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on the enforceability of close-out netting
provisions
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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. 5) 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 Governments of France and Japan.

These comments are reproduced hereunder.

COMMENTS SUBMITTED BY MEMBER STATES

France

Principles 3 and 4 (eligible parties and obligations)

Our proposal is the common joint proposal of UK, US and France (see C.G.E./Netting/2/W.P. 4), based on the proposal which was made during the first session in Roma, October 2012. With the same objective, that is to mean to propose a minimum "core pillar" which would be harmonized among all implementing States without preventing some of them from going beyond, we took great note of the substantive concerns that were raised by other delegations in response to our original joint proposal, and notably the need to include at least some corporations within the minimum scope of "eligible parties," and the need to avoid artificially dividing the list of spot transactions by excluding currencies and precious metals. We also propose a number of definitions to be as precise

as possible in our attempt to meet the maximum of concerns and viewpoints – see for instance eligible party meaning any person or entity other than a consumer and including a partnership, unincorporated association or other body of persons.

The rationale behind the "core pillar" approach is to recognize that, despite their interest and contribution to the mitigation of counterparty risk, the close-out netting provisions may conflict with major principles such as the recovery and resolution of corporations, the powers usually recognized to insolvency estates or courts etc. We then propose a "core pillar" as a signal for the implementing States that there is a general agreement on the need to put in place, at a minimum, an efficient close-out netting system for a determined type of parties and obligations (which are, for us, parties and obligations which may entail "systemic risk" in its broadest sense) whereas it would be still possible for the implementing States willing to, to go beyond. One example of a prudent approach could be the European directive on financial collateral arrangements adopted in 2002, which limits the close-out netting provisions to "financial transactions" between counterparties at least one of whom is a public authority or a financial institution.

Principle 8

We globally support the new drafting of Principle 8 which now refers not only to an exception to Principle 7(c)(ii) but more generally to all Principles and enlarges the notion of a "temporary stay" to a "stay".

However, as Principle 8 is particularly important regarding the efficiency of the resolution regimes applicable to the financial institutions, we propose some amendments, in order to precise its scope. We should ensure that the UNIDROIT Principles are consistent with the national resolution regimes which would be adopted along the lines of the "Key Attributes of Effective Resolution Regimes for Financial Institutions". In this sense, we should distinguish between two key elements of the "Key Attributes of Effective Resolution Regimes for Financial Institutions" Part 4 "*Set-off, netting, collateralisation, segregation of client assets*":

- On the one hand, point 4.2 provides that "subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed";
- But on the other hand, point 4.3 also provides that "should contractual acceleration or early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers".

In its present draft, Principle 8 seems to refer only to "a stay" (either temporary or not) whereas it should also mention the fact that entry into resolution and the exercise of any resolution powers should not trigger close out netting provisions, or constitute an event that entitles any counterparty of the firm in resolution to exercise close out netting provisions provided the substantive obligations under the contract continue to be performed. That is the reason why we suggest replacing "stay" by "any restriction related to the operation of a close-out netting provision". The power of the competent authority to delay the operation of close-out netting provisions should be interpreted as an additional measure, applicable in any case, for a very short and appropriate period of time.

Moreover, beyond crisis management measures (which are literally the resolution measures), the special derogation provided under Principle 8 should also cover crisis prevention measures, which are available to the competent authorities in order to ensure the financial stability and prevent the

occurrence of the systemic risk. Such prevention measures, which should be defined precisely, may consist in exercising one of the resolution powers (for instance the appointment of an administrator in order to administer reorganisation measures) without triggering formally the entry into a resolution regime. Such approach has been adopted for instance in the last Presidency compromise on the European Commission proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (see provisional article 60a and recital 87a in Annex).

Drafting suggestion:

Principle 8: Resolution of Financial Institutions

8. These Principles are without prejudice to **any restriction related to a stay of** the operation of a close-out netting provision which the law of the implementing State, subject to appropriate safeguards, may provide for **in the exercise of any resolution powers, including prevention crisis measures** ~~in the course of resolution proceedings~~ for financial institutions.

Principle 9

As explained in the key considerations, Principle 9 does not itself prescribe rules for identifying the law governing a close-out netting provision. Rather, the Principle describes the scope of the issues governed by this law. Furthermore, Principle 9(5) allows an opt-out for implementing States to retain more control over the enforceability of close-out netting provisions in insolvency proceedings before their own courts in the interest of their public policy choices. While we fully agree with this objective, we would suggest some minor changes to this draft paragraph to make it clearer that the implementing State could provide in its law the determination of the scope and the conditions of enforcement of the close-out netting. Thus, a State could choose either that its "lex concursus" should prevail over the "lex contractus" or the contrary. The expression "the law of the opening of proceedings" appears more accurate with respect to the internal legal order of the State. We also suggest the addition of "resolution proceedings", consistently with Principle 8, to avoid the confusion between two procedures which are very different¹.

Drafting suggestion:

(5) Notwithstanding the above, if insolvency **or resolution** proceedings have been commenced in respect of a party to the close-out netting provision [or a branch of that party] and under a law other than the law determined in accordance with paragraph (1), the implementing State may provide that the law ~~governing the insolvency~~ **of the opening of** proceedings governs also

a) the determination of the scope of parties and obligations that are eligible for close-out netting ~~for the purposes of~~

b) the conditions of enforcement of the close-out netting provision in the context of insolvency **or resolution** proceedings before the courts of the relevant implementing State; and

~~b) c)~~ the avoidance of a close-out netting provision as a fraudulent transaction or as a preference that is detrimental to other creditors of the insolvent party.

General comments

The comments of the draft principles are right to underline the advantages of close-out netting, such as the reduction of systemic risk and risk of counterparty. However, we think that this presentation could be improved by mentioning that, over all after the financial crisis, close-out

¹ We would suggest similar changes in the Explanation and commentary to distinguish "resolution" and "insolvency" rather than assimilating them.

netting has also some drawbacks -additionally to the interferences with insolvency proceedings. For instance, the effect of close-out netting on systemic risk is in reality more ambivalent than strictly positive: indeed, the automaticity of the triggering of close-out netting can lead to systemic risk. Moreover, thanks to the protection it creates, close-out netting gives the possibility to take much bigger exposures on financial markets which at the end could negatively impact on the global financial stability.

Such arguments were developed by previous UNIDROIT S78B/CEM/1/Doc.2 document (August 2010) from Ph. Paech: "*Since the 2007/2009 financial crisis it has become clear that automatic enforceability of netting agreements not only brings advantages but may carry significant disadvantages in times of pressure on the financial market. The Basel Cross-border Bank Resolution Group (CBRG) insists that these dangers, if not addressed appropriately, are anything but negligible. (...) The possibility of close-out netting actually exacerbating the risk to systemic stability represents a serious drawback of automatic close-out mechanisms featuring as an element of netting agreements.*" We would suggest quoting some of these elements to be integrated in the Introduction or the Explanation/Commentary parts of the Draft Principles.

Annex: Last provisional Presidency compromise on the European Commission proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms

Recital 87a 'crisis prevention measure' means the appointment of a special manager under Article 24 or the exercise of the write down power under Article 51;

Article 60 (a)

Exclusion of termination, suspension and set-off rights

- 1. A crisis prevention measure or a crisis management measure shall in itself not be recognised as an enforcement event within the meaning of Directive 2002/47/EC of the European Parliament and of the Council or as insolvency proceedings within the meaning of Directive 98/26/EC of the European Parliament and of the Council.***
- 2. A crisis prevention measure or a crisis management measure shall in itself not make it possible for anyone to:***
 - (a) exercise any termination, suspension or set-off right;***
 - (b) obtain possession or exercise control over any property of the institution under resolution;***
 - (c) affect any contractual rights of the institution under resolution.***
- 3. This Article shall not affect the right of a person to take an action referred to in paragraph 2 where that right arises by virtue of an event other than the crisis prevention measure or the crisis management measure.***

Japan

1. Scope: Principle 1 of the Draft Principles regarding the enforceability of close-out netting provisions (C.G.E./Netting/2/W.P.2) ("Draft Principles") and Joint Proposal concerning Principles 3 and 4 (C.G.E./Netting/2/W.P.4) ("Joint Proposal").

We ask a question concerning possible negative implications of the Draft Principles limiting the scope of application. We believe that the Draft Principles are intended to seek minimum harmonisation and not to prohibit states from recognising the enforceability of close-out netting provisions in the area outside the scope of the Principles (see paragraphs 11 and 12 of the Draft Principles). In this context, if the "Joint Proposal" is adopted, what would be the meaning of a state extending the scope? We believe that such extension does not mean that the state would be prohibited from recognising the enforceability of close-out netting provisions beyond such extended scope. If this understanding is correct, there may be no need for a state to extend the scope, because the state is free to recognise the enforceability of close-out netting provisions outside the Principles. We ask for clarification on this point.

2. Avoidance of an underlying obligation: Principle 7(1) c) and d)

We raised this point in our meeting in October 2012, but would like to raise it here again for clarification. The position of Principle 7(1) c) is that "mere entering into and operation" of a close-out netting provision should not be subject to avoidance on the basis of disturbing equal treatment of creditors. This means that the rise of an underlying obligation can be avoided for that reason, although it is protected from purely time-based avoidance (see Principle 7(1) d)). Is our understanding correct? We might also add that under the new wording of Principle 7(1) d), it is unclear whether the rise of an underlying obligation is protected from purely time-based avoidance, despite the explanation in footnote 53 of the "Revision Note" (C.G.E./Netting/2/W.P. 03). If so, the wording should be improved.

3. The law governing the insolvency proceedings: Principle 9(5)

We thought in our meeting in October 2012 that Principle 9(5) applies to the situations which Principle 7(1) does not cover. Namely, Principle 9(5) means that for the matters which Principle 7(1) does not cover, the law governing the insolvency proceedings applies. However, upon reading paragraph 146 of the Draft Principles, it suggests otherwise, namely, Principle 9(5) does apply to the matters covered by Principle 7(1) (see also Principle 7(2)). Thus we ask for clarification on this point.