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Proposal for a Convention on the Netting of Financial Instruments

(submitted by the Secretariat)

Summary	*Consideration of a proposal on the netting of financial instruments*
Mandate	*Work Programme*
Action to be taken	*Future work*
Related documents	*C.D. (88) 7*

Introduction

1. Netting is a clearly defined topic and the subject of standard contracts in industry, certain aspects of which are already addressed in Chapter VI of the draft Convention on Substantive Rules regarding Intermediated Securities. Netting forms *part of the principles needed* for the development of *emerging markets.*

2. Recognising the importance of the subject and in order to assist the Governing Council to take a decision on future work in this field, the Secretariat requested the International Swaps and Derivatives Association (ISDA) to submit a proposal for a Convention on the Netting of Financial Instruments. This proposal is set out in the Annexe to this document.

ANNEXE

Proposal for a Convention on the Netting of Financial Instruments

(submitted by the International Swaps and Derivatives Association – ISDA)

This memorandum sets out the case for an international convention on netting of financial instruments (a **Netting Convention**), including the purpose, scope and desired substantive effect of a Netting Convention as well as a number of legal and practical issues that should be considered during the course of drafting of a Netting Convention and the principal issues that would arise when considering the interaction of the Netting Convention with the domestic law of a signatory to the Netting Convention (a **Member State**), whether the Netting Convention is self-executing under that law or requires implementation by domestic legislation.

There are two principal forms of netting used in the financial markets, close-out netting and payment (or settlement) netting. Close-out netting is the process by which mutual obligations between financial market counterparties are reduced to a single net balance following a default by one of the parties. Payment netting is the process by which amounts due in the same currency on the same day between financial market counterparties are reduced to a single net balance for settlement purposes.[1]

Each form of netting has a crucial role to play in reducing risk in financial systems, close-out netting in reducing credit risk arising upon a default and payment netting in reducing settlement risk, which can be substantial given the high volumes of payments flowing through the financial markets each day.

The importance of netting, and in particular close-out netting, to efficiency, reduction of credit risk and therefore reduction of systemic risk in financial systems has been acknowledged by various national and international bodies, including the Bank for International Settlements, in numerous documents over the years. The leading banking supervisors have recognised the risk-reducing effect of close-out netting by permitting the allocation of regulatory capital against net rather than gross credit exposures, provided that certain conditions are met (including the obtaining of robust legal comfort in all jurisdictions relevant to any close-out netting arrangement intended to benefit from this capital relief). Therefore in dealing with international banks, financial market participants in countries with robust legal regimes for close-out netting enjoy a clear competitive advantage over financial market participants in countries where such legal certainty is not available.

Over the past 20 years or so, more than 30 countries, including the world's leading developed jurisdictions and some emerging market jurisdictions, have adopted legislation to give effect to or strengthen netting and to ensure that it is enforceable against a local counterparty in the event of that counterparty's insolvency. A number of other countries are currently considering adopting netting legislation. A list of countries that have adopted netting legislation is on the ISDA website at http://www.isda.org/docproj/stat_of_net_leg.html. ISDA has been closely involved in most of these efforts, providing information and support to legislators, regulators and local financial market associations and market participants. ISDA's Model Netting Act (http://www.isda.org/docproj/model_netting.html), first published in 1996 and most recently revised in 2007, has been used as a model for the legislation in a number of countries.

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[1] A specialised form of payment netting exists called netting by novation. It is largely confined to the foreign exchange market and is not widely used as it is somewhat cumbersome and systems-intensive to operate. It was principally developed by supervised financial institutions as a way to reduce regulatory capital requirements, as it is the only form of netting recognised by the original Basel Capital Accord in 1988. With the introduction of the recognition of close-out netting under the 1994 amendment to the 1988 Basel Capital Accord, the cost-benefit analysis of netting by novation means that it is rarely worth implementing it.

This work, however, has necessarily proceeded piecemeal, and many different approaches have been taken. Not all of this legislation is of the same quality and there is considerable variation in the scope, core principles and degree of certainty of the legislation in different countries. There are a number of reasons for these variations, but they were largely driven by extraneous political, economic and historical factors at the time the legislation was adopted (some of the earliest such legislation is now nearly 20 years old). In other words, there is no conceptual obstacle to the development of a common international set of legal rules for netting in financial markets.

The development of an international instrument, ideally a Netting Convention, to set out core rules for netting and to deal with some closely related issues (such as the inadvertent effect of anti-gambling laws, restrictions on legal capacity and the unintended application of insurance laws on legitimate financial market transactions), would:

- Potentially increase the number of countries where netting is enforceable, thereby further reducing systemic risk for financial markets involving participants from those countries
- Enhance legal certainty for cross-border financial transactions by creating a common set of international norms for netting
- Extend the benefits of netting to emerging market jurisdictions seeking to develop and strengthen their financial market infrastructure as part of broader economic development programmes
- Help to create a level playing field in the cross-border financial markets, increasing the ability of emerging market firms to compete for business in the international financial markets
- Improve the efficiency of the financial markets and therefore improve the ability of small- and medium-sized enterprises to obtain cost-effective access to financial services in order to find their growth and manage associated financial risks.

It should be remembered that the risk-reducing benefits of netting are not limited to derivatives markets but can be applied in virtually all sectors of the financial markets, including spot trading in foreign exchange, securities, energy, metals and other commodities, as well as in the context of securities and commodities lending and repurchase (repo) transactions.

A Netting Convention has the clear advantage over other possible international instruments that might be considered, such as a set of model principles. A Netting Convention, if well drafted, would be a practical and targeted measure, amply justified by existing empirical studies (including those by the Bank for International Settlements, as already mentioned) supporting the benefits of close-out netting, and as attested to by the number of countries that have already adopted netting legislation.

In this memorandum, for ease and transparency of analysis, netting is considered principally in the context of a bilateral arrangement, off-exchange, between two financial market participants in relation to wholesale financial market transactions such as privately negotiated (so-called 'over-the-counter') derivatives, foreign exchange spot, forward and option transactions, securities and commodities sale and repurchase (repo) transactions and securities and commodities lending transactions. The principles outlined below, however, should also be considered in relation to multilateral netting arrangements such as those operated in the context of clearing and settlement systems, clearing houses and multilateral trading facilities. Multilateral netting raises other issues, of course, as well, although many of these are systems issues, which do not alter the basic application of the principles discussed below.

References below to the Netting Convention are to a proposed Netting Convention reflecting the scope and substantive provisions outlined in Annex 1. This is, of course, purely for discussion purposes as analysis and elaboration of this proposal may lead to additional ideas and proposals regarding the scope and substantive content of a Netting Convention.

1. PRELIMINARY CONSIDERATIONS

1.1 The objectives of a Netting Convention

The primary purpose of a Netting Convention should be to provide for the enforceability of close-out netting upon the occurrence of any termination event or event of default under a netting agreement entered into between financial market participants, both prior to and following the commencement of insolvency proceedings, in each case in accordance with the terms of the agreement between the parties. This purpose can be achieved in various ways, but there are broadly two approaches seen to date in countries that have implemented netting legislation, namely:

(a) Identifying specific obstacles in provisions of domestic law to the recognition of netting and selectively disapplying those provisions in relation to netting agreements; and

(b) Setting out a separate regime for netting agreements.

The former could be achieved by making changes to domestic provisions of law that go beyond merely protecting netting agreements, for example, by eliminating gaming laws or, at least, restricting their application so that they do not apply to financial and commercial transactions (whether or not netting applies). The latter approach typically leaves domestic law untouched where transactions fall outside the netting regime.

The 'surgical' approach of (a) above is clearly not possible to apply via an international convention. The separate regime approach of (b) is, in any event, the more common approach and is exemplified by netting statutes of a type similar to (or even in a number of cases based on) the ISDA's Model Netting Act.

There are a number of issues with creating a separate regime for netting that require careful consideration. First of all, determining the scope with precision is of fundamental importance as uncertainty about the boundaries of the regime (in terms of persons, types of transactions or types of agreements that fall within and benefit from the regime) would undermine much of the benefit of having a separate regime. Secondly, a separate regime for netting may appear to create a 'privilege' for those market participants who are able to qualify for the regime, particularly in relation to domestic insolvency law. This can be alleviated to some extent by having the broadest possible personal scope of the regime so that, for example, private individuals and ordinary corporations benefit from the regime as well as supervised financial institutions. The appearance of creating a 'privilege' by virtue of the regime can also be addressed (and has been in many countries where such regimes have been implemented) by clearly setting out the policy basis for the regime, including the protection of the local financial system (and therefore all users of that system) from the risk of default of a local financial market participant through reduction of credit risk via netting.

Accordingly, the recommended approach for a Netting Convention is a unitary scheme that protects the close-out netting process in its various phases (pre insolvency in respect of the potential conflict between gaming laws and the enforceability of qualified financial contracts, post insolvency, single-branch and multi-branch), while systematically addressing the legal issues which have been found to apply most commonly (principally, of course, insolvency laws).

In developing the Netting Convention, careful consideration should be given to identifying relevant areas of domestic law that could potentially conflict with the effectiveness of netting agreements, so that all relevant issues are adequately covered. These would typically fall in one or more of the following categories:

- insolvency laws (including provisions of local law enacted for the prevention of insolvency), which most frequently are the primary obstacle;
- any specific mandatory provisions enacted for the protection of debtors generally (that is, in addition to insolvency law) or for the protection of certain categories of debtors;

- gaming, gambling, wagering and similar laws; and
- Less frequently, general principles of contract law or the law of property.

1.2 Policy considerations

Careful consideration should be given in the development of the Netting Convention to identifying likely policy considerations so that the scope of the Netting Convention is defined with clarity.

Defining the scope of the Netting Convention has a technical aspect (defining, for example, through the use of legal definitions or legal concepts the transactions or the parties that will benefit from the proposed netting regime) but also has a more political aspect, since by defining the scope of the netting law the Netting Convention will necessarily reflect policy choices. For example, law makers may decide that, because the benefit of netting legislation involves a regime that derogates from the normally applicable insolvency rules, these derogations may only be justified:

- in favour of certain eligible parties (in which case the scope of the Netting Convention will be restricted by reference to such parties – *ratione personae*); and/or
- In certain specific contexts (in which case the scope of the legislation will be restricted by reference to such matters – *ratione materiae*).

In order to be able to define clearly the scope of the Netting Convention (see below), those involved in drafting the Netting Convention will, of course, want to consider, among other things, netting in the context of regulatory policy and netting in relation to systemic risk. While it may be appropriate, by law or regulation, in a particular jurisdiction to limit certain types of financial activity to certain types of market participants, subject to appropriate conditions and limitations, it does not necessarily, make sense to limit the effectiveness of close-out netting by reference to types of market participants. The systemic risk reduction of effective close-out netting benefits all potential market participants, including corporations, insurance companies, special purpose vehicles used for structured financings, governmental authorities, charitable organizations hedging in the market, private individuals and so on. In other words, it reduces credit risk both for solvent and insolvent parties, and reduces the risk of a large insolvency having a "domino" effect on the solvency of other market participants who have dealt with the insolvent.

Although existing netting legislation in some countries does limit eligibility for the benefits of close-out netting to certain categories of market participant, such limitations do not necessarily make sense from a system risk point view. They potentially lead to difficult issues of characterization in relation to certain market participants, therefore creating legal uncertainty, and require periodic updating to reflect the continuing evolution of a dynamic market.

2. DEFINING THE SCOPE OF THE NETTING CONVENTION

2.1 Defining the scope of the Netting Convention *ratione materiae*

While it is in theory possible to draft a Netting Convention that would cover all types of financial transactions without distinction, the scope of most current netting legislation seeks to clarify in some way or other the types of financial transaction that benefit from the netting regime. This is also the approach of ISDA's Model Netting Act. It is clearly important to do this in a way that both provides that greatest amount of legal certainty as to scope but also is capable of accommodating continuing development and innovation in the financial markets.

In Appendix 2 to this memorandum, a proposed scope of transactions to fall within the Netting Convention is set out. It lists the various types of financial transactions that should ideally be covered. It also includes broad wording at the end of the definition intended to capture all types of financial transaction of a comparable nature in a way that is flexible enough to accommodate the development of new products. This avoids the need to introduce amending legislation periodically

in order to keep pace with the markets, as has happened in a number of countries that introduce early netting statutes that were relatively restricted in scope.

Appendix 2 covers not only derivative types of transactions but also securities and commodity sale and repurchase (repo) transactions and securities and commodities lending transactions. These should benefit from the same favourable netting regime, as well as related financial collateral arrangements, whether created by way of security or by outright transfer of title.

The Netting Convention should adopt a functional approach in defining the scope *ratione materiae* given the necessity for the Netting Convention to apply to a wide variety of jurisdictions, which characterise these types of transactions in a variety of ways. The use of some terms, such as "forward contract" will have different meanings in different jurisdictions. For instance, in many civil law jurisdictions, the concept of a forward contract would typically cover derivatives generally (other than options) but would not cover many products listed in Appendix 2 such as "spot" transactions, securities lending, repurchase transactions, collateral, clearing and settlement transactions and so on.). A combination of concepts would in most cases be inevitable.

Traditional legal concepts originating decades ago may be inappropriate to describe with clarity and certainty more recent products listed by the Netting Convention or to cover future financial innovations. As a result, certain jurisdictions that traditionally used their existing legal concepts in financial legislation and regulation found, when implementing their netting legislation, that it was desirable to take a more pragmatic approach in relation to the definition of product scope.

In addition to the use of generic language of the type reflected at the end of Appendix 1, the Netting Convention could provide that a local central bank or other relevant local authority should have the power to designate additional transactions, agreements and contracts as within the scope of the Netting Convention. Where the relevant authority has this power, it may use it in relation to a newly developed product, to enhance legal certainty in relation to that developing market.

The generic language and the designation power give more flexibility to the determination of the scope of the Netting Convention.

Finally, we suggest that the definition *ratione materiae* of the scope of the Netting Convention offers a good opportunity to clarify certain legal issues that may interfere with the enforceability of certain financial transactions set out in Appendix 2. For example, there is some uncertainty in certain legal systems as to the possible characterisation of derivative transactions as unenforceable gaming contracts. Some discussions have also arisen in various jurisdictions as to the possible characterisation of credit protection transactions such as credit default swaps (CDS) as guarantee or insurance contracts. Although the objective of the netting law would typically not be to deal with these issues, the definition of qualifying transactions could be the opportunity for the legislator to clarify any identified uncertainty in these respects.

2.2 Defining the scope of local legislation *ratione personae*

After defining which type of financial transactions should be covered by the Netting Convention, consideration should be given to defining the parties who will be eligible to benefit from the special netting regime. This consideration is likely to be heavily influenced by policy issues. The scope *ratione personae* was, for example, heavily discussed during the drafting and implementation of the European Financial Collateral Arrangements Directive (the FCAD), which covers a number of issues related to netting. The FCAD offered European member states the option to exclude non-regulated entities (that is, mainly corporate entities) from the scope of national legislation implementing the Directive (the so-called "opt-out" of article 1(3) of the Directive). When implementing the Directive, most European jurisdictions decided to include both financial and non-financial entities within the scope of the netting legislation. Certain countries, such as Austria, the Slovak Republic and Sweden, excluded non financial entities. An alternate solution was adopted by France and Germany (albeit using different legislative approaches), under which, broadly speaking, non-financial entities benefit from the netting regime for transactions entered into with a

"regulated" entity (that is, mainly a financial entity, an investment fund or certain public law governed entities) where these transactions are linked to financial instruments.

There are, however, as discussed above in this memorandum, strong policy and practical considerations in favour of adopting as broad a scope as possible for the Netting Convention and dealing with other policy concerns via financial regulation or other appropriate legislation that does not affect the enforceability of netting, and in particular close-out netting, against the broad range of financial market participants.

2.3 Netting and collateral arrangements

Once the eligible transactions and eligible parties (if necessary) have been defined, the Netting Convention needs to define the types of netting arrangement or agreement that will be covered. In Appendix 1, a broad definition of 'netting agreement' is proposed, which covers master agreements, 'master-master' netting agreements (that is, an umbrella agreement that provides for netting across master agreements) as well as collateral arrangements related to these types of agreements or master-master agreements:

As noted in Appendix 1, in relation to defining 'netting' itself it is important to avoid relying on jurisdiction-specific legal concepts and instead to adopt a functional approach, describing the economic effect intended by the parties, namely, the determination of a net balance, regardless of the legal mechanism used to achieve it.

This approach may prove difficult to translate in certain legal systems that traditionally organize or regulate a specific legal concept of 'set-off' (for example, *compensation* under the French civil code), which refers to a payment mechanism whereby respective obligations may be discharged. In such cases, it would be worth using a definition of 'netting' to clarify that netting, for these purposes, is a complex reality which involves:

- the termination or acceleration of the future payment and delivery obligations under the relevant individual transactions (but not the netting agreement itself which should not be required to be terminated);
- the valuation of the respective exposures of the parties thereunder at the time of termination (which may also be thought of as valuing the costs to each party of replacing each terminated transaction with a new transaction concluded with a third party in the market at that time); and
- The computation of a netted termination amount in a single currency reflecting such net exposures as well as the set-off of respective obligations in respect of amounts which were already due and payable.

The Netting Convention should not list specific types of agreements (for example, the 2002 ISDA Master Agreement) or indeed require that 'industry standard' or internationally or nationally 'recognised' master agreements must be used as a condition of falling within the scope of the Netting Convention. Many netting arrangements are customised and a number of financial areas are not served by specific trade association standard forms, for example, prime brokerage and cash pooling arrangements. Nonetheless, the policy reasons for protecting such netting arrangements are the same as for arrangements done on industry standard documentation.

In certain jurisdictions the use of specific domestic standard documentation governed by the law of the jurisdiction may be common. The Netting Convention should therefore include a broad definition of 'netting agreement', without limitation as whether or not based on an industry standard form, regardless of governing law, without the requirement that the form used by approved by a local authority and so on.

In countries where such restrictions had been initially introduced (for example, France), they have proved inappropriate both for reasons of principle and for practical purposes: it is indeed questionable whether any public authority has relevant competence to determine the

appropriateness of a given standard to govern privately negotiated contracts. In addition, such restrictions create legal uncertainty, as the relevant public authority will inevitably take considerably more time to approve new documentation or evolutions of existing documentation than the time it will typically take for the markets to adopt such documentation.

In respect of the close-out netting provisions, the netting legislation will, as set out above, need to specify that the qualifying transactions that are subject to the close-out netting can be governed by one or more master agreements to allow the use of bridge or master-master or umbrella agreements. This latter type of agreement permits a further netting to occur after netting has occurred under each individual master agreement covered by the master-master agreement.

The definition of 'netting agreements' should also refer to collateral arrangements to strengthen the risk reduction achieved by the netting agreement by incorporating exposures under related collateral arrangements. In particular, title transfer collateral arrangements are often integrated into the mechanism of the netting agreement to which they relate (and hence the definition of 'netting agreement' in Appendix 1 and the list of qualifying transactions in Appendix 2 refer to them) and incorporation of such arrangements into the protection of the Netting Convention further strengthens such arrangements.

3. CONFIRMING THE ENFORCEABILITY OF NETTING AGREEMENTS

Once the scope of the Netting Convention has been defined, adequate operative provisions will be required to effectively implement the purpose described above, namely the enforceability of close-out netting upon the occurrence of any termination event or event of default under the netting agreement, both prior to and following commencement of insolvency proceedings, in each case in accordance with the terms of the parties' contract.

In many jurisdictions, the main obstacles relate to the situation where one of the parties is subject to insolvency proceedings. The Netting Convention needs to be broad enough, therefore to ensure that netting agreements will be shielded from the effect of local insolvency rules.

3.1 General

The Netting Convention should confirm the enforceability of close-out netting upon the occurrence of any termination event or event of default under the netting agreement, both prior to and following commencement of insolvency proceedings, in each case in accordance with the terms of the parties' contract. The Netting Convention should, in other words, expressly confirm that the provisions of a netting agreement will be enforceable in accordance with its terms even if the counterparty is subject to insolvency proceedings.

The Netting Convention does not need to list termination events or events of default which would allow the parties to the netting agreement to terminate the underlying transactions. These events will be provided by the netting agreement entered into by the parties.

The Netting Convention should not require 'termination' of the netting agreement but only the termination of the transactions under the netting agreement. The netting agreement itself should survive so that its netting provisions can effectively be performed post-termination.

The Netting Convention should also provide that the inclusion of non-qualifying transactions under the netting agreement would not destroy close-out netting for the remaining qualifying transactions under the netting agreement. This helps to ensure that the entire benefit of a netting agreement is not lost simply due to uncertainty about the eligibility of one included transaction. Ireland is an example of a jurisdictions where this risk of 'contamination' previously existed, and which chose to amend its netting legislation to eliminate it.

Finally, once the relevant transactions are terminated, the provisions of a netting agreement typically provide for the calculation of a single net amount, which, in principle, will be owed by one party to

the other. Consequently, the netting legislation should specify that the only obligation or entitlement due to or from a party to a netting agreement upon close-out netting of transactions is its net obligation or entitlement as determined in accordance with the terms of the netting agreement. It would be helpful for the Netting Convention to confirm this. Again, it is stressed that the netting legislation should not limit itself to confirming the availability of set-off or netting of the separate obligations owed under each transaction, but should instead recognize the single net obligation or entitlement for all transactions which results from the close-out netting process. This is particularly important given the various ways in which netting may be affected, as discussed above.

3.2 Enforceability outside insolvency proceedings

Most, if not all, jurisdictions would recognize the enforceability of netting agreements outside the scope of insolvency proceedings. The Netting Convention should, however, confirm the enforceability of close-out netting and related collateral arrangements upon the occurrence of any termination event or event of default under the netting agreement in accordance with the terms of the parties' contract. Consequently, the Netting Convention should confirm that despite local rules that could conflict with the effectiveness of the netting and collateral provisions, these provisions will be enforceable. Appendix 1 deals with the issue of gaming, gambling, wagering and similar laws and suggests that a qualifying transaction should not be unenforceable by reason of any such law.

In addition, the Netting Convention should also ensure that the netting legislation will recognize the enforceability of the netting arrangement if rights of the defaulting party are subject to any attachment procedure by a third party creditor.

3.3 Enforceability in the case of insolvency proceedings

As discussed above, the protection of a netting agreement is crucial where one party to the netting agreement is subject to insolvency proceedings. This explains the particular focus in the Netting Convention on enforceability vis-à-vis an insolvent party and any insolvency official.

Insolvency law, in particular in countries where the insolvency provisions are more favourable to the insolvent debtor than to the creditors of the insolvent party, might not, in the absence of netting legislation, authorize close-out netting of transactions where one party is subject to insolvency proceedings.

Prohibition of early termination

Typically, insolvency laws might limit the effectiveness of contractual termination provisions when they are triggered on the basis of the opening of the insolvency proceedings. Given the importance of termination in the close-out netting process, the Netting Convention should go beyond the general affirmation of the pre-insolvency enforceability of netting agreements and provide that a liquidator shall not be able to prevent the termination of any qualifying transaction or the acceleration of any payment owed under any qualifying transaction or related netting agreement.

"Cherry-picking"

In addition, under insolvency legislation, the liquidator often has the power to require the continuation of transactions favourable to the party in liquidation together with the power to repudiate transactions that are unfavourable to the party in liquidation. In the latter case, of course, normally the repudiated transactions are not nullified, but instead the creditor simply has an unsecured claim for damages in relation to the repudiated transactions.

A liquidator's power of this type is often referred to as a 'cherry-picking' power. Such a power would obviously undermine the effect of a netting arrangement. The Netting Convention should therefore include a clause preventing the liquidator from 'cherry-picking' only specific transactions (or specific rights and/or liabilities) under the netting agreement. The 'cherry-picking' power should

only be exercisable, if at all, in relation to the netting agreement as a whole, so that it is either affirmed (continued) or repudiated as a whole. In the latter case, the creditor should have a valid net claim against the insolvent company.

Limitations on set-off

Many insolvency laws limit the availability of set-off in an insolvency. For example, in certain civil law jurisdictions, respective obligations are only available for set-off when they have fallen due. Even when they are due, set-off will only be possible with respect to obligations that either arise under the same agreement or are otherwise strongly interconnected (this is sometimes referred to as the 'connexity' requirement). Such requirements might jeopardize the effectiveness of netting agreements. The Netting Convention should address this issue.

Preferences

The netting law will also need to ensure that any payment or transfer of collateral made in respect of the qualifying transactions during any 'suspect period' are not treated as a preference and are consequently not void or voidable, as is frequently the case under insolvency law. The Netting Convention should provide that a liquidator of an insolvent party may not avoid a transfer or a payment of financial collateral in connection with a netting agreement on the ground of it constituting a preference or transfer during a suspect period by the insolvent party to the non-insolvent party.

Other Considerations

The Netting Convention should affirm in each case the validity of the netting and collateral arrangements over any insolvency provisions that would otherwise conflict with the netting provisions. This is a common approach in existing netting legislation.

French law, for example, specifies in an article of its monetary and financial code that close-out netting is valid under French law and in a latter article confirms that none of its insolvency provisions may interfere with the application of the former article. Consequently, by 'disapplying' all the insolvency law provisions instead of affirming in certain specific situations that the netting and collateral arrangements will be valid, French law sets out clearly that insolvency law may not be used to challenge the principle of the validity of close-out netting and precludes the risk of failing to enumerate any specific cases which could be problematic.

Finally, it is important, as noted in Appendix 1, that the reference to insolvency law in the Netting Convention should be as broad as possible to ensure that all relevant liquidation and reorganisation measures that might apply in any country that becomes a signatory to the Netting Convention would be covered. The scope of this definition should therefore include not only judicial proceedings but also voluntary arrangements with creditors. Insolvency proceedings should consequently cover bankruptcy, liquidation (judicial or voluntary), winding-up, reorganisation, composition, administration, receivership, rehabilitation, conservatorship and any similar or additional measure under the laws of the relevant jurisdiction. This is consistent with the functional approach recommended above for the Netting Convention.

4. MULTIBRANCH NETTING

The Netting Convention should protect multibranch netting, that is, netting under a master agreement where at least one party has a head office in one jurisdiction and various branches in other jurisdictions, including in the local jurisdiction. An example of such provisions appears in ISDA's Model Netting Act.

Such provisions are particularly important in jurisdictions that provide for a ring-fencing of the assets and/or liabilities of an insolvent local branch. Such ring-fencing would otherwise potentially undermine the effectiveness of the netting mechanism, which is supposed to operate globally on

the basis of all respective obligations and entitlements of the parties, irrespective of the place of booking of individual transactions.

The multibranch provisions of ISDA's Model Netting Act are based on the New York banking law provisions that expressly enforce multibranch close-out netting for derivatives transactions in a constructive attempt to reconcile the ring fencing of New York branches and the interest in enforcing multibranch close-out netting.

20 February 2009

Appendix 1

OUTLINE OF A CONVENTION ON NETTING ARRANGEMENTS

Subject matter and scope

- The proposed convention on netting of financial instruments (the **Netting Convention**) should apply to bilateral close-out netting arrangements and the transactions entered into under such arrangements.
- It should also cover multilateral close-out netting arrangements, for example, in clearing and settlement systems and clearing houses and under multilateral trading facilities.
- The coverage of close-out netting arrangements should be as broad as possible and include close-out netting arrangements where one or both parties are natural persons.
- The transactions that qualify for inclusion within the scope of the Netting Convention (Qualifying Transactions) could be defined in a separate Annex to the Netting Convention. The definition should be broad in order to cover all types of transactions irrespective of the type of underlying and of whether the relevant transaction is exchange-traded or concluded 'over the counter' or whether cash settlement or physical settlement applies to the transaction. The definition should also be broad enough to cover foreseeable future market developments. An example of such an Annex (the Qualifying Transactions Annex) is attached as Appendix 2 to this memorandum.
- It should also be clarified that the inclusion in any close-out netting arrangement of any transaction not listed in the Qualifying Transactions Annex should not affect the enforceability of the arrangement in relation to all transactions that are within the scope of the Qualifying Transactions Annex.
- The Netting Convention should clarify in relation to a multibranch entity (which would typically be a bank) that the enforceability of close-out netting against the multibranch entity in the jurisdiction of the main proceedings (in relation to a non-bank company) or home country proceedings (in relation to a bank or insurance undertaking) should not be affected by the laws of any jurisdiction where a branch of that entity might be located (whether that jurisdiction is in a state that is a signatory to the Netting Convention or otherwise).
- See also 'Definitions' below for additional points relating to scope of the Netting Convention.

Definitions

- A term such as 'Qualifying Transaction' may be introduced to help define the scope *ratione materiae* of the Netting Convention. This is comparable to the definition "qualified financial contract" used in ISDA's Model Netting Act. As indicated above in this memorandum, a model scope of transactions covered is set out in Appendix 2 to this memorandum.

- The definition of 'netting agreement', that is, the type of agreement that would fall within the scope of the Netting Convention, needs to be sufficiently broad. A possible definition would be

  > *'netting agreement' means (i) any agreement between two parties that provides for netting of present or future payment or delivery obligations or entitlements arising under or in connection with one or more [Qualifying Transactions] entered into under the agreement by the parties to the agreement (a 'master netting agreement'), (ii) any master agreement between two parties that provides for netting of the amounts due under two or more master netting agreements (a 'master-master netting agreement') and (iii) any collateral arrangement related to one or more of the foregoing.*

- The definition of 'close-netting' in the Netting Convention needs to be broad enough to recognise that there are various possible legal approaches to effecting a close-out netting arrangement, including the use of a contractual set-off provision, the use of conditional clauses (sometimes referred to as a 'flawed asset' approach), conditional remission of debt (used in some settlement systems), statutory netting (where netting is effected if certain statutory conditions are met) and so on.
- The 'flawed asset' approach, for example, is the primary approach of the ISDA Master Agreements as well as the European Master Agreement, while contractual set-off provisions are the principal netting mechanism of the 2000 Global Master Repurchase Agreement used for securities repurchase (repo) transactions and the 2000 ISLA Global Master Securities Lending Agreement used for securities lending transactions.
- The definitions of liquidation and reorganisation measures need to be broad enough to encompass the wide variety of such measures internationally.
- Consideration should be given to extending these to cover pre-insolvency intervention measures by financial supervisory authorities in relation to banks, investment firms, insurance companies and other financial institutions, or these should be covered by a separate definition.

Formal requirements

- The Netting Convention should ensure that the validity and enforceability or the admissibility in evidence of a close-out netting arrangement or transactions governed by it are not dependent on the performance of any formal act.
- Formal acts include, amongst other requirements, registration, notarization or the provision of a 'certain date'.
- The Netting Convention should be applicable to all close-out netting arrangements and transactions, which can be evidenced in writing or in a legally equivalent manner. As far as transactions are concerned, 'legally equivalent' should also cover trades that have been concluded orally and that are evidenced by tape recordings or statement of a witness only or otherwise.

Enforceability of close-out netting arrangements

- The Netting Convention should ensure that, on the occurrence of a close-out event, the close-out netting arrangement comes into effect and is enforceable as provided in the terms agreed therein.
- The Netting Convention should explicitly name those specify examples of events or actions that should not constitute a requirement for the enforceability of the close-out netting arrangement.

- Specified examples should include (i) prior notices of the intention to terminate and close-out (ii) approvals of a court, public officer or other person and (iii) the determination of current values, costs or losses as of a prescribed date or point in time or in a prescribed manner.
- It should also be ensured that close-out netting arrangements can take effect notwithstanding the commencement or continuation of liquidation proceedings or reorganisation measures or any purported assignment, attachment or other disposition of or in respect of the close-out netting arrangement.
- The Netting Convention should also ensure that covered transactions are not void or voidable or otherwise unenforceable just by reason of a law relating to gaming, gambling, wagering or any similar law.

Certain insolvency provisions disapplied

- The Netting Convention should ensure that any transfer of cash, or financial instruments or commodities under the close-out netting arrangement or any transaction should not be declared invalid or void on the sole basis that the transfer was made on the day of the commencement of winding-up proceedings or reorganisation measures in a prescribed period prior to the commencement of such proceedings.
- It should also be provided that the operation of a close-out netting arrangement shall not be affected by any moratorium, stay, freeze or any decree or order with a similar effect made by any administrative or judicial authority or liquidator or similar official.

Conflict of laws

- The Netting Convention should ensure that all questions arising in relation to the enforceability of a close-out netting arrangement shall be governed solely by the substantive civil law chosen by the parties of the close-out netting arrangement.
- The relevant matters governed by such laws should be explicitly named, including (i) the legal nature of a close-out netting arrangement, (ii) the requirements and legal steps necessary to render a close-out netting arrangement and the transactions thereunder effective and enforceable and (iii) the rules relating to whether a transaction detrimental to other creditors is void, voidable or unenforceable.

Appendix 2

TRANSACTIONS WITHIN THE SCOPE OF THE NETTING CONVENTION

The following would be 'qualifying transactions' for the purposes of the Netting Convention:

1. a currency, cross-currency or interest rate swap;
2. a basis swap;
3. a spot, future, forward or other foreign exchange transaction;
4. a cap, collar or floor transaction;
5. a commodity swap;
6. a forward rate agreement;
7. a currency or interest rate future;

8. a currency or interest rate option;

9. an equity derivative, such as an equity or equity index swap, equity forward, equity option or equity index option;

10. a derivative relating to bonds or other debt securities or to a bond or debt security index, such as a total return swap, index swap, forward, option or index option;

11. a credit derivative, such as a credit default swap, credit default basket swap, total return swap or credit default option;

12. an energy derivative, such as an electricity derivative, oil derivative, coal derivative or gas derivative;

13. a weather derivative, such as a weather swap or weather option;

14. a bandwidth derivative;

15. a freight derivative;

16. an emissions derivative, such as an emissions allowance or emissions reduction transaction;

17. an economic statistics derivative, such as an inflation derivative;

18. a property index derivative;

19. a spot, future, forward or other securities or commodities transaction;

20. a securities contract, including a margin loan and an agreement to buy, sell, borrow or lend securities, such as a securities repurchase or reverse repurchase agreement, a securities lending agreement or a securities buy/sell-back agreement, including any such contract or agreement relating to mortgage loans, interests in mortgage loans or mortgage-related securities;

21. a commodities contract, including an agreement to buy, sell, borrow or lend commodities, such as a commodities repurchase or reverse repurchase agreement, a commodities lending agreement or a commodities buy/sell-back agreement;

22. a collateral arrangement;

23. an agreement to clear or settle securities transactions or to act as a depository for securities;

24. any other agreement, contract or transaction similar to any agreement, contract or transaction referred to in paragraphs 1 to 23 with respect to one or more reference items or indices relating to (without limitation) interest rates, currencies, commodities, energy products, electricity, equities, weather, bonds and other debt instruments, precious metals, 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 ;

25. any swap, forward, option, contract for differences or other derivative in respect of, or combination of, one or more agreements or contracts referred to in paragraphs 1 to 24; and

26. Any agreement, contract or transaction designated as such by the [central bank or other relevant local authority] for the purposes of the Netting Convention.