15 as it was and not delete the application to underlying obligations. They argued that the provision was essential for the protection of netting because the risk of invalidity created by suspect periods posed a much more systematic threat to the effectiveness of close-out netting than other limitations. In jurisdictions that provided for suspect periods, every single closing-out was preceded by a suspect period and thus a large part of every netting set would be affected by restrictions imposed on suspect period transactions. Netting protection that did not exempt the underlying obligations from the application of suspect periods would therefore be seriously flawed. That rationale explained also why a similar provision was included, for instance, into the EU collateral directive.¹⁰⁴

107. Still, some participants raised concerns regarding the consistency of the Draft Principles and advocated that the Study Group should refrain from covering the underlying obligations at all unless it decided to widen the scope of the project.

108. One participant proposed to distinguish between suspect periods, which should be covered, and other reasons for avoiding the obligation. He invited the Study Group to further discuss that issue in another meeting.

III. Planning of further work

A. Conflict of laws

109. The Secretariat conducted an in-depth study of conflict-of-law issues as they relate to netting. Based on the findings of that study, the Secretariat will, in consultation with the Hague Conference, submit to the group a revised set of provisions for discussion at a later stage. For this reason, the Study refrained from discussing Draft Principles 18-20.

B. The third meeting of the Study Group

110. The Study Group agreed that its third meeting should be held on 7-9 February 2012 at the seat of UNIDROIT in Rome.

111. The Study Group further agreed that, depending on the outcome of its third meeting, the Governing Council of UNIDROIT could be invited to authorise the convening of a Committee of Governmental Experts for the finalisation of the Draft Principles with a view to their subsequent adoption by the UNIDROIT Governing Council.

¹⁰³ Cf. above I.D.1, paras. 38-43, p. 14 f.

¹⁰⁴ Cf. Art. 8(1) of the Financial Collateral Directive 2002/47/EC (available under <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0050:EN:PDF>).

APPENDIX I**LIST OF PARTICIPANTS**

Mr Fernando R. DE ALMEIDA PRADO	Partner Pinheiro Neto Advogados Brazil
Mr BAO Xiangming	Managing Director of Market Discipline Department National Association of Financial Market Institutional Investors (NAFMII) P.R. China
Mr Carl BJERRE	University of Oregon – School of Law Professor of Law - Private Sector Adviser - Uniform Law Commissioner United States of America
Mr Diego DEVOS	General Counsel Bank for International Settlements (BIS) Switzerland
Mr Ignacio GÓMEZ-SANCHA	Managing Partner GÓMEZ-SANCHA Abogados Spain
Ms Joyce HANSEN	Deputy General Counsel and Senior Vice President Federal Reserve Bank of New York United States of America
Mr Holger HARTENFELS	Managing Director and Senior Counsel Legal Regulatory & Governance Germany
Mr Hideki KANDA	Professor of Law University of Tokyo Japan
Mr Rostislav KOKOREV	Deputy Director Ministry of Economic Development of the Russian Federation Department of Innovation Development and Corporate Governance Russian Federation
Mr Hans KUHN	Director Legal and Property Services Swiss National Bank Switzerland

Mr LIU Yin	Associate of Market Discipline Department National Association of Financial Market Institutional Investors P.R. China
Mr Klaus LÖBER	Head of Oversight Division European Central Bank (ECB) Germany
Ms Monica MARCUCCI	Legal Services and Law Studies Department Senior Lawyer Bank of Italy Italy
Mr Guy MORTON	Partner Freshfields Bruckhaus Deringer United Kingdom
Mr Philipp PAECH <i>Adviser to the UNIDROIT Secretariat</i>	Lecturer in Financial Law and Regulation London School of Economics and Political Science (LSE) - Department of Law United Kingdom
Ms Béatrice PASSERA	Adjointe de Direction Banque de France Direction des Services Juridiques - Service du Droit Communautaire et des Marchés Financiers France
Mr Stanislaw SOŁTYSIŃSKI Chairman of the UNIDROIT Study Group	SOŁTYSIŃSKI KAWECKI & SZLĘZAK Of Counsel Professor of Law - A. Mickiewicz University Poland

OBSERVERS

EUROPEAN COMMISSION (EC)	Mr Rogier WEZENBEEK Directorate-General for the Internal Market and Services
INTERNATIONAL MONETARY FUND (IMF)	Mr Alessandro GULLO Consulting Counsel - Legal Department
THE WORLD BANK	Ms WONG Sau Ngan Senior Counsel – Finance, Private Sector Development & Infrastructure Legal Vice Presidency

INTERNATIONAL SWAPS AND DERIVATIVES
ASSOCIATION (ISDA)

Mr Edward H. MURRAY
Chair of the International Swaps and
Derivatives Association Inc. (ISDA) Financial
Law Reform Committee

Mr Peter M. WERNER
Senior Director

UNIDROIT SECRETARIAT

Mr Alberto MAZZONI

President

Mr José Angelo ESTRELLA-FARIA

Secretary General

Ms Annick MOITEAUX

Assistant Officer

Mr Carsten KERN

Assistant Officer

APPENDIX II**UNIDROIT Study Group on principles and rules on the netting of financial instruments*****Second Meeting*****Rome, 13 – 15 September 2011**UNIDROIT 2011
Study LXXVIII C – Doc. 5
Original: English
July 2011**ANNOTATED DRAFT AGENDA**

1. Opening of the meeting
2. Adoption of the agenda and organisation of the meeting
3. Reports on the proceedings of relevant institutions
 - (a) Basel Committee on Banking Supervision
 - (b) EU Commission
4. Determining the scope of the Principles on Close-out Netting of Financial Instruments
5. Consideration of the Second Preliminary Draft of the Principles on Close-out Netting of Financial Instruments (UNIDROIT 2011 – Study LXXVIII C – Doc. 6)
6. Summary of the findings; planning of further work
7. Any other business
8. Closing of the meeting

ANNOTATIONS TO THE DRAFT AGENDA

Item No. 1 Opening of the meeting

1. The meeting will be held at the seat of Unidroit (Via Panisperna 28, 1084 Rome) and will be opened on Tuesday, 13 September 2011 at 10:00 hours.

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

2. Meeting hours will be from 10:00 to 12:30 and 14:00 to 18:00 hours.

Item No. 4 - Determining the scope of possible principles and rules on netting of financial instruments

At its first meeting in April 2011, the Study Group has identified important questions that should be addressed at a later stage of the proceedings, such as the definitions of eligible financial instruments and of eligible parties. Upon the request of members of the Study Group, ISDA has agreed to prepare a paper of relevant financial transactions. This document will be distributed to the members of the Study Group and made available on the [internet](#) by 31 August 2011.

The Study Group has also postponed a decision on whether and how to address payment and settlement systems in possible principles and rules. The Secretariat is currently preparing a paper on payment and settlement systems that apply or might interfere with close-out netting agreements (UNIDROIT 2011 - Study LXXVIII C - Doc. 8), which will also be distributed to the Members of the Study Group and published on the [internet](#) by 31 August 2011.

Last, the Study Group has not taken a decision yet whether multilateral netting and collateral arrangements should be covered by the Principles.

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

The second preliminary draft of possible principles and rules on close-out netting of financial instruments (UNIDROIT 2011 - Study LXXVIII C - Doc. 6) will be distributed to the members of the Study Group in the first weeks of August 2011.

The Secretariat invites the members of the Study Group to analyse mechanisms that can be used to challenge close-out netting agreements by liquidators or unsecured creditors. Ideally, the Study Group might want to develop approaches how to address these challenges in the possible principles and rules on netting of financial instruments.

During the deliberations of the first meeting, no decision was reached on walk-away clauses and on whether a fixed or flexible time limit for closing-out should be included in the possible principles and rules. The Study Group also addressed the potential interplay between the principles and rules and regulatory measures in the context of bank resolution. The Secretariat invites the Study Group to express its view on those issues.

APPENDIX III**UNIDROIT Study Group on principles and rules on the netting of financial instruments*****Second Meeting*****Rome, 13 – 15 September 2011**UNIDROIT 2011
Study LXXVIII C – Doc. 6
Original: English
August 2011

~~A first tentative structure for~~ Revised Preliminary Draft of
Principles regarding the Enforceability of Close-out Netting [Agreements/Provisions¹⁰⁵]¹⁰⁶

(prepared by the Secretariat)

Introduction¹⁰⁷

The enforceability of Close-out Netting [Agreements/Provisions¹⁰⁸] contributes to the stability of financial systems.¹⁰⁹ It allows eligible parties to reduce their exposure towards their counterparties to a net position. By this means, close-out netting reduces the risk that the inability of one financial market participant to meet its obligations leads to a chain of failures or difficulties of other market participants (contagion effect).

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

¹⁰⁵ In its first meeting, the Study Group discussed whether the term "Agreement" was broad enough to encompass all netting mechanisms that exist today. Some participants voiced concerns and favoured a broader term such as "Netting Provision" (cf. Doc. 4 [42], p. 9). The problem might be addressed in a proper definition clarifying that "For the purpose of these Principles, an agreements does not require negotiations between the parties. It can be contained in regulatory acts, rule books of central counterparties or General Terms and Conditions."

¹⁰⁶ Square brackets indicate proposals made during the first meeting of the Study Group from 18 to 21 April 2011 to amend or delete their content.

¹⁰⁷ The Study Group decided in its first meeting to describe the fundamental objectives and mechanisms of insolvency law in the future instrument and to explain why they are not in conflict with the protection of the Close-out Netting mechanism (cf. Doc. 4 [64], p. 12).

¹⁰⁸ Cf. footnote 1 on the terminology discussion relating to "Agreement" and "Provision".

¹⁰⁹ This fact is today widely recognized (cf. for the ongoing Regulatory debate the "Report and Recommendations of the Cross-border Bank Resolution Group" of the Basle Committee on Banking Supervision that refers close-out netting in Recommendation 8 [p. 36 - 39] in a list of mechanisms capable of mitigating systemic risk in the first place along with collateralisation, segregation of client assets and standardisation - <http://www.bis.org/publ/bcbs169.pdf>).

predictability about the allocation of assets and risks in insolvency. This promotes stability in the financial market and fosters transactions. The protection of Close-out Netting [Agreements/Provisions¹¹⁰] aims therefore at achieving objectives that are largely consistent with and supportive of common objectives of general insolvency laws.¹¹¹ Indeed, insolvency regimes typically aim at preserving the insolvency estate to allow equitable distribution to creditors and at providing for timely, efficient and impartial resolution of insolvency and for certainty in the market.¹¹²

Definitions

1. “Close-out Netting [Agreement/Provision¹¹³]” means [an agreement/a provision] [relating to eligible financial contracts]¹¹⁴ between two [or more]¹¹⁵ parties under which, on the occurrence of an enforcement event in relation to one of the parties, [either or both]¹¹⁶ of the following should occur, or may at the election of the other party occur, [whether through the operation of set-off, novation or otherwise]¹¹⁷:

Alternative a¹¹⁸

- the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;

¹¹⁰ Cf. footnote 1 on the terminology discussion relating to “Agreement” and “Provision”.

¹¹¹ Special protection given to netting [Agreements/Provisions] might appear to conflict with some insolvency objectives. Upon taking a closer look, however, the protection reveals to be consistent with the fundamental objectives of insolvency law. The objective of maximizing the value of insolvency assets may have to stand back behind the predictability of contractual relations (Key objective 2 of the UNCITRAL Legislative Guide to Insolvency Law, p. 10 f) if that is critical to investment decisions. The objective of equitable treatment of creditors should be seen in the context of a fair attribution of risks and should reflect the commercial bargains the different creditors have struck with the debtor (Key objective 4 of the UNCITRAL Legislative Guide to Insolvency Law, p. 11 f). A liquidator cannot have greater rights than the insolvent party whose estate he inherits or manages. The insolvent party would only be entitled to claim a single net obligation. Any rule of insolvency that disrupts this pooling of obligations and entitlements and allows cherry-picking within what is economically one single asset would create both uncertainty and unfairness (cf. Doc. 4 [21] p. 5 f). Largely the same objectives are also pursued by bank resolution mechanisms (cf. the Preamble of Annex 1 to the Consultative Document “Effective Resolution of Systemically Important Financial Institutions” issued by the Financial Stability Board on 19 July 2011 (p. 23) and Key Attribute 5.1 of the same Annex, p. 26 (http://www.financialstabilityboard.org/publications/r_110719.pdf)).

¹¹² The objectives of insolvency law are taken from Recommendations 1-4 [paras. 4-13] of the UNCITRAL Legislative Guide to Insolvency Law of 25 June 2004 (http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf).

¹¹³ Cf. footnote 1 on the terminology discussion relating to “Agreement” and “Provision”.

¹¹⁴ The Study Group agreed that the list of the eligible parties and eligible financial contracts needed to be integrated into the definitions (cf. Doc. 4 [39], p. 8).

¹¹⁵ The Study Group considered deleting the words “or more” and thus limiting the Principles to bilateral netting (Cf. Doc. 4 [43], p. 9 f.). However, it postponed a decision in that regard.

¹¹⁶ One participant at the first meeting of the Study Group cautioned that the definition would also apply to netting agreements without aggregation since it was sufficient that “either or both” indents were fulfilled and since the first indent did not require aggregation. The participant voiced the opinion that the definition should require all three elements of netting: termination/acceleration, valuation and aggregation (cf. Doc. 4 [46], p. 10).

¹¹⁷ Several participants proposed to add the words “whether through the operation of set-off, novation or otherwise” to the definition and referred to the wording of the definition of close-out netting agreements in Art. 2 (1)(n) of the EU Financial Directive 2002/47/EC (Cf. Doc. 4 [45], p. 10).

¹¹⁸ Adapted from the Geneva Securities Convention, Article 31(j); EU Financial Collateral Directive, Article 2(1)(n) (Cf. Doc. 2 [83-85], [109]-[110], [278]-[282]).

- [an account is taken]¹¹⁹ of what is due from each party to the other in relation to such [accelerated]¹²⁰ obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

Alternative b¹²¹

- 1) one or more eligible financial contracts are terminated and the obligations or entitlements thereunder are liquidated and/or the obligations or entitlements under one or more eligible contract are accelerated;¹²²
- 2) a close-out value, market value, liquidation value or replacement value is calculated or estimated in respect of each obligation or entitlement or group of obligations or entitlements;
- 3) a net balance of the values calculated is computed into a net sum.¹²³ A single obligation of one eligible party to the other equal to that net sum payable by the eligible party from whom the larger amount is due to the other replaces all obligations and entitlements between the eligible parties.¹²⁴

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

2. ~~3.~~ “Enforcement event”¹²⁵ means, in relation to a Close-out Netting [Agreement/Provision], an event of default of one of the parties or other event in relation to one of the parties on the occurrence of which, under the terms of that Close-out Netting [Agreement/Provision]

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

¹¹⁹ One participant at the first meeting of the Study Group explained that the wording “an account is taken” was taken from the bankruptcy law of the UK, which referred to set-off. He suggested that the definition should be broadened to encompass other means of aggregation (Cf. Doc. 4 [47], p. 10).

¹²⁰ Varying views were expressed during the first meeting of the Study Group as to whether the second indent of the definition needed to refer also to acceleration (Cf. Doc. 4 [40], p. 9).

¹²¹ Alternative definition based on the three-step approach generally accepted by the Study Group (cf. Doc. 4 [17-20] p. 4 f. and [39] p. 8 f) and adapted from the “netting” definition of the ISDA Model Netting Act 2006 Version 2 (published October 10, 2007).

¹²² The Study Group might wish to consider whether obligations that have already fallen due but have not been fulfilled prior to the enforcement should be covered by this definition.

¹²³ The Study Group might wish to consider whether the netting mechanism implies a logical order of acceleration and then aggregation or whether the order is irrelevant. The findings might be clarified in an explanatory note.

¹²⁴ The first tentative structure for Principles regarding the Enforceability of Netting Agreements (Doc. 3) preserved in draft Principle 13 the application of legal requirements “pursuant to which the valuation of the respective obligations of the parties as part of the operation of a close-out netting agreement must be conducted in a commercially reasonable manner”. That provision has now been redrafted so as to deal essentially with the time frame for termination and valuation. The Study Group might wish to consider whether the term commercially reasonable as used in Art. 4 (6) of the EU Financial Collateral Directive entails any element other than the time factor on which guidance might be appropriate.

¹²⁵ Adapted from the Geneva Securities Convention, Article 31(h); EU Financial Collateral Directive, Article 2(1)(l).

3. ~~4.~~ “Insolvency proceeding”¹²⁶

4. “Eligible financial contract” means any contract between eligible parties generating a fluctuating forward exposure by reference to market movements in some assets (e.g. commodities, indices) [,which for commercial and risk control reasons is closely connected to contracts of the same kind]¹²⁷, such as in particular¹²⁸

- Derivatives instruments (including forwards and options that are physically settled, spot transactions [...]);
- Securities financing transactions (including repurchase securities, margin loans [...]);
- [- Money market services and deposits (“deposit netting”, including interbank lending and deposits, money market overnight facilities [...])¹²⁹

This includes contracts on the maintenance of financial instruments and contracts generating obligations under master-master agreements, under clearing and settlement arrangements and under title-transfer arrangements relating to such eligible financial contracts.¹³⁰

5. “Eligible party” means any natural or legal person who acts for purposes other than for their personal, family or household use.¹³¹

Formal requirements for Close-out Netting [Agreements/Provisions]¹³²

6. ~~5.~~¹³³ The creation, validity, **perfection** [effectiveness against third parties,]¹³⁴ enforceability or admissibility in evidence of a Close-out Netting [Agreement/Provision] should not be dependent on the performance of [any formal act]¹³⁵.

¹²⁶ The Study Group decided to postpone a decision on the definition of insolvency proceedings (cf. Doc. 4 [45], p. 10) The original proposal – which was adapted from Article 1(h) of the Geneva Securities Convention, was as follows: “*Insolvency proceeding*” means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation.

¹²⁷ Definition based on the proposal for a generic definition of eligible financial contracts that was discussed controversially by the Study Group (cf. Doc. 4 [100-103], p. 18 f).

¹²⁸ Positive enumeration based on Doc. 4 [103-107], p. 19 f. A decision as to whether a negative or positive definition of eligible financial instruments shall be drafted has not yet been taken (cf. Doc. 4 [103], p. 19).

¹²⁹ Varying views were expressed at the first meeting of the Study Group towards the inclusion of money market services and deposits (cf. Doc. 4 [105], p. 20).

¹³⁰ The Study Group agreed in its first meeting that master-master agreements should be covered by the future instrument and discussed whether obligations arising under title-transfer arrangements and contracts on the maintenance of financial instruments needed and merited the same protection (cf. Doc. 4 [104], p. 20).

¹³¹ Adapted from Art. 2(a) of the United Nations Convention on contracts for the international sale of goods of 1980 (CISG). An alternative wording adapted from Art. 2(a) of Directive 2005/29/EC of 11 May 2005 concerning unfair business-to-consumer commercial practices, from Art. 2(1)(f) of Directive 2008/122/EC of 14 January 2009 on the protection of consumers in respect of certain aspects of timeshare, long-term holiday product, resale and exchange contracts and from Recommendation 2 of Commission recommendations of 12 May 2010 on the use of a harmonised methodology for classifying and reporting consumer complaints and enquiries (2010/304/EU) could be: “*Eligible party*” means any natural or legal person other than consumers. “*Consumer*” means any national person who is acting for purposes which are outside that person’s trade, business, craft or profession.

¹³² Cf. Doc. 2 [93-94]; [283]-[289].

¹³³ Adapted from the EU Financial Collateral Directive, Article 3(1).

¹³⁴ The Study Group decided to delete the term “perfection” since it might create confusion: under UK Law, for example, perfection refers only to pledges, while under French Law, it is a synonym for making rights effective

7. ~~6.~~¹³⁶ Principle 6 is without prejudice to ~~any~~^{the}¹³⁷ requirement that a Close-out Netting [Agreement/Provision] shall be evidenced in writing or any legally equivalent form.

8. ~~7.~~ [~~Notwithstanding~~¹³⁸ ~~the general rule set out in Principle 6, Principle 5 is without prejudice to any requirement regarding States may require~~ the registration of the financial contracts covered by the Close-out Netting [Agreement/Provision] with a trade repository or similar organisation [for purposes of prudential supervision]¹³⁹. A failure to comply with that requirement should not affect the creation, validity, ~~perfection~~ [effectiveness against third parties,]¹⁴⁰ enforceability or admissibility in evidence of a Close-out Netting [Agreement/Provision].]¹⁴¹

9. ~~8.~~—The creation, validity, ~~perfection~~ [effectiveness against third parties,]¹⁴² enforceability or admissibility in evidence of a Close-out Netting [Agreement/Provision] should not depend on the use of standardised terms, ~~as~~ for example the terms of specific trade associations.

Enforceability of Close-out Netting [Agreements/Provisions]¹⁴³

10. ~~9.~~—A Close-out Netting [Agreement/Provision] should take effect in accordance with its terms.¹⁴⁴

11. ~~10.~~ Except as otherwise provided in a Close-out Netting [Agreement/Provision], a Close-out Netting [Agreement/Provision] should be enforceable notwithstanding the commencement or continuation of insolvency proceedings in relation to one of the parties to the agreement. ~~This principle is subject to any contrary provision of the netting agreement.~~¹⁴⁵

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

¹³⁵ The Study Group was concerned that the term “formal act” might be not sufficiently precise and at the same time not broad enough to encompass all possible enforcement requirements (cf. Doc. 4 [56], p. 11).

¹³⁶ Adapted from the EU Financial Collateral Directive, Article 3(2).

¹³⁷ It was proposed to replace the direct article “the” with its indirect equivalent “any” to clarify that the Principles did not intend to establish a writing requirement but simply did not displace existing writing requirements (cf. Doc. 4 [57], p. 11).

¹³⁸ The expression “without prejudice” was considered to be misleading since it implied that draft Principle 8 was incompatible with draft Principle 6. Therefore, one participant proposed to replace the expression with the term “notwithstanding” (cf. Doc. 4 [59], p. 12).

¹³⁹ One participant suggested that the expression “for purpose of prudential supervision” was superfluous (cf. Doc. 4 [60], p. 12).

¹⁴⁰ The Study Group decided to delete the term “perfection” (see above fn. 30).

¹⁴¹ The Study Group might want to consider whether the Principle excludes other possible consequences of failure to comply with a registration requirement. On more general terms, some participants proposed to delete the draft Principle since they considered that the clarifications made in draft Principle 8 belonged into the commentary (cf. Doc. 4 [58], p. 11).

¹⁴² The Study Group decided to delete the term “perfection” (see above fn. 30).

¹⁴³ The Study Group discussed in its first meeting whether the Principles should address the interplay between netting protection and banking resolution powers. It agreed that it should keep this question under consideration (cf. Doc. 4 [28-33], p. 7f.).

¹⁴⁴ Adapted from the Geneva Securities Convention, Article 32, and Article 7(1) EU Financial Collateral Directive. This reproduces the original sentence which was met with strong support by the participants of the first meeting of the Study Group. To the extent however that draft Principle 10 might be understood as merely reflecting a general principle of law, the Study Group may wish to consider whether the purpose of this provision could be more clearly specified either by combining it with draft Principle 13 or with draft Principle 11 along the lines of Art. 4 of the ISDA Model Netting Act 2006 Version 2 (published October 10, 2007).

¹⁴⁵ Adapted from the Geneva Securities Convention, Article 33(3)(b); Article 4(5) EU Financial Collateral Directive.

[...] ¹⁴⁶

12. ~~11.~~—Notwithstanding Principle 10, any provision in an eligible financial contract that suspends, conditions, or extinguishes a payment obligation of a party that would otherwise exist, solely because of such party's status as a nondefaulting party in connection with the insolvency of the other party, and not as a result of the exercise by a party of any right to offset, set-off or net obligations that exist under the eligible financial contract or the obligations thereunder or the applicable law ("walkaway" clause) shall not be enforceable.¹⁴⁷

~~After the commencement of insolvency proceeding:~~

- ~~– the net sum is payable to the insolvent party by the other party if it is owed by the latter;~~
- ~~– if the insolvent party owes the net sum to the other party, the latter becomes creditor in the insolvency proceeding to the amount of the net sum.~~¹⁴⁸

13. ~~12.~~—Except as otherwise provided in the Close-out Netting [Agreement/Provision], a Close-out Netting [Agreement/Provision] should be enforceable without any requirement that:¹⁴⁹

- ~~– [prior] notice of the intention to operate the Close-out Netting [Agreement/Provision] should have been given [prior to the opening of insolvency proceedings]¹⁵⁰;~~
- ~~– the terms of the realisation or the operation of the Close-out Netting [Agreement/Provision] be approved by any court, public officer or other person; or~~
- ~~– the realisation be conducted by public auction or in any other prescribed manner or the Close-out Netting [Agreement/Provision] be operated in any prescribed manner.~~

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

¹⁴⁶ The Study Group planned to expand the draft Principle to include an enumeration of insolvency principles that shall be disapplied to Close-out Netting [Agreements/Provisions] ("insolvency carve-out", cf. Doc. 4 [64], p. 12). This part of the draft Principle has yet to be formulated (cf. also Doc. 2 [44]-[54]; [292]-[296]).

¹⁴⁷ Several participants considered that the Principles should address the issue of walk-away clauses (cf. Doc. 4 [66-60], p. 13). The proposal is adapted from § 210(c)(8)(F) of the Dodd-Frank Act. An alternative formulation could be adapted from Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, Annex III, Nr. 3(b)(iii): *Notwithstanding Principle 11, any provision in a contract which permits a non-defaulting counterparty to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor ("walkaway clause") shall not be enforceable.*

¹⁴⁸ Several participants considered the original draft Principle 11 to be redundant in the light of draft Principle 9 (today draft Principle 10) and cautioned that a description of the netting process in the section on the enforceability of Close-Out Netting [Agreements/Provisions] might invite a party to infer that insolvency protection is given to close-out netting only under different or additional conditions (cf. Doc. 4 [65], p. 12).

¹⁴⁹ Adapted from the Geneva Securities Convention, Article 33(3)(a); Article 4(4) EU Financial Collateral Directive.

¹⁵⁰ The proposal to clarify in the Principles that a notice of the intention to operate the close-out netting agreement does not have to be given "prior to the opening of insolvency proceedings" was made in view of the fact that parties to a netting agreement cannot serve the notification of termination after the opening of insolvency proceedings in certain jurisdictions. The parties in these jurisdictions had to rely on automatic termination. However, automatic termination was considered to be the cause of many practical problems (cf. Doc. 4 [70], p. 13 f).

~~the valuation of the respective obligations of the parties **must be completed within an additional brief timeframe (e.g. business days).***in a commercially reasonable manner.*~~¹⁵¹

15. ~~14.~~—A Close-out Netting [Agreement/Provision] or an obligation covered by it should not be treated as invalid, reversed or declared void solely on the basis that the [Agreement is entered into /Provision is agreed to]¹⁵² or the obligation is incurred during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in relation of one of the parties.¹⁵³

16. ~~15.~~—A Close-out Netting [Agreement/Provision] should remain enforceable [as regards the remaining financial contracts]¹⁵⁴ even if one or more of the covered [financial contracts]¹⁵⁵ otherwise eligible for netting¹⁵⁶ are ineffective, void or voidable.

~~Enforceability of umbrella netting agreements~~¹⁵⁷

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

¹⁵¹ The Study Group considered that a nondefaulting party should not have an indefinite “power to wait and see”. Such a power arises under certain close-out netting agreements, which grant a nondefaulting party the right to withhold payments upon the default of its counterparty while at the same time not allowing the defaulting party to terminate the contract. The Study Group envisaged to provide for a time limitation on termination and valuation but has not yet decided on the length of this time limitation. One participant cautioned that any reference to a “commercially reasonable manner” was too vague and might encourage litigation. Some participants preferred therefore to determine a fixed time limitation in the Principles whilst one participant proposed to address the time limitation on a case-by-case basis in the supervisory framework (cf. Doc. 4 [72-78], p. 14 f.). Some experts proposed to distinguish between providing a time limitation on the continuation of conditions precedent (e.g. under Sect. 2(iii)(a) of ISDA Master Agreement) on the one hand and on the termination of transactions on the other hand. They felt that the a time limitation on the continuation of conditions precedent was sufficient to abolish the “power to wait and see” and explained that a time limitation on termination has not been suggested or requested by any public authority so far. The Study Group might wish to consider this distinction in its discussions and might wish to decide which time limitations should be provided for in the Principles. The current proposal is based on fixed time limitations for termination and valuation, the lengths of which will have to be determined by the Study Group. A proposal for time limitations determined in a supervisory framework would be: *Principle 10 does not affect the application of any rule of law pursuant to which the termination of the financial contracts and/or the valuation of the underlying obligations must be conducted within a timeframe defined in [name of a supervisory framework].*

¹⁵² Cf. footnote 1 on the terminology discussion relating to “Agreement” and “Provision”.

¹⁵³ Adapted from the Geneva Securities Convention, Article 37; EU Financial Collateral Directive, Article 8(1). This draft Principle does not exclude the possibility that an obligation is avoided for reasons other than the mere fact that it was created during a suspect period (e.g. for reasons of fraud). The Study Group might wish to consider the method for recalculating the single payment obligation in the event that the creation of any such obligation is avoided.

¹⁵⁴ It was proposed to amend the phrase “as regards the remaining financial contracts” to clarify that Principle 17 was not intended to enable the parties to count an invalid transaction into the netting calculation but simply held that the presence of one invalid transaction would not prevent netting from being effective (Cf. Doc. 4 [84], p. 16).

¹⁵⁵ It was proposed to replace the term “financial contract” by a broader term to encompass also obligations under the regime of unjust enrichment. The Study Group considered that obligations arising under the regime of unjust enrichment based on payments made under a transaction that was subsequently challenged, declared void or turned out to be void should be protected by the Principles (cf. Doc. 4 [82], p. 16).

¹⁵⁶ The amendment was proposed to clarify that the inclusion of one ineligible – but otherwise effective and valid – transaction – into a close-out netting agreement could not take the entire agreement out of the scope of netting protection (Cf. Doc. 4 [83], p. 16).

¹⁵⁷ Cf. Doc. 2 [290]-[291].

Conflict of laws (Optional section)

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

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

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

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

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

Notice

This draft is a work in progress and has been released at this time for discussion purposes only. The draft will undergo future revisions as regards both substance and form on the basis of ongoing discussions in the UNIDROIT Study Group on principles and rules on the netting of financial instruments.

Members of the UNIDROIT Study Group for this project who have participated in the development of this draft have done so on a strictly personal basis. While their collaboration on the project brings extensive experience in the field from around the world, their views as expressed in this draft do not necessarily reflect the views of the institutions they represent.

Comments on substantive issues raised by this draft may be sent by mail to the International Institute for the Unification of Private Law (UNIDROIT), attn. Annick Moiteaux, Via Panisperna 28, 00184 Rome, Italy, or by e-mail to a.moiteaux@unidroit.org.

APPENDIX IV**UNIDROIT Study Group on principles and rules on the netting of financial instruments*****Second Meeting*****Rome, 13 – 15 September 2011**UNIDROIT 2011
Study LXXVIII C – Doc. 8
Original: English
September 2011

Responding to a request of the Study Group at its first meeting from 18-21 April 2011, the International Swaps and Derivatives Association (ISDA) kindly agreed to prepare the following drafting proposal on eligible financial contracts for the purpose of enhancing the discussion at the second meeting. The document was distributed to the Study Group prior to the second meeting as Study Group document 8.

ISDA Note for the Study Group on Netting re eligible financial contracts

For consideration by the Study Group on netting at its second meeting in Rome from 13 to 15 September 2011, the International Swaps and Derivatives Association (**ISDA**) would like to offer a possible definition of “eligible financial contract”, together with related definitions, to determine the scope of transactions that would be eligible for the protection of a statutory netting regime reflecting the proposed UNIDROIT rules and principles.

The principal definition would be:

“**Eligible financial contract**” means any financial contract, agreement or transaction that is:

- (a) a financial instrument;
- (b) a[n eligible] deposit;
- (c) a[n eligible] loan;
- (d) a contract for the sale, purchase or delivery of:
 - (i) transferable securities;
 - (ii) money market instruments;
 - (iii) the currency of any country, territory or monetary union;
 - (iv) gold, silver, platinum, palladium or any other precious metal; or
 - (v) any other commodity;
- (e) surety transaction; or
- (f) title transfer collateral agreement;

or is a combination of one or more of the above contracts, agreements or transactions.

The related definitions would be:

“Derivative instrument” means an option, forward, future, swap, contract for differences or other derivative transaction in respect of a reference value, whether:

- (a) (i) transacted on a regulated market, exchange or trading platform or (ii) privately negotiated;
- (b) (i) cleared and settled through a recognized clearing house or settlement system or (ii) privately settled; and
- (c) (i) settled in cash or (ii) wholly or partly physically settled.

“Eligible deposit” means a deposit made with a banking institution [other than a deposit that is insured under a state deposit guarantee scheme].]

“Eligible loan” means a loan other than [a loan to a consumer or a loan secured by a residential mortgage].]

“Financial instrument” means:

- (a) a transferable security;
- (b) a money-market instrument;
- (c) a unit in a collective investment undertaking; or
- (d) a derivative instrument.

“Money market instrument” means an instrument that of a type normally traded on the money market, such as a treasury bill, certificate of deposit or commercial paper, excluding an instrument of payment.

“Reference value” means 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, property or other measures of financial, commercial or economic risk or value.

“Surety transaction” means a guarantee or surety issued by any person or a letter of credit issued by a banking institution.

“Title transfer collateral agreement” means an agreement, including an agreement providing for the sale and repurchase of transferable securities, under which a party provides (in whatever terms) for the transfer of full ownership of transferable securities by that party to the other party for the purpose of securing or otherwise covering the performance of obligations arising under that agreement or a related agreement.

“Transferable security” means a security of a type normally traded on the capital market, including:

- (a) a share or other security equivalent to a share in a company, partnership or other corporate entity, including a depositary receipt in respect of a share or equivalent security;

- (b) a bond and other form of securitized debt, including a depository receipt in respect of a bond or other form of securitized debt; and
- (c) any other security giving the right to acquire or any type of security falling within (a) or (b) above or giving rise to a cash settlement determined by reference to a reference value.

We are aware that there will be divergent views within the Study Group on the scope of the definition of "eligible financial contract". We hope that by setting out the definition together with related definitions in the way we have done, it will facilitate a focused discussion of the different potential elements.

We are looking forward to discussing these and the various other issues on the agenda at the Study Group meeting next week.

Yours faithfully

Dr Peter M Werner
Senior Director
pwerner@isda.org

Edward Murray
Chairman
ISDA Financial Law Reform Committee
ed.murray@allenovery.com

APPENDIX V**UNIDROIT Study Group on principles and rules on the netting of financial instruments*****Second Meeting*****Rome, 13-15 September 2011**UNIDROIT 2011
Study LXXVIII C – INF. 5
Original: English
September 2011**Alternative draft on definitions
submitted by Messrs Kanda, Morton and Paech**

'Close-out Netting Provision' means a provision relating to obligations outstanding under an eligible financial contract, etc.

'Eligible party' means

- a. a person other than a natural person,
- b. a partnership or unincorporated association (whether or not including natural persons as members), and
- c. any other person designated as an Eligible Party under the law of the relevant State

Explanation: Paragraph c of this definition reflects the policy considerations raised by the possible participation of individuals in financial market transactions. States may decide not to apply these principles to individuals at all or to apply them only to restricted classes of individuals such as professional, sophisticated or high-net-worth individuals. Such a decision will generally be made within the overall framework of the relevant State's rules and policy on the protection of individuals in general and consumers in particular.

'Eligible Financial Contract' means

- a. derivatives,
- b. sale and repurchase and lending agreements relating to securities and [fungible] commodities,
- c. title transfer collateral arrangements,
Commentary: the right to the return of collateral provided under a pledge, charge or other traditional security interest is proprietary in character and therefore not generally susceptible to netting as generally understood. However, if the law of the relevant state permits parties to agree that the proprietary right may be replaced by a contractual right to the return of equivalent assets, that right may be included in a netting provision in the same way as rights arising under a title transfer collateral arrangement. This will in particular generally be the position where a traditional pledge permits the pledgee to use or 'rehypothecate' the pledged securities.
- d. [eligible deposits]
- e. [eligible loans]
- f. contracts for the sale or delivery of

- 1.- transferable securities
- 2.- money market instruments
- 3.- units in a collective investment scheme
- 4.- currency of any country, territory or monetary union
- 5.- gold, silver, platinum, palladium, iridium, or any other precious metal
- 6.- any other [fungible] commodity.

Explanation: This paragraph applies to contracts described regardless of whether for other purposes they may be subdivided into, for example, spot, forward and futures contracts, and regardless of the purposes for which parties enter into them, since the exposures give rise to similar risk regardless of these subdivisions.

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

Explanation: The categories of eligible contracts listed above have been specified because they share characteristics which justify/necessitate conferring special protection against rules of law (in particular insolvency law) which might otherwise call into question the effectiveness of the aggregate net determination of exposure in the event of default or insolvency of one of the parties. These characteristics are (a) that the contracts are of a type which typically gives rise to exposures which can fluctuate rapidly in response to market movements, (b) that major market participants will typically have a large number of such transactions outstanding with a given counterparty and will for reasons of prudent risk management monitor and manage the exposures arising from such transactions collectively; (c) as a consequence any doubt about the effectiveness of prompt aggregate determination of the net exposure for all such transactions in the event of the default or insolvency of a counterparty is liable to give rise to legal uncertainty and unclear and uncontrollable exposure with resulting systemic risk implications.

States which adopt these principles may form different judgements about the extent to which or the circumstances under which these factors apply to loans and deposits. Accordingly, subparagraphs [d.] and [e.] are in square brackets.