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Draft Principles regarding the enforceability of close-out netting provisions

COMMENTS

(submitted by Governments)

INTRODUCTION

Subsequently to the comments (C.G.E./Netting/2/W.P. 6) on the text of the UNIDROIT Draft Principles regarding the enforceability of close-out netting provisions (C.G.E./Netting/2/W.P. 2) and on a joint proposal submitted by the Governments of France, the United Kingdom and the United States of America concerning the principles on eligible parties and obligations (C.G.E./Netting/2/W.P. 4) for consideration by the Committee of Governmental Experts on the enforceability of close-out netting provisions at its second session from 4 to 8 March 2013, the UNIDROIT Secretariat received comments from the Government of Canada. These comments are reproduced hereunder.

COMMENTS SUBMITTED BY MEMBER STATES

Canada

Introduction

The following are Canada's comments on the December 2012 draft of the UNIDROIT Principles Regarding the Enforceability of Close-out Netting Provisions. Canada is supportive of the UNIDROIT initiative to harmonize laws relating to this important aspect of financial contracts and financial stability. This latest draft of the Principles is an improvement over the previous draft in many respects; however, we still have some concerns and queries which are explained below.

Principle 3: Definition of "Eligible Party"

Canada has previously raised the issue that a trust can be a party to a close-out netting provision – for example, an investment vehicle or a special purpose vehicle that is structured as a trust. The definition of "eligible party" in Principle 2 now explicitly includes "any…legal entity" but it

is still not clear whether "legal entity" would include a trust. At least in the common law, a trust is not a legal entity but simply a legal relationship in which one person holds property for the benefit of another. If the Principles are to apply to close-out netting arrangements involving a trust structure (as opposed to the trustee, which is generally a legal entity), UNIDROIT should consider expanding the scope of "eligible party" beyond legal entities. This could be accomplished by simply deleting the word "legal" before "entity".

Principle 4: Definition of "Eligible Obligation"

We support the latest draft of Principle 4 as addressing two concerns which Canada had previously expressed with this Principle: the definition now includes security interests and other collateral arrangements (not just title transfer arrangements) that secure another eligible obligation; and paragraph 4(e) would permit implementing States to extend the list of eligible obligations to include contracts to clear obligations (confirmed by paragraph 68 of the commentary).

The only other issue we would point out is a drafting issue. In paragraph 4(e), it is unclear what is meant by "designated to that effect". Designated to what effect? When one refers back to the *chapeau* of this Principle, it's not clear what "effect" is being referred to. Perhaps the meaning could be better conveyed by replacing "designated to that effect" with "designated as an eligible obligation".

Principle 7: Additional Rules on the Operation of Close-out Netting Provisions in Insolvency

In Canada's view, Principle 7 together with Principle 8 are at the heart of the UNIDROIT Principles and will largely determine the utility of the Principles for governments and legislators. We believe that the latest draft of Principle 7, with the inclusion of paragraph (2), strikes the right balance between the need to uphold the enforceability of close-out netting provisions in insolvency proceedings and the valid need of implementing States to restrict the operation of those provisions in situations where the provision amounts to a defrauding of creditors or the grant of unfair preference to some creditors over others. We note that paragraph (2) is in square brackets and we would strongly support retaining this paragraph as conveying the balanced approach that Principle 7 attempts to achieve.

Principle 8: Resolution of Financial Institutions

Principle 8 is the key policy exception to the protection that Principle 7 attempts to give to close-out netting provisions in insolvency proceedings. It is Canada's view that the exception to the protection afforded by Principle 7 should be measured and limited. We therefore supported the earlier draft of Principle 8 as reflecting well the balance that the FSB Key Attributes for Effective Resolution Regimes (section 4 and Annex IV) attempt to strike between the need to protect the exercise of close-out rights by counterparties to financial contracts and clearing systems and the need for resolution authorities to be able to stay the exercise of those rights in order to ensure an orderly resolution process. Accordingly, the previous draft of Principle 8 clearly stipulated that stays imposed in exercising resolution powers should be temporary and limited – in the sense that only close-out rights arising because of the commencement of resolution proceedings should be stayed.

We are therefore concerned to see that the latest draft of Principle 8 appears to abandon this balancing approach in favour of a broader, more general approach of stating simply that the Principles (specifically, Principle 7) are without prejudice to the implementing State's right, "subject to appropriate safeguards", to impose stays on the operation of close-out netting in the course of resolution proceedings. In Canada's view, this latest formulation does not adequately reflect the nuanced approach of the FSB Key Attributes on this issue and potentially undermines the protections that Principle 7 purports to give to close-out netting in insolvency situations. The Key

Attributes have been unanimously adopted by all G-20 countries for over a year and those countries are currently engaging in a self-assessment of their compliance. The Attributes will also form an important part of the regular FSAP review of countries' financial sectors. The expectation is that countries will try to adhere to the policy approach that section 4 and Annex IV set out with respect to stays in resolution proceedings.

Since the purpose of the UNIDROIT Principles is "to provide detailed guidance to national legislators seeking to revise or introduce national legislation relevant to the functioning of close-out netting provisions", we would think that Principle 8 should seek to assist countries in giving legal effect to the policy standards that have been set by the FSB and other international standard-setting bodies. Canada is concerned that the latest formulation of Principle 8 would convey the intention that implementing States should have broad discretion to impose stays on the exercise of close-out rights in resolution situations – thereby providing little in the way of policy guidance to legislators. Although the commentary under the Principle suggests that legislators should have regard to the FSB Key Attributes in imposing stays, this approach does not carry the same weight as reflecting the Key Attributes in the "black letter" of the Principle itself. Canada therefore urges UNIDROIT to reconsider reverting to the previous approach of closely reflecting the Key Attributes in the wording of Principle 8.

Principle 9: Governing Law

Canada has concerns with the lack of clarity in the drafting of Principle 9. Paragraph (1) of the Principle suggests that implementing States may defer to their own private international law rules in choosing which laws will govern the operation of close-out netting provisions. However, paragraph (1) adds "taking into account, to the extent permitted by the laws of the implementing State, any choice of the governing laws by the parties". If this phrase is a recommendation that States give effect to a choice of law clause, then the phrase is not consistent with the first part of paragraph (1). If however the intent is that the Principles will not recommend any conflict rule, the phrase should be removed as its scope is unclear.

Yet, in paragraph (3), the implication seems to be that a contractual choice of law in a netting provision should always prevail. We believe that the determination of the applicable law and effect to be given to choice of law clauses in close-out netting provisions are issues that should be clarified.