INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

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UNIDROIT Committee of governmental experts on the enforceability of close-out netting provisions
Second session
Rome, 4 – 8 March 2013

UNIDROIT 2013
C.G.E./Netting/2/W.P. 4
Original: English
January 2013

JOINT PROPOSAL

concerning Principles 3 and 4

submitted by the Governments of France, the United Kingdom and the United States of America

INTRODUCTION

The UNIDROIT Secretariat has received the following joint proposal submitted by the Governments of France, the United Kingdom and the United States of America concerning the principles on eligible parties and obligations (Draft Principles 3 and 4 of the revised draft in C.G.E./Netting/2/W.P. 2).

JOINT PROPOSAL

<u>Principles 3 and 4</u>

Principle 3: Eligible party and other definitions

"eligible party" means any person or entity other than a natural person who is acting as a consumer and includes a partnership, unincorporated association or other body of persons;

"financial institution" means any of the following –

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

(b) an insurance or reinsurance company;

(c) an investment fund or undertaking for collective investment in transferable securities;

(d) a central counterparty subject to regulation or prudential supervision;

(e) a clearing and/or settlement system;

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

Explanatory note

The commentary would explain that the intent of clause (f) is to ensure that at least some corporations and other entities — in particular those that are significant market participants and are therefore relevant for systemic risk purposes — could be included within the "core pillar" of harmonisation, in accordance with the legislation of the implementing State. The reference to "authorisation and/or supervision" is intended to allow implementing States to take into account the characteristics of their domestic markets in determining which entities are allowed to take advantage of netting. While States can effect such authorisation or supervision on an entity-by-entity basis, they can also do so by allowing certain types of entities to be eligible by law. Such authorisation or supervision could be granted and/or imposed by each State according to criteria including for instance the size of the corporation or entity (measured by reference to assets, revenues, or otherwise) or the scale of its dealings in such markets. Establishing uniform criteria of these types for all States in these Principles would not be appropriate or feasible. However, the criteria chosen by a State should offer all guarantees of legal certainty and predictability to counterparties while ensuring that systemically-important entities are not excluded.

"public authority" means any of the following –

(a) a governmental or other public authority;

(b) a central bank;

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

Principle 4: Eligible obligations

"*Eligible obligation*" means, subject as provided below –

(a) an obligation arising under a contract of a kind referred to in Part I of the list below between eligible parties at least one of whom is a public authority or a financial institution; and

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

A State adopting these principles may elect to broaden the scope of paragraph (a) in one or both of the following ways –

1. by providing that it is to extend to obligations arising under contracts between eligible parties neither of whom is a public authority or a financial institution; and/or

2. by providing that it is to extend to obligations arising under contracts of a kind referred to in Part II of the list below;

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

Explanatory notes

Paragraphs 1 and 2 allow states which adopt the principles to extend their scope beyond the minimum core described in paragraphs (a) and (b) of the definition.

Paragraph 1 allows a state to relax the requirement that at least one of the parties must be a public authority or financial institution as defined in Principle 3. The relaxation may be complete, so that all contracts between eligible parties of whatever description are covered, or it may be subject to specified exceptions or limitations. A state may therefore choose to extend the principles to some, but not all, contracts between two parties neither of whom qualifies as a public authority or financial institution under Principle 3.

Paragraph 2 allow a state to extend the categories of contract under which eligible obligations arise by adding any or all of the contracts described in Part II of the list. Again, it may make the extension subject to specified exceptions or limitations.

List of contracts

Part I

1. Derivative instruments

"Derivative instrument" means options, forwards, futures, swaps, contracts for differences and any other transaction in respect of a reference value that is, or in future becomes, the subject of recurrent contracts in the derivatives markets, whatever their underlying, including currencies and fungible commodities.

2. Repurchase agreements, securities lending agreements and any other transactions on financial instruments, in each case in respect of securities, money market instruments or units in collective investment schemes.

3. Title transfer collateral arrangements related to eligible obligations.

4. Contracts for the sale, purchase or delivery of –

(a) securities;

(b) money market instruments;

(c) units in a collective investment scheme;

(d) currency of any country, territory, or monetary union;

(e) gold, silver, platinum, palladium, or other precious metals.

Part II

5. Contracts for the sale, deposit, purchase or delivery of any other fungible commodity.

6. Contracts for the pledge, mortgage or charge of, or the creation of any other security interest in respect of, any property of a kind referred to in paragraph 4 or paragraph 5 above

in so far as, under the law of a State adopting these principles, rights to the return of property provided under such a contract, or to payment or credit of its value, can be included in a close-out netting provision.

Explanatory note

A traditional security interest collateral arrangement such as a pledge or mortgage gives rise to an in rem *proprietary interest. The classical position under many legal systems is that such an interest is different in kind from, and cannot therefore be combined with or netted against, a monetary obligation. Where this is the case, enforcement of the rights of the pledgee is by way of sale of the pledged property and discharge of the secured obligations out of the proceeds of sale. The laws of some States, however, do permit enforcement by way of a close-out netting in which, broadly, the pledged property remains with the pledgee but a claim equal to its value is included in the netting calculation. This paragraph makes it clear that such States may extend the scope of the principles accordingly.*

7. Any contracts giving rise to a cash settlement or a delivery of financial instruments when all the parties are financial institutions or public authorities.