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

COMMENTS

(submitted by Governments and Organisations)

INTRODUCTION

Subsequently to the comments (C.G.E./Netting/1/W.P. 3 and W.P. 4) on the text of the UNIDROIT Draft Principles regarding the enforceability of close-out netting provisions (C.G.E./Netting/1/W.P. 2 and Addendum) for consideration by the Committee of Governmental Experts on the enforceability of close-out netting provisions at its first session from 1 to 5 October 2012, the UNIDROIT Secretariat received additional comments from the Government of Canada. This paper reproduces these additional comments hereunder

COMMENTS SUBMITTED BY MEMBER STATES

Canada

Introduction

Canada welcomes the Draft Principles and supports the harmonisation objective of this instrument. From a broad perspective, the Draft Principles are consistent with Canadian law and their most important features have already been implemented in Canada.

Canada's comments are not exhaustive and only relate to certain matters that should be clarified or refined. The comments below are confined to the provisions of the Draft Principles and do not deal with the very useful explanatory notes as these notes will evolve with the development of the Principles.

Principle 1 : Definition of « close-net netting provision »

Principle 1 provides for a definition which at the same time circumscribes the scope of application of the instrument. Unidroit should consider whether the purpose and scope of application of the Principles might be addressed more directly in an introductory provision.

We note that the definition in Principle 1 is confined to the netting of obligations after the occurrence of a predefined event. In a clearing and settlement system, there are rules providing for the continuous novation and netting throughout the day of transactions between the participants with the central counterparty becoming the counterparty to each participant. Close-out will only occur at a later stage, for example, upon the default of a participant. For the close-out netting between the central counterparty and a participant to be effective, the novation of the obligations preceding the close-out must also be valid and effective. Consideration should be given to the legal recognition of the novation process.

In another vein, we believe that the French language version of the term “close-out netting” should be replaced by “résiliation-compensation” as suggested by France in document C.G.E./Netting/1/W.P.4. The current term “compensation avec déchéance du terme” does not fully convey the termination feature of close-out netting

Principle 2: Definition of “eligible party”

The definition of eligible party should be broad enough to accommodate any entity which might not be a “person” under the laws of the applicable legal system but which could be a market participant (e.g. a trust). Paragraph 2a) appears too restrictive in that it contemplates that apart from a legal person only a partnership or an unincorporated association may be an eligible party.

In this regard, we note that paragraph 2c) applies only to a “person” and, on a literal reading, would only permit the designation of a natural person: paragraph 2a) already applies to any “person other than a natural person”. Thus, an entity not covered by paragraph 2b) which is not a person could not be designated under paragraph 2c).

Principle 3: Definition of “eligible obligation”

The definition includes “title transfer collateral arrangements” but makes no mention of a security interest. In order to be neutral and to accommodate various legal systems, security interests in collateral should also be captured. First, the collateral taker has an obligation to redeliver the collateral upon satisfaction of the secured obligations and that obligation is capable of being subject to close-out netting; many agreements used in the market provide for the close-out netting of financial assets held under a security interest. Second, in some legal systems (such as under the laws of the Canadian provinces), title transfer collateral arrangements are generally treated as security interests or, at least, are subject to secured transactions law rules; Unidroit should therefore use a more generic term to describe an arrangement whereby collateral is used as a security device.

It is not clear that contracts for the clearing or settlement of securities and other financial instruments are covered by the definition. This should be clarified. We also wonder if mention should be made of master agreements relating to obligations listed in Principle 3.

Principles 4-6 on formal requirements for close-out netting provisions

If the intent is that an agreement providing for the close-out netting of collateral is effective without the need to fulfill secured transactions law perfection requirements, it is unclear whether the reference to “any formal act” is sufficient to exclude control, filing or registration requirements. The policy for the exclusion should however be considered further.

Principle 7: Enforceability of close-out netting

Whether the protection from fraudulent preferences (paragraph 7c)iv) should apply in all circumstances needs to be considered further. There is a good policy reason for conferring protection where the absence of protection may create a systemic risk (e.g. obligations under a clearing and settlement system).

Principle 8: Exception in respect of resolution of financial institutions

The scope of this principle needs further consideration, including as to the duration of the stay and whether the stay also applies to the exercise of close-out netting rights by a regulated central counterparty.

Principle 9: Governing law of close-out netting provisions

The determination of the governing law applicable to close-out netting provisions is a difficult issue that often cannot be separated from the law governing *in rem* rights or property interests in the assets to be subject to the close-out netting.

The rule proposed in paragraph 9(1) appears to be sound in the light of the objectives of the instrument. We note, however, that the possibility for the applicable law to provide for formal steps to be taken to render the close-out netting right valid and effective might be at odds with Principle 4 (validity and effectiveness not dependent on any "formal act").

As well, it is not obvious that the governing law of the close-out netting provision should also determine if a party is eligible for protection (as is currently provided in paragraph 9(2)). It is arguable that the law of the forum (e.g. in insolvency proceedings) should govern the issue.

Finally, we note that Principle 9 abstains from establishing that a contractual choice of law for the agreement will be effective without the necessity of a connection with the law chosen by the parties. This should be examined further and the case can be made that no connection is required for the choice to be valid.