



**EN**

**GOVERNING COUNCIL**  
**91<sup>st</sup> session**  
**Rome, 7 - 9 May 2012**

UNIDROIT 2012  
C.D. (91) 5(a) Add. 1  
Original: English  
April 2012

**Item No. 6 on the agenda: Transactions on transnational and connected capital markets**

**(a) PRINCIPLES AND RULES ON THE NETTING OF FINANCIAL INSTRUMENTS**

**Addendum to C.D. (91) 5(a)**

(Draft Principles prepared by Mr Philipp Paech, member of the Study Group)<sup>1</sup>

<i>Summary</i>	<i>Draft Principles regarding the enforceability of close-out netting provisions</i>
<i>Action to be taken</i>	<i>See C.D. (91) 5(a) paragraph 25</i>
<i>Mandate</i>	<i>Work Programme 2011-2013</i>
<i>Priority level</i>	<i>High</i>
<i>Status</i>	<i>On target</i>
<i>Related documents</i>	<i>Final report of the Study Group (C.D. (91) 5(a))</i>

**INTRODUCTION**

1. Financial institutions and other financial market participants in their daily operations use a number of mechanisms designed to reduce their risk exposure. Amongst other things, first, they provide to each other security or collateral. In addition, they may agree that close-out netting shall apply to the contracts into which they enter with each other. Both mechanisms, security/collateral on the one hand and close-out netting on the other hand, serve the same purpose, that is, to ensure that one party's exposure to the other parties' solvency and to considerable changes in the value of the relevant assets is kept at manageable levels. Both mechanisms are capable of independently mitigating counterparty risk as well as market risk. However, in practice, their functions are intimately linked: where collateral and netting mechanisms are used cumulatively, netting reduces the exposure in the sense that much less collateral has to be put up. Taken together, security/collateral and close-out netting are one of the primary tools of risk management in the financial market.

<sup>1</sup> This draft is based on Documents 2, 3, 9, 11 and on the deliberations of the Members of the UNIDROIT Study Group. The author and the UNIDROIT Secretariat would like to thank the members of the Study Group for their useful comments on an earlier draft of this document.

2. The notion of close-out netting is a relatively new addition to the legal terminology and it is not particularly well-defined. Broadly speaking, close-out netting is often understood as resembling the classical concept of set-off applied upon default or insolvency of one of the parties. However, close-out netting encompasses many additional elements and is functionally and conceptually different from traditional set-off. A close-out netting mechanism comes into operation either by a declaration ('close-out') of one party when a pre-defined event occurs, in particular default or insolvency of its counterparty ('termination event'), or it is triggered automatically when such an event occurs ('automatic termination'). The mechanism extends to a number, often hundreds, of contracts between the parties that are contractually included in a netting provision. Upon close-out or automatic termination, all contracts covered are terminated and the market value of each is determined under a pre-defined valuation mechanism. The sum value of all contracts is then aggregated resulting in one single payment obligation ('net amount'). The net amount remains the only obligation to be settled and is generally due immediately after being determined.

3. Close-out netting provisions are widely used in the financial market by private sector entities, in particular banks, but also private non-financial institutions. In the public sector, entities such as, especially, central banks and supranational financial institutions such as development banks make use of netting provisions. Close-out netting is typically applied to transactions such as derivatives, repurchase and securities lending agreements, and other kinds of transaction that tend to carry a high counterparty and/or market risk.

4. Regulatory authorities (most recently, the *Financial Stability Board* (FSB) and the *Cross-border Bank Resolution Group* of the Basel Committee on Banking Supervision) strongly encourage the use of such close-out netting provisions (alongside collateral) because of their beneficial effects on the stability of the financial system.<sup>2</sup> The reason is that referring market participants' claims in the event of default of the counterparty to regular insolvency proceedings on a gross basis instead of on a net basis might expose the non-defaulting party to levels of credit risk and market risk that are difficult to calculate and manage for the relevant types of contract due to rapid changes in market values and uncertainty regarding the risk of repudiation of contracts during the proceeding.

5. However, these beneficial effects can be particularly felt in the event of the insolvency of a party. In that case, the use of close-out netting assumes that the legal effects stipulated to that end by the parties (the close-out netting provision) will be recognised by and be enforceable under the applicable insolvency law. However, the current situation is that, even if about 40 jurisdictions<sup>3</sup> recognise netting in insolvency, the extent to which they do so and the scope and legal effects of close-out netting provisions differ significantly. Furthermore, some jurisdictions do not clearly recognise netting, and the legal practice in such jurisdictions often resorts to the principles governing set-off, failing to recognise the fundamental differences between the two mechanisms. This global 'patchwork' is unsatisfactory in cross-jurisdictional situations, since it exposes the financial market participants' risk management to unnecessary legal uncertainty and may even jeopardise it.<sup>4</sup>

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<sup>2</sup> Bank for International Settlements/Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, Recommendation 8, p. 36 *et seq.*; <http://www.bis.org/publ/bcbs162.pdf?noframes=1>; Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, section 4.1.

<sup>3</sup> According to a list regularly updated by the International Swaps and Derivatives Association (ISDA), the following jurisdictions have accommodated close-out netting in their law: Andorra, Anguilla, Australia, Austria, Belgium, Brazil, British Virgin Islands, Canada, Colombia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan, Luxembourg, Malta, Mauritius, Mexico, New Zealand, Norway, Peru, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, South Korea, Spain, Sweden, Switzerland, United Kingdom and the United States. According to the same list, netting-friendly legislation is under consideration in the following jurisdictions: Argentina, Chile, Pakistan and Seychelles. Source: [http://www.isda.org/docproj/stat\\_of\\_net\\_leg.html](http://www.isda.org/docproj/stat_of_net_leg.html).

<sup>4</sup> Cf. for a detailed analysis Doc. 2, 1<sup>st</sup> Part, in particular pp. 32 *et seq.*

6. An additional aspect of the enforceability of netting provisions has come to the fore since the beginning of the recent financial crisis: regulatory authorities, while underlining the usefulness of netting, have contemplated the need for a brief stay on the netting mechanism in pre-insolvency or insolvency situations affecting a financial institution, so as to allow the regulator the time needed to decide if and how to resolve an ailing financial institution in an orderly fashion so as to mitigate risks to financial stability. The FSB has recently provided guidance as to how the regulatory intervention should be reconciled with financial institutions' and its regulators' needs to rely on the enforceability of close-out netting for risk management and mitigation purposes.

7. The emerging international regulatory consensus regarding the interplay between close-out netting and bank resolution is set out in the FSB report on bank resolution.<sup>5</sup> However, this newly developing regulatory approach has to deal with a patchwork where the relevant legal mechanisms in which close-out netting is embedded are not compatible or comparable across borders. Therefore, the sensitive connection of, on the one hand, regulatory measures such as stays on termination or portfolio transfers to, on the other hand, the essential insolvency and commercial law framework might fail in certain cases. Notably, stays might achieve a better cross-jurisdictional effect on the basis of harmonised legal principles. Equally, legal uncertainties arising in the context of asset transfers to domestic or foreign bridge banks can be more effectively mitigated on the basis of a more consistent international picture of the underlying commercial and insolvency law. This situation calls for a more harmonised and streamlined framework regarding close-out netting on which market participants and regulatory authorities can rely across all financial markets.<sup>6</sup>

8. First steps have already been taken towards an international consensus on the legal cornerstones regarding enforceability of close-out netting provisions. The Geneva Securities Convention sets out an optional framework for the protection of collateral transactions. This protection extends to netting provisions provided they are concluded as part of a collateral transaction. The Convention therefore contains a definition of close-out netting and a key rule on enforceability.<sup>7</sup>

9. Furthermore, netting has also been recognised in the work of other International Organisations. Notably, the UNCITRAL Legislative Guide on Insolvency Law refers to the enforceability of netting as a feature to be considered when designing insolvency law, and advises that netting should be allowed under the applicable insolvency procedure.<sup>8</sup> Moreover, the EU Member States have implemented a partly harmonised legal framework for close-out netting provisions.<sup>9</sup>

10. The aim of the following Principles is to provide detailed guidance to national legislators seeking to revise or introduce national legislation relevant to the functioning of close-out netting. These Principles are designed to improve the enforceability of close-out netting, especially in cross-jurisdictional situations, in order to provide a sound basis, in commercial and insolvency law terms, for risk management and mitigation by financial institutions and for the application of regulatory policies in the international context.

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<sup>5</sup> Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, section 4, in particular section 4.3.

<sup>6</sup> Cf. for a detailed analysis Document 2, 2<sup>nd</sup> Part, in particular pp. 68 *et seq.*

<sup>7</sup> UNIDROIT Convention on Substantive Rules for Intermediated Securities, adopted in Geneva on 9 October 2009; in particular Article 31(3)(j) and Article 32(3).

<sup>8</sup> UNCITRAL, Legislative Guide on Insolvency, 2005, Recommendations 7(g) and pp. 101-107.

<sup>9</sup> Cf. Doc. 2, p. 24-25 for a brief description of the various rules in place.

### **Principle 1: Definition of 'close-out netting provision'**

**1. "Close-out netting provision" means a contractual provision relating to eligible obligations between eligible parties under which, upon the occurrence of a predefined event in relation to one of the parties, the respective due and undue obligations of the parties are reduced to a single net obligation representing the remaining value of all combined obligations, which is then payable by one party to the other. Depending on the contractual agreement and applicable law, close-out netting occurs automatically by operation of the contractual agreement or may occur at the election of one of the parties.**

#### Key considerations in respect of this definition

- The definition of close-out netting provision shall be broad so as to encompass different types of provision which achieve a functionally identical result.
- It shall not privilege one or the other legal method to achieve the result that may exist in different jurisdictions and in different standard market contracts.
- The definition shall exclusively relate to contractual close-out netting. It does not address close-out netting to the extent that its functionalities are achieved under statutory provisions.

#### Explanation and commentary

##### 'Close-out netting'

11. Close-out netting is best described in functional terms, *i.e.* by reference to a result. The process, in practical terms, is the following. A bundle of contracts between the parties is contractually covered by a netting provision. All non-performed contracts covered by the netting provision cease to be treated individually. Upon the occurrence of a predefined event, their aggregate value is computed so as to result in one single net payment obligation. This obligation is owed by the party which is 'out of the money' to the party which is 'in the money'. This obligation remains the only obligation (which may include incidental fees, costs or other expenses) to be settled and is generally due shortly after being determined.

##### 'Provision'

12. This definition covers contractual close-out netting, as opposed to statutory rules that may achieve an identical or similar result.

13. Where the result of close-out netting is achieved through a combination of statutory rules with contractual rules (*e.g.*, the right to terminate is statutory, acceleration, valuation and aggregation are arranged for contractually), these Principles exclusively cover the contractual part, *cf. infra, paragraph 22*.

14. In practice, a clause allowing for close-out netting between the parties may be included in standard master documentation (such as the ISDA Master Agreement), or be part of a tailor-made framework agreement, or be an entirely self-standing agreement. These Principles therefore refer to "close-out netting provision", rather than to "arrangement" or "agreement", so as to encompass these various possibilities. However, the term 'close-out netting provision' covers only those parts of an agreement that actually implement the close-out netting mechanism itself, and nothing else. Definitions, schedules and annexes that the parties may have related to their agreement are covered only to the extent that their content is necessary for the proper operation of the close-out netting mechanism.

15. The internal rules of clearing, settlement and payment systems, as well as central counterparties are also contemplated by this definition. Despite the fact that they are usually approved by the relevant regulatory authority, the character of the relationship between the system and its participants is, or in any case is treated by this instrument as, one of commercial law (membership agreement, by-laws) as regards the treatment of the assets to be settled in the system.

'Relating to eligible obligations'

16. Cf. relevant definition.

'Between eligible parties'

17. Cf. relevant definition. Contracts concluded between two parties may be settled either bilaterally, between the parties themselves, or through a central entity interposed between the parties. Close-out netting is *equally important* in both scenarios.

18. Bilateral settlement between the parties is the standard case and covered by these Principles.

19. These Principles also cover 'central clearing' mechanisms which are ultimately also built on bilateral relationships. Central clearing is used as a collective term for the functionalities of central counterparties, net payment systems and clearing and settlement systems in general. Central clearing applies by virtue of contractual agreements between market participants or as a legal requirement. The arrangement usually works by interposing a central entity between the parties to every contract, so that it becomes 'buyer to every seller and seller to every buyer'. In other words, the bilateral settlement obligations that exist between the system's participants are entirely replaced by bilateral obligations between each participant and the central clearing entity. As a consequence, the net risk exposure is calculated on a bilateral basis, so that each participant's exposure exists exclusively against the central entity. Thus, given that, from a legal point of view, central clearing breaks down to strictly bilateral relationships, considerations in respect of bilateral close-out netting generally apply to central clearing. This applies both inside and outside insolvency of the participants and the system. Therefore, legal certainty requires also that the conversion of the original contractual relationships between the clearing participants into bilateral relationships between each participant and the central clearing entity is insolvency-proof.

20. Truly multilateral close-out netting is probably an exceptional case. Under such a scheme, more than two parties compute their mutual exposure on a multilateral basis, employing functionalities similar to those used in close-out netting. A mechanism similar in concept to multilateral netting is sometimes used as a tool to circumscribe the exposure of one market participant *vis-à-vis* a multitude of other market participants, typically a bank managing its risk exposure under one single netting provision against several entities belonging to the same group of companies (hence this form of netting is also called 'cross-affiliate netting'). The recognition of a multilateral netting provision by the applicable insolvency law depends in part on whether the law is able to accommodate the lack of mutuality of the relevant contracts or on whether the 'mutuality' created through cross-guarantees, cross-collateralisation agreements or similar arrangements is recognised. Truly multilateral close-out netting is *not* covered by the above definition.

'Predefined event'

21. The event that usually triggers the application of the netting provision (the 'predefined event') is commonly referred to in the relevant documentation as the 'termination event', 'enforcement event', 'specified event' or 'default event'. Close-out netting can occur both in situations where both parties are solvent and in the event of the insolvency of either, since it is the

parties to the netting provision themselves that determine the trigger for the operation of the mechanism. This event may consist, for example, in one of the parties defaulting on one or more of its obligations, or in its filing for insolvency, in the appointment of a state administrator or a similar intervention by the public authorities, or in the opening of an insolvency proceeding or an administration, resolution or restructuring procedure. Netting provisions additionally include external circumstances as termination events, such as the objective impossibility of performing an obligation under one of the contracts, or the downgrading of one of the parties' credit rating following its merger with another company.

22. It is worth noting that the event triggering termination is determined, in certain jurisdictions, under the relevant legislation itself. In particular, the insolvency of one of the parties may lead to the termination of all open contracts by operation of the statutory law. Parties may supplement this statutory consequence of the termination event with additional contractual rules providing for other elements needed to achieve the result of close-out netting (*cf. supra, paragraph 13*). Such arrangements are likewise envisaged by the present definition.

'Reduced to a single net obligation'

23. A close-out netting mechanism is commonly understood as resulting in a single payment obligation owed by the party that is 'out of the money' to the party that is 'in the money'. However, a number of different functional steps can be used to achieve this result, and these can potentially be based on a number of differing legal concepts.

24. A netting mechanism generally involves several or all of the following steps: (i) termination of the contracts, (ii) acceleration of obligations, (iii) valuation of the contracts', and, (iv) aggregation to result in an overall net amount. The order of acceleration, aggregation and valuation can vary according to the actual netting provisions. Not all netting provisions need all of these steps to come to the functional result of close-out netting. Which elements are needed and used depends, rather, on the design of the relevant provision and the boundaries under the applicable law. Examples:

- Termination of each contract; valuation of each contract; aggregation of all values to form one net payment obligation.
- Acceleration of each contract, valuation of each contract, aggregation of all values to form one net payment obligation.
- Termination of each contract; valuation of each contract; aggregation of all values to form one net payment obligation; acceleration of the net obligation.
- Termination of each contract; valuation of each contract; creation of a new (immediately due and payable) payment obligation representing the overall value.
- *Etc.*

25. These functional steps merely describe what happens in practical terms. The relevant close-out netting provision in combination with the applicable law need to provide the necessary legal concepts, since the result (a single net payment obligation) is first and foremost a legal one. The legal concepts and terminology that underlie these steps differ, depending on the design of the netting provision and on the law applicable to it.

26. Termination is a term used to express the functional result of the relevant open contracts being put to an end. National laws achieve this result by legal mechanisms called cancellation, close-out, rescission, termination, *etc.*

27. Acceleration is a term used to express the concept that an obligation becomes due and payable before the contractually agreed date; there might be other legal concepts and terms to achieve an identical functional result such as the replacement of the original and as yet unmatured obligation with a new obligation that must be performed immediately ('novation').

28. The aggregation element collapses all relevant contracts or the value resulting from them so as to produce one single obligation. This is functionally the same result as the outcome of classical set-off of all valued and payable obligations. Also novation (*i.e.*, the parties agreement that after termination of all open contracts a *new* obligation arises representing the relevant aggregate value) is a suitable concept to achieve the effect of aggregation.

29. The valuation of the terminated contracts or the entire (aggregate) contractual relationship generally seeks to establish a fair and commercially reasonable compensation for the party that was 'in the money'. The valuation is usually (but not necessarily) effected by the non-defaulting party under a mechanism which has been pre-defined in the agreement. The parties are free to define the valuation mechanism and may use concepts such as replacement or market value or any other method that allows for a practicable valuation process and a fair and commercially reasonable result.

#### 'Payable by one party to the other'

30. Where close-out netting occurs in the context of the insolvency of one of the parties, and the net amount is positive for the solvent party, that party is paid from the insolvency estate as an unsecured creditor and may therefore lose some or the entirety of its claim, if unsecured. In the amount of this net sum, the position of the solvent party *vis-à-vis* the insolvent estate is no better than that of any other party: it needs to be secured in order to be certain of payment and the same requirements apply regarding the necessary proof of the claim. Where the net amount is positive for the insolvent party, as a rule the solvent party must pay the insolvency estate.

31. However, parties may have agreed on a clause that allows a non-defaulting party which is 'out of the money' to refuse payment to the defaulting party ('walk-away clause'). The background of such clauses is that a defaulting party should not benefit from its own default. However, not all jurisdictions permit such clauses because of their effect on systemic stability. There is a regulatory debate on whether they should be valid in the event of insolvency of the defaulting party. As this issue is not immediately linked to the enforceability of close-out netting provisions, it falls outside the scope of the Principles.

#### Automatic or elective operation of the close-out netting mechanism

32. Depending on the specific contractual agreement, close-out netting either occurs automatically, by operation of the contractual agreement ('automatic termination', which is not allowed in a number of jurisdictions), or it may occur at the discretion of the party which is not the party to which the predefined event relates.

33. The extent to which the non-defaulting party should be able to wait for a period of time or for an indefinite period of time to exercise its rights to close-out is currently under discussion among market participants and regulatory authorities, particularly where the defaulting party is in resolution or insolvency. One concern is that a non-defaulting party which is "out of the money" can choose not to terminate and exercise close-out in order to avoid making a payment to the defaulting party. Several different courts with jurisdiction over recent cross-border insolvency proceedings of large financial institutions have come to different conclusions on this issue. Close-out netting provisions employing either elective or automatic termination are covered by these Principles. However, these Principles do not address the issue of whether a non-defaulting party may wait for a period of time or for an indefinite period to exercise its rights to terminate and net on a close-out basis.

## **Principle 2: Definition of 'eligible party'**

### **2. "Eligible party" means**

- a) a person other than a natural person,**
- b) a partnership or unincorporated association (whether or not its membership includes natural persons), and**
- c) any other person designated as an eligible party under the law of the relevant State.**

### Key considerations in respect of this definition

- The definition of eligible party determines and restricts the scope of these Principles, in conjunction with the definition of eligible obligation. Therefore, the application of these Principles to a legal relationship between two parties depends on whether both are eligible parties, and, *cumulatively*, whether the relevant legal relationship represents an eligible obligation.
- The definition of eligible parties, as a criterion for determining the personal scope, should be shaped in a broad and comprehensive manner. One of the main issues to be taken into account is consumer protection. Many jurisdictions apply specific measures with a view to protecting consumers. National legislators/regulators shall determine the extent to which the application of these Principles is compatible with the relevant consumer protection policy.
- Other restrictions regarding the personal and material scope (apart from excluding consumers) frequently exist in national law; these are both highly diverse and difficult to categorise conceptually from an international point of view. The key question appears to be whether a certain kind of *business* should be able to be included within the ambit of netting. From the point of view of international compatibility, this issue would be best tackled in a precise and consistent manner by restricting the definition of eligible obligations, while leaving the definition of eligible parties as broad as possible.

### Explanation and commentary

#### Paragraph (a)

34. *Paragraph (a)* covers the greater part of all parties contemplated by these Principles. It follows the key consideration that the personal scope of these Principles should be as broad as possible, given that it is well-nigh impossible properly to classify the different types of actor in the financial market.

35. In particular, professional actors in the financial market, such as banks and securities firms, will usually be organised in a form other than that of a natural person. They are covered by *paragraph (a)*.

36. Commercial firms such as airlines, energy dealers, producers of chemical industrial goods, *etc.*, are likewise covered. They use derivative contracts for hedging purposes on an ongoing basis. Such contracts typically contain netting clauses.

37. Public law entities are also covered to the extent that they are 'persons', *i.e.*, that they have legally recognised personality. This includes States and their divisions, including central banks. Moreover, more or less independent bodies of public law with legal personality are likewise included such as municipalities as well as agencies that are constitutionally independent from the



state. Furthermore, entities created under public international law, in particular intergovernmental organisations, are also covered.

Paragraph (b)

38. The inclusion of the term 'unincorporated associations' guarantees that organisations such as universities, religious associations, football clubs, etc. are covered, since they may participate in the financial market to a considerable extent.

39. It should be noted that it is quite easy in many jurisdictions to form such unincorporated associations or partnerships and for them to be given some legal recognition, with few formalities required. This includes associations of natural persons which, if acting as individuals, would fall within the remit of *paragraph (c)*. The fact of being associated and of entering into those contracts enumerated in draft Principle 3 places such groups of individuals within the scope of these Principles.

Paragraph (c)

40. This paragraph reflects the policy considerations raised by the possible participation of individuals in financial market transactions. States may decide

- not to apply these Principles to individuals at all,
- to apply these Principles only to restricted classes of individual such as professionals and other sophisticated or high-net-worth individuals,
- to apply these Principles to restricted classes of individual and in respect of certain types of contract into which these individuals may enter,
- to apply these Principles to individuals only to the extent that they contract with a counterparty falling within the ambit of *paragraphs (a)* or *(b)*.
- Such a decision will generally be made within the overall framework of the relevant state's rules and policy on the protection of individuals in general and of consumers in particular.

41. This paragraph aims to cover persons commonly referred to as 'natural persons' (*cf.* also the negative use of that definition under *paragraph (a)*). However, the Principles intentionally do not use this term in *paragraph (c)* in order to avoid confusion with the category described under *paragraph (b)*. Natural persons organised in a partnership or an association and acting as such fall within *paragraph (b)*, although many jurisdictions would still regard them as natural persons in legal terms. As a consequence, *paragraph (c)* covers natural persons acting individually, or 'individuals'.

42. Unincorporated entrepreneurs (merchants) are covered by *paragraph (c)* even where they engage in business usually conducted by incorporated companies. As a consequence, they fall within the scope of the netting principles only if and to the extent that they are designated as eligible parties under the law of the relevant state.

**Principle 3: Definition of 'eligible obligation'**

**3. "Eligible obligation" means an obligation arising under one of the following contracts -**

**a) derivative instruments,**

*'derivative instrument' means an option, forward, future, swap, contract for differences or other transaction in respect of a reference value that is, or in the future becomes, the subject of recurrent contracts in the derivatives markets.*

**b) repurchase agreements, lending agreements and margin loans relating to securities, money market instruments and units in collective investment schemes,**

**c) title transfer collateral arrangements,**

**d) contracts for the sale, purchase or delivery of**

**1.- securities**

**2.- money market instruments**

**3.- units in a collective investment scheme**

**4.- currency of any country, territory or monetary union**

**5.- gold, silver, platinum, palladium, or any other precious metal**

**6.- any other fungible commodity,**

*'Fungible commodity' means a commodity that is or in the future becomes the subject of recurrent contracts in the spot, forward or derivatives markets.*

**e) any other type of contract designated to that effect under the relevant law,**

**f) agreements under which a party undertakes (whether by way of surety or as principal debtor) to perform obligations assumed by another person under any agreement referred to in paragraphs [a] to [e].**

**Key considerations in respect of this definition**

- From the perspective of the purely legal mechanisms involved, netting is possible in respect of all mutual contractual relationships the value of which can be expressed in an amount of currency. However, in the event of default of one of the parties, netting offers special treatment of the non-defaulting party in relation to the insolvent's general creditors. Therefore, there need to be elements justifying a contractual relationship being covered by a netting provision. There are three such elements.
- *Single relationship*: contracts entered into on the understanding that each as a practical matter affects the others should be covered. (i) A first such case is the quasi 'natural' category of transactions in which the single relationship is directly implied. For example, swaps or repurchase transactions are entered into on the understanding that the mutual rights and obligations (which are legally distinct from each other) within a single transaction cannot be separated by the parties and should not be looked at separately in the event of one of the parties becoming insolvent (*i.e.*, no cherry picking should apply in relation to only one leg of these transactions). (ii) In a second category of cases, this single relationship is wider and created contractually by the parties. However, given that close-out netting leads to special treatment in the event of insolvency, this contractual single relationship can only be established where there are good objective reasons to deal with a multitude of contracts on a collective basis. The main reasoning here is that it is more efficient for parties to monitor and manage their mutual risk exposure on the basis of an overall assessment of all contracts outstanding between them.

- *Rapid changes of value*: A second justification for applying close-out netting to certain of the parties' mutual rights and obligations stems from the fact that the volatility of the value of certain financial transactions would expose parties to considerable market and credit risk which they would have difficulty managing if they were not allowed to terminate such transactions upon the occurrence of one of the pre-defined termination events, in order to determine gains and losses and to re-hedge their portfolio. Any stay on termination imposed by (in particular) insolvency law would lead to the contractual close-out rights being delayed. Rapid and significant changes in the contract value during this time might expose the non-defaulting party to a multiple of the anticipated counterparty and market risk which cannot be hedged any more in an appropriate way.
- *Systemic risk*: A third justification is the avoidance of systemic risk. This element flows partly from the second justification. In deteriorating market conditions, the ability to terminate contracts and thus to limit exposures is important in guarding against the situation where the failure by one of the parties to perform its obligations causes its counterparty likewise to become unable to perform its obligations *vis-à-vis* third parties.

### Explanation and Commentary

#### General

43. The term 'contracts' is understood in a broad sense and also includes contracts that might be categorised as 'commercial' contracts. It is impossible to make a neat distinction between financial contracts, on the one hand, and commercial contracts, on the other hand. For instance, futures and forwards are both used by industrial and commercial companies to hedge price swings in relation to raw materials, *etc.* Application of these rules to contracts entered into by energy traders, airlines and similar businesses would be beneficial as these face similar exposures to rapid price swings as face financial firms.

#### Paragraph (a) – Derivative instruments

44. The term 'derivative instrument' describes a contract the value of which depends on a reference value. The reference value can consist of rates or indices, or of any other measure of economic value, or of factual events. In today's markets, the reference value usually consists of a rate, yield, price or index relating to interest rates, currencies, transferable securities, money market instruments, commodities, precious metals, credit risk, energy, emissions, economic or monetary statistics, actuarial or other insurance-related data, meteorological data, freight forward rates, bandwidth or property. However, other reference values are also conceivable.

45. Derivative instruments will typically fulfil all three criteria (*cf.* key considerations, *supra*) for inclusion into the list of contracts. First, two typical financial market participants like banks, merchant banks, funds, insurance companies, *etc.* will always regard the multitude of their open derivative instruments with each other as one single relationship. The risk monitoring and assessment will be done by the parties on an aggregate basis.

46. Derivative instruments also pass the test of the second criterion, *i.e.* exposure to considerable market and credit risk. They are often highly volatile transactions with rapid and significant price movements. Rapid price movements combined with large outstanding counterparty credit exposures and transaction volumes also pose the threat of systemic risk (third criterion).

47. Financial markets subdivide derivatives contracts into a number of categories, notably options, forwards, futures, swaps, contracts for differences, and their respective subcategories. The boundaries between these categories are not always clear-cut. Moreover, the list of derivatives categories can never be exclusive, in view of the need to cater for future market developments and differences in categorisation. Therefore, the underlying consideration is that these Principles apply

to all derivatives covered by the definition in the preceding paragraph, regardless of which category market practice may attribute to them.

48. Derivatives can be either physically settled or cash settled. Both are included within the scope of these Principles.

49. For the purpose of these Principles, it is immaterial whether the relevant contracts are entered on-exchange or off-exchange, or whether they are settled 'over-the-counter' or through a clearing mechanism or central counterparty (*n.b.* that in the latter cases, a bilateral close-out netting provision between the central entity and the system participant emerges, *cf. supra paragraph 19*).

Paragraph (b) – Securities repurchase agreement, securities lending and margin loans

50. *Paragraph (b)* covers three methods of securities financing: sale and repurchase agreements, securities lending agreements, and margin loans.

51. A repurchase agreement is a combination of two processes simultaneously agreed upon between the same parties: first, the sale and outright transfer of an asset (*e.g.* a bond), and second, the subsequent repurchase and re-transfer of that same asset at a slightly higher price. This type of agreement is usually driven by cash needs, *i.e.*, in functional terms, it has the same effect as a secured cash loan. The cost of financing (reflected, under a loan agreement, by the payment of interest) is here expressed in the price difference between the sale and repurchase legs of the transaction.

52. Securities lending entails that the securities are made available to the counterparty with a simultaneous agreement to retransfer or return them, or equivalent securities, at a predetermined point in time. The borrower must provide collateral (*e.g.* in the form of cash) to the lender for the duration of the arrangement. Securities lending is mostly driven by the borrower's need for a certain type of securities.

53. In functional terms, the mutual flows of assets are identical for both types of transaction. Both types consist of a pair of reciprocal transactions. Although in both cases, each separate transaction could be regarded as legally independent, neither a repurchase agreement nor a securities lending agreement should be at risk of unbundling in an insolvency procedure. Therefore, a repurchase or a securities lending agreement *per se* fulfils the first element of justification mentioned above (single relationship, first case).

54. In much the same way, under a margin loan money is advanced by a bank to its customer to purchase financial instruments on condition that the bank can subsequently regard these financial instruments as collateral securing the loan. Again, the two prongs of such arrangements are (i) a flow of cash in one direction, and, (ii) the provision of rights over securities (collateral) in the other direction. The collateral can be provided under a title transfer arrangement or a non-title transfer arrangement (*cf. paragraph (c), infra*), *i.e.*, depending on the arrangement, ownership of the securities is transferred to the bank.

55. Where two parties have a multitude of repurchase, securities lending and margin lending agreements, these are usually closely interconnected as the cash and collateral flows are managed on an aggregate basis rather than separately. As a consequence, there is an objective reason for the parties to cover their mutual exposures flowing from these types of transaction by a close-out netting provision (single relationship, second case).

Paragraph (c) - Title transfer collateral arrangements

56. There are title-transfer collateral arrangements and non-title transfer collateral arrangements. They differ as to their nature and the analysis as to whether they are suitable to be included in a netting provision differs accordingly.

57. One type of collateral arrangement involves traditional security agreements such as pledge or charge. These are characterised by the fact that they are proprietary in nature and both the collateral provider and the collateral taker have proprietary interests in the encumbered asset. In particular, the collateral provider will usually retain legal title to the asset. This type of arrangement is not generally susceptible to close-out netting as commonly understood, since a proprietary interest cannot be combined with a claim of a monetary character. However, where both close-out netting and a traditional security interest apply under the parties' agreement, close-out netting operates under exclusion of the security interest. Rather, the security interest, in a second logical step, secures the net amount.

58. Under a title transfer collateral arrangement, full legal title is passed to the collateral taker and the collateral provider receives a claim for transfer of the identical sum or asset at a later stage (*cf.* also *paragraph (b)*). No property interest is retained on the provider's side. As a consequence, the valuation and inclusion in the net amount of both legal positions are possible because there are claims for retransfer on both sides (a claim for repayment/retransfer of the value of the transaction, and a claim for retransfer of the collateral).

59. An important hybrid category is the non-title transfer collateral arrangement which includes a right of use. In these cases, the relevant law permits parties to agree, generally or in effect, that the proprietary right may, under a non-title transfer collateral arrangement, be replaced, at the election of the collateral taker, by a right to the return of identical or equivalent assets. This is the case, in particular, where the agreement, sanctioned by the relevant law, permits the collateral taker to use the encumbered asset for its own purposes, in particular to 'rehypothecate' it, and subsequently to return not the *same* asset but an *equivalent* one. In this instance, the residual property interest originally vested in the collateral provider may cease to exist in this instance and is replaced by a contractual claim for re-transfer or the equivalent thereof. In other words, the use of the encumbered asset by the collateral taker for its own purposes transforms the legal characteristics of a non-title transfer collateral interest into an interest equivalent to that of a title transfer collateral arrangement. As a consequence, again, there are claims on both sides (*cf.* preceding paragraph). Therefore, such an arrangement is capable of being included in a netting provision.

60. As is the case with repurchase agreements and securities lending agreements, the separate obligations which constitute a title transfer collateral agreement (and a non-title transfer collateral agreement including a right of use) should not be at risk of being unbundled by the insolvency law (single relationship, first case). Likewise, collateral is managed on an aggregate basis. For this reason, a multitude of collateral arrangements between two parties should also be capable of being included in the scope of close-out netting.

61. It is important to note that repurchase, securities-lending as well as title transfer-collateral agreements are collectively managed and monitored from the perspective of counterparty risk. Because of the functional convergence of these types of transaction, there is good reason to do so. Therefore, it makes sense to cover all transactions falling into one of these three categories by a netting provision between two parties.

*Paragraph (d) – Contracts for the sale and delivery of certain assets*

62. *Paragraph (d)* relates to contracts for the sale and delivery of certain assets against payment in so far as they are not covered by the definition of derivative instruments, in particular futures and forwards. For example, on the spot market, prices are agreed and paid immediately whereas delivery occurs within a time frame of less than one month. A typical example is the spot market for crude oil.

63. The relevant contracts are regularly entered into on the basis of a single relationship, and are subject to the same type of credit risk and change in value as other types of eligible obligation. In addition, they may be subject to settlement risk.

Paragraph e) – Other types of contract

64. A State may decide to include other types of contract in the list, which means that the obligations flowing from such a contract would be eligible for inclusion in a close-out netting provision. The question of whether loans and deposits should be included is particularly relevant. However, there might be other types of contract which States may decide to include.

65. The inclusion of loans and deposits in the list of contracts is controversial because a number of reasons speak for their inclusion whereas other aspects advise against. From the outset, the discussion has not been about 'consumer' deposits and loans, as individuals are generally excluded from the scope of these Principles (they can be included only at the election of the national legislator, *cf.* Principle 2).

66. Loans and deposits are closely related to one another from a functional perspective. Both are technically an advance of money (the principal) by one party to another, entailing a promise to return the principal at some point. Both generally, but not necessarily, carry the obligation to pay interest. A more superficial difference concerns the parties' motivation. It is assumed that a borrower accepts the principal from the lender in order to satisfy its own funding needs, whereas the depositary rather takes the role of safe-keeper of the money in the depositor's interest. However, in practice, banks' traditional sources of financing have been their clients' deposits, a fact which rather blurs that distinction. From a functional and legal point of view, therefore, loans and deposits are akin to one another. From a regulatory point of view, on the other hand, deposits enjoy specific protection, most particularly the circumstance that traditionally, only licensed credit institutions ('banks') are able to take deposits.

67. It might be argued that neither loans nor deposits pose a particular risk or a threat to systemic stability that can be best prevented by the application of close-out netting. They are not necessarily subject to rapid changes in value and the volatility of markets. They are not used for hedging but rather for funding and they are not traded in large volumes. However, a number of factors suggest that the inclusion of loans and deposits might be worth considering in certain circumstances.

- Loans mainly consist of a transfer and retransfer of cash. This functionality is identical to the cash leg of a number of transactions used by banks and central banks, notably repurchase agreements, securities-lending agreements and cash-title transfer collateral agreements. The latter are all undoubtedly within the scope of close-out netting. Carving out loans generally would mean that a clear distinction would have to be made between (ineligible) loans and the cash leg of the aforementioned (eligible) transactions. This might be difficult, particularly in a cross-jurisdictional situation, and thereby create legal uncertainty and provoke regulatory arbitrage. On the other hand the presence of a non-cash leg in the eligible transactions might substantially mitigate the potential uncertainty and arbitrage.
- Banks regularly post deposits with and give loans to one another. Such deposits might be very short term and thus as a funding source be quite volatile as volumes might change from day to day according to the relevant needs and because they are often provided in different currencies. Such arrangements expose the parties to credit risk and market (currency) risk. Banks might wish to calculate their mutual risk exposure flowing from these operations on a net, rather than a gross basis.
- Central banks take deposits from banks (in fulfilment of their minimum reserves policy) and extend loans to banks (in the framework of their monetary operations). A central bank will have an interest in being able to manage the risk exposure to each of the relevant banks on a net basis, *i.e.*, in being able to apply close-out netting. Therefore, many central banks apply close-out netting to such loans and deposits.

- Furthermore, the phenomenon of ‘cash-pooling’ benefits from close-out netting. Cash pooling occurs where member companies of the same group manage their cash reserves collectively. Typically, the positive credit balance of one member of the group is made available to any others members that are in need of cash, through a common master cash account held by the parent company. A deposit (alternatively: loan) arrangement comparable to a revolving account facility exists between each member of the cash pool and the parent company, under which mutual repayment obligations are expressed as a net credit balance. Legally, mutual payment obligations are not settled until the member in question exits the cash pool arrangement (despite the fact that the current exposure is expressed as a net balance). However, the parties would not enter into such agreement if their exposure were not limited to the net exposure in the event of the counterparty’s insolvency. If the insolvency administrator were able to cherry-pick those deposits/loans that were favourable to the insolvent estate, and if it could at the same time set aside those that were unfavourable, the risk to the solvent party would be considerably increased.

68. On the other hand, there are arguments against making loans and deposits eligible for close-out netting. In addition to the reasons articulated above:

- including loans and deposits would mean that that part of a bank’s balance sheet that was subject to close-out netting would be considerably increased.
- excluding deposits and loans from the scope of application of close-out netting would not necessarily mean that set-off was equally excluded. Many of the aforementioned arguments put forward in favour of the eligibility of loans and deposits for close-out netting could probably be addressed by set-off.

Paragraph (f) – Surety agreements

69. This paragraph ensures that not only the (direct) parties to one of the contracts enumerated in draft Principle 3 fall within the scope of these Principles but also third parties that promise to perform on the obligation of another of the parties to that contract. The most prominent of such arrangements are guarantee and indemnity arrangements or letters of credit, or other types of personal surety that may exist in different jurisdictions and regardless of the wording employed.

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

**4. The law should not make the creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of a close-out netting provision dependent on the performance of any formal act, but the law may require that a close-out netting provision shall be evidenced in writing or any legally equivalent form.**

**5. The law should not make the creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of a close-out netting provision dependent on the use of standardised terms of specific trade associations.**

**6. To the extent that the law requires data relating to contracts covered by a close-out netting provision to be reported to a trade repository or similar organisation for regulatory purposes, a failure to comply with that requirement should not affect the creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of the contracts and the close-out netting provision.**

### Key considerations in respect of these Principles

- Formal requirements that impinge on the legal enforceability of close-out netting provisions have considerable potential to create legal uncertainty in a cross-jurisdictional context. Accordingly, the enforceability of close-out netting provisions should not depend on requirements such as prior registration with a public register or notarisation.
- The enforceability of close-out netting should not depend on the use of standard documentation so as to allow for tailor-made close-out netting provisions and framework agreements, for individual changes to existing standard documentation or for market-led changes of standard documentation itself. The regulatory framework may impose restrictions in this regard; however, these must not hamper enforceability in commercial and insolvency law terms.
- The reporting of data in relation to certain financial transactions to trade repositories and similar organisations is an important feature of the supervisory framework. However, non-compliance with the duty to report such data should not entail the non-enforceability of the relevant contracts and the close-out netting provision which covers them.

### Explanation and commentary

70. The effect of non-compliance with formal requirements (in the broadest sense) needs to be considered carefully. Where such non-compliance entails invalidity or unenforceability of a contract, the legislator should always have regard to the fact that *both* parties to a contract are affected by this consequence. The effect of a considerable number of contracts and/or a close-out netting provision being unenforceable can pose a significant risk to one or both of the parties. In particular in cross-jurisdictional situations, at least one of the parties might be taken by surprise by that consequence. Thus, where the rules on formalities aim at promoting safe and sound market conditions, unenforceability will undermine rather than promote these objectives, and it might be better to settle for other enforcement measures, such as fines, personal liability of staff, withdrawal of license, *etc.*, which can be imposed without creating additional legal uncertainty for the counterparty.

### Principle 4

71. For the above reasons, in a cross-border context, any formal requirements other than writing (or equivalent forms) appear to create additional risk. There are two strands of such potential risk.



72. First, there is the general risk that, in a cross-border context, formal requirements other than writing are liable to be misunderstood or mishandled from an operational point of view. Such requirements might be overlooked, in particular as it cannot be excluded that different laws may be applicable within a single bundle of contracts covered by a netting provision. The necessary steps might not be carried out simply because of practical difficulties such as language requirements.

73. Second, even if formal requirements are initially complied with under the first law, any possibility of transferring a close-out netting provision (including the contracts covered) to a new, foreign entity would be in jeopardy since it is unlikely that the law of the acquirer would require compliance with exactly the same formal steps.<sup>10</sup>

- This aspect is particularly relevant where a holding company re-integrates with a hitherto legally independent foreign subsidiary, in which case all contractual agreements entered into by the subsidiary would from that point on be subject to a different insolvency law, *i.e.*, the law applicable to the parent company. It is unclear whether a contract transferred in this manner would be upheld in the event of the parent company's insolvency if the formal requirements regarding the close-out netting provision differed.
- It is equally relevant in the context of bank resolution powers, which usually include the possibility of transfer, by regulatory order, of part or all of a bank's business to a second (solvent) bank. If the receiving second bank is subject to a different insolvency law, and if that law imposes formalities on close-out netting provisions, it is very unlikely that the formalities (if any) under which the close-out provision was originally entered into would suffice.

74. The registration of close-out netting provisions (and in some cases, the obligations covered by them) is required in certain jurisdictions as a condition for the creation, validity, enforceability, effectiveness against third parties, or admissibility of the close-out netting provision. In some cases, this requirement has a deterrent function against fraud, *e.g.*, to exclude fraudulent backdating of close-out netting provisions prior, but close to insolvency. However, this means that all domestic and foreign parties, including those acting in good faith and in the absence of any fraudulent behaviour, as well as in the absence of insolvency of one of the parties, would be hit by the unenforceability of the netting provision as a consequence of non-compliance with the registration requirement, *e.g.*, due to a simple operational mistake. This situation might potentially create great legal uncertainty, and this is why registration should not be linked to the unenforceability of the netting provision. However, there is nothing in these Principles to prevent courts from sanctioning fraudulent behaviour occurring prior, but close to insolvency: Principle 7 leaves open the possibility for the insolvency law to treat netting provisions as unenforceable as a consequence of fraudulent behaviour (*cf.* Principle 7(c)(iv)).

#### Principle 5

75. Another issue is the tension between netting provisions contained in a standard master agreement and agreements between parties that wish to customise the close-out netting provision. If jurisdictions were to protect the enforceability of netting provisions only where the latter are included in standard documentation, individual amendments would imperil enforceability.

76. However, the relationship between two financial institutions can be quite an elaborate one and call for the master agreement to be customised to some degree. It is impossible to harmonise the extent to which such changes should be admissible, simply because there are too many different, individual situations. Hence, the concept of only protecting the enforceability of netting provisions that are part of standard documentation is not appropriate, especially not in a cross-jurisdictional context.

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<sup>10</sup> *Cf.* Doc. 2, p. 37 (Example 7), p. 71 (Example 17).

Principle 6

77. In attempting to render the derivatives market more transparent, many jurisdictions have recently introduced or are about to introduce a duty to report data (parties, volume, type of transaction, date) relating to certain types of standardised derivatives to a trade repository. This measure serves prudential/supervisory purposes. It should not be made a condition for a contract's capability of being included in a close-out netting provision, since the underlying motivation is not the same. Additionally, the legal consequences are different: failure to report as such, in the supervisory context, does not produce risk but will merely entail fines or similar sanctions. Should reporting be a prerequisite for the enforceability of the netting provision, any non-compliance would actually *create* risk, since it would endanger enforceability in situations which the parties (and possibly also their regulator) might not have anticipated since the failure will in most cases be a consequence of unintentional operational failure. This result would be clearly disproportionate and dangerous.

**Principle 7: Enforceability of close-out netting**

**7. The law should ensure that a close-out netting provision is enforceable in accordance with its terms, before and after the commencement of an insolvency proceeding in relation to one of the parties. Without limiting the generality of the foregoing –**

- a) The law should not impose enforcement requirements beyond those specified in the close-out netting provision itself.**
- b) A close-out netting provision should remain enforceable even if one or more of the obligations covered are, and remain, unenforceable or ineligible.**
- c) If an insolvency proceeding in relation to one of the parties has been commenced,**
  - i. the insolvency administrator or court should not be allowed to demand from the other party performance on only some of the obligations covered by the close-out netting provision, while repudiating the remaining obligations;**
  - ii. the operation of the close-out netting provision should not be stayed;**
  - iii. the operation of the close-out netting provision should not be impaired on grounds that such operation or the mere fact of entering into such provision violated the principles relating to the equal treatment of creditors;**
  - iv. a close-out netting provision and any of the obligations covered by it should not become unenforceable solely on the ground that it was entered into during a prescribed period before, or on the day of but before, the commencement of the proceeding.**

**Key considerations in respect of this principle**

- The enforceability of close-out netting provisions often conflicts with a number of insolvency law rules. This Principle aims at protecting close-out netting provisions from the effect of the application of these rules.
- Close-out netting provisions shall be enforceable between the parties and against third parties, including the insolvency administrator and the general insolvency creditors, if applicable, of the defaulting party.
- However, close-out netting is not shielded against every rule of commercial or insolvency law. The demarcation between those legal rules that should not apply to close-out netting and other legal provisions that should continue to apply requires careful consideration. As a general rule, the sole fact of entering into a close-out netting provision should not cause the application of insolvency avoidance rules. However, if a situation involves qualifying elements (for example, fraud *vis-à-vis* other creditors), the relevant insolvency tools (avoidance, *actio pauliana*) should continue to apply.
- For purposes of international compatibility, a common standard in this regard is of utmost importance.

**Explanation and commentary****Chapeau**

78. The *chapeau* of this Principle aims at clarifying two aspects.

79. First, it makes sure that the scope of the protection covers non-insolvency situations as well as the insolvency of one of the parties to the netting provision.

80. Second, it is a 'catch-all' provision addressing all statutory rules that could potentially conflict with close-out netting provisions but should not (reservations apply, *cf. infra*).

81. The background of the formula '*before and after the commencement of an insolvency proceeding*' in the *chapeau* is as follows. A close-out netting provision is a bilateral contractual relationship. Outside insolvency, such a netting provision rarely clashes with policy considerations. Therefore, the law has scant reason to prohibit or limit its use. As a consequence, a netting provision will generally be effective and enforceable as between two solvent parties.

82. The role of close-out netting in reducing counterparty and systemic risk becomes dominant in particular in the event of the counterparty's insolvency. However, rules of insolvency law intended to preserve the insolvency estate for distribution to creditors and to ensure equal treatment of the latter are potentially incompatible with essential features of close-out netting. One of the primary purposes of insolvency law is to determine the question of which creditors' claims should be prioritised over other creditors' claims. Insolvency law traditionally provides for tools such as 'cherry picking' and avoidance of contracts to put its insolvency policies into practice (*cf. infra*), and the application of such rules may render close-out netting provisions meaningless. However, the enforceability of close-out netting is crucial both inside *and* outside insolvency. Accordingly, the purpose of the *chapeau* is to make clear that the law should protect the enforceability of a close-out netting provision throughout its lifetime and in both situations.

83. For the purpose of these Principles, the understanding of which 'insolvency' procedures should accommodate close-out netting should be very broad, *i.e.* the law governing a great variety of different procedures is targeted by these Principles. Reference is made to Article 1(h) of the Geneva Securities Convention<sup>11</sup>: "*insolvency proceeding*" means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation. Both judicial and administrative proceedings are covered, aiming at either liquidation or reorganisation.

84. Consequently, the definition also covers the newly developed 'resolution regimes for financial institutions', as described in the relevant document of the FSB.<sup>12</sup> Under such procedures, a national authority (typically the central bank or the financial services authority, or both) takes appropriate measures in respect of a financial institution that is no longer viable, such as, in particular, transferring the failed firm's assets and liabilities to a bridge institution, overriding shareholders' rights, conducting a 'bail-in', *etc.* It follows from FSB Key Attribute 4.1 that, first, the legal framework for close-out netting during a crisis should be clear and that netting should be enforceable. Accordingly, these Principles should, in general, also apply to administrative procedures aiming at the resolution of financial institutions. Second, however, close-out netting should not hamper the effective implementation of resolution measures: in particular, the early termination of large volumes of assets under close-out netting provisions has the potential of undermining the effectiveness of the authority's measures since such termination might occur before the appropriate measures can be taken. That is why the FSB document requires, in its section 4.3, that the regulator be given the right temporarily to stay early termination and acceleration rights. This exception to Principle 7(c)(ii) is addressed separately in Principle 8.

85. The wording '*enforceable in accordance with its terms*' is the core idea of these Principles. It relates to the challenge posed to close-out netting provisions by some quasi-universally recognised legal rules. The best example is probably the insolvency administrator's right to 'cherry

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<sup>11</sup> UNIDROIT Convention on Substantive Rules for Intermediated Securities, adopted in Geneva, on 9 October 2009.

<sup>12</sup> *Cf.* Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.

pick' (*cf. infra*), but there are others. However, the diversity of legal systems and of the rules within them makes it very difficult to find a general, international formula that precisely describes which insolvency or commercial law rules and principles cause problems. Such a description is possible only in relation to the most obvious rules, which are here captured under *paragraphs (a)-(c)*. However, as close-out netting provisions are embedded in commercial and insolvency law in much the same way as any other contract, many other legal obstacles are capable of rendering a close-out netting provision unenforceable. These are potentially numerous, but difficult to describe.

86. An important reason for this is that close-out netting is a new concept as yet not properly addressed in many jurisdictions, thereby forcing the courts to seek analogies to deal with this new matter.

87. A telling example of a conflict that might hamper the enforceability of close-out netting would be its assimilation to statutory set-off rights under commercial law and the resulting application of the requirements for set-off to close-out netting. Despite the fact that statutory set-off is more limited than close-out netting, in the absence of any clarifying legal rule courts and insolvency administrators might apply its requirements in analogy to close-out netting provisions, thus potentially distorting the enforceability of close-out netting. In particular, (i) set-off traditionally applies only to obligations that are due; (ii) set-off traditionally applies only to obligations flowing from the same agreement, or that are very closely connected to each other; (iii) set-off applies only to payment obligations or obligations of the same kind. As these requirements will rarely be complied with by a close-out netting provision, there is a real risk that it will be stayed or declared invalid.

88. Similar impediments to the enforceability of close-out netting provisions might stem from their perceived similarity to such known concepts as, for example, novation, and the subsequent application of the enforceability requirements of a novation agreement to a close-out netting provision. However, as analogies like these are probably very diverse, there is a need for a 'catch-all' rule. This is why the *chapeau* prescribes that close-out netting, as defined in functional terms in Principle 1, should be generally enforceable.

89. It is obvious, though, that close-out netting provisions would never be allowed to trump certain other fundamental rules, such as the rules relating to misrepresentation and fraud to the detriment of the counterparty, its creditors or the insolvent estate. In certain cases, the distinction may be quite difficult to make (*cf. in particular paragraphs (c)(iii) and (iv), infra*). This is why in *paragraphs (a)-(c)* this Principle sets out the most typical challenges to close-out netting provisions stemming from general insolvency and commercial law rules that should be disapplied in order to guarantee the enforceability of close-out netting.

90. It is worth noting that there are legal rules specifically intended to supersede close-out netting provisions, in particular rules applicable in the context of bank resolution. These are addressed in Principle 8.

#### Paragraph (a) – Additional enforcement requirements

91. Whereas Principle 4 deals with the formalities required to contractually conclude a valid and enforceable close-out netting provision, the present Principle 7(a) relates to additional conditions for the *enforcement* of a close-out netting provision. The practical value and effect of close-out netting would be significantly diminished or even rendered void if the law were to impose formal, procedural or other specific requirements as conditions for the enforcement of close-out netting provisions that went beyond those that the parties might have contractually agreed. In particular, the requirements traditionally imposed on the realisation of security interests such as pledges, charges and mortgages should not be made to apply to close-out netting. Such specific requirements may include, for example,

- prior notice to the defaulting party that the close-out netting provision may be put into operation;

- approval of the terms of the realisation or operation of the close-out netting provision by a court or other public authority; or that
- the realisation be conducted by public auction or in any other prescribed manner; or that
- the close-out netting provision be operated in a legally prescribed manner; or that
- the close-out netting provision be subject to the requirements that may apply in the context of enforcing set-off.

92. It should be noted, however, that since the parties' contract is based on contractual freedom, they are free to include any of the above or similar requirements in the close-out netting provision, if they so wish.

Paragraph (b) – Non-enforceable/ineligible obligation included

93. Another group of potential obstacles to the enforceability of netting provisions relates to the obligations covered. One or several of the obligations covered might flow from a particular type of contract which is ineligible or unenforceable. Since the close-out netting provision and all the obligations to which it applies are often regarded as *one* contract, general principles of commercial law could hamper the enforceability of the bundle as a whole. This might endanger the enforceability of the netting provision as a whole, *i.e.*, with respect to all remaining obligations. A better solution would be to exclude from the netting mechanism only specific ineligible or non-enforceable contracts once they have been identified.

94. A contract is ineligible if it is not of a type listed above in Principle 3. Ineligible contracts should simply be severed from the bundle of obligations covered by the close-out netting provision and continue their separate lives, whereas the remainder of the obligations can be netted.

95. Even if in principle eligible, a contract can be unenforceable for various reasons. A prominent case relates to wagering or gaming prohibitions which might apply in relation to certain derivatives transactions in certain jurisdictions. Unenforceable contracts should remain unenforceable and simply be severed from the bundle of obligations covered, whereas the remainder of the bundle of obligations covered by the close-out netting provision can be netted.

96. It is important to stress that this rule does not interfere with the question of whether the *single* obligation is ineligible or enforceable under the applicable law.

Paragraph (c)(i) – Cherry picking

97. In an insolvency proceeding, the insolvency administrator or court may have the right to 'cherry pick' from the insolvent party's non-performed contracts. This means the right to require any counterparty to perform those contracts that are favourable to the insolvent estate while repudiating those that are unfavourable to it.

98. If it were possible to cherry pick among a netting set, the bundle of contracts would be disassembled and the solvent party would be required to perform all the contracts that were unfavourable from its perspective, whereas the insolvency administrator would not perform the favourable contracts – ultimately, the solvent party would be exposed to the full counterparty risk.

99. Cherry picking is essentially contrary to the characteristics of a single relationship set out *supra* (*cf.* key considerations in respect of Principle 3). Furthermore, cherry picking disproportionately increases the counterparty risk for the non-defaulting party. Therefore, it should not be available to the insolvency administrator.

100. Those jurisdictions that accommodate close-out netting tend to solve the conflict between cherry picking and enforceability of netting provisions by disallowing the selection of isolated obligations but giving the insolvency administrator the right to decide whether the parties are required to perform on *all* obligations covered by the close-out netting provision or whether the

entire bundle of obligations covered is to be repudiated – in which case the close-out netting provision applies and all obligations will be terminated.

101. The same principles apply where close-out netting provisions and their underlying obligations are again bundled by an 'umbrella' close-out netting provision (in practice, several master agreements are bundled by a 'master-master agreement'). The insolvency administrator should not be allowed to require performance on just one of them.

Paragraph (c)(ii) – Stay

102. Insolvency rules often impose a stay on all transactions with the insolvent estate as from the moment of the commencement of the proceeding. Such a stay would traditionally also inhibit the operation of set-off. The reasoning is that further outflow of assets must be stopped and the insolvency administrator given the right to repudiate all unfavourable contracts. However, a stay imposed on the close-out netting of eligible obligations leads to a situation in which it becomes impossible effectively to manage the credit *and* market risk associated with the bundle of obligations covered. During the stay, their value might fluctuate considerably and cause much greater potential damage to the solvent party than would have occurred had termination been possible at the moment of insolvency. Furthermore, from a conceptual angle, a stay appears unnecessary because the insolvency administrator should not have the right to choose among the unperformed contracts (no cherry picking, *cf. supra*).

103. Principle 8, *infra*, addresses an important exception to this rule, accommodating the temporary stay of termination and acceleration rights necessary in the context of resolution of financial institutions, *cf. also paragraph 84, supra*.

Paragraph (c)(iii) – No conflict with equal treatment of creditors

104. This paragraph suggests that the domestic law should not impair the operation of a close-out netting provision on the grounds that such operation, or the mere fact of entering into such a provision, violated the principles relating to the equal treatment of creditors of the insolvent estate by favouring one creditor to the detriment of the other creditors.

105. First, this rule is particularly relevant because the effects of a close-out netting provision often occur at the moment of opening the insolvency proceedings, or shortly before. Therefore, a conflict with the so-called 'anti-deprivation' principle might arise. This principle prohibits any contractual agreement containing a condition precedent to transfer assets from the insolvent estate to another party upon the opening of insolvency proceedings.

106. Second, this Principle addresses the concern that the mere inclusion of a close-out netting provision in the contractual documentation might be regarded as fraud to the detriment of other creditors of the insolvent estate. In the absence of any qualifying facts, the conclusion of a close-out netting provision is neutral, as it is not clear which party, if any, will default. Furthermore, at the time when they enter into the close-out netting provision, parties do not know who will be 'in the money' or 'out of the money' at any given point in time in the future.

107. However, the domestic law can impair the operation of a close-out netting provision should there be qualifying elements, going beyond the *mere* fact of entering into the close-out netting provision. Such qualifying facts can consist, in particular, of the parties' knowledge of the imminent insolvency of one of their number at the time they entered into the close-out netting provision.

Paragraph (c)(iv) – Suspect periods and zero-hour rules

108. National insolvency laws often contain rules avoiding (or allowing the administrator or court to avoid) transfers, payments and provision of collateral which have occurred during a prescribed period prior to insolvency. Such a period is either defined as a fixed period prior to the

commencement of insolvency proceedings (*e.g.*, the three months preceding the date of commencement), or it can be defined by the insolvency court, counting, in particular, from the point in time when the over-indebtedness or similar indicator first occurred. The reasoning for such rules is to increase the pool of assets available for distribution amongst general creditors and to avoid unjustified preference of one or more creditors over the remaining creditors by 'clawing back' the relevant payments or property.

109. Neither the close-out netting provision nor any obligations covered by it should be subject to such avoidance rights.

*In relation to the close-out netting provision*

110. In some jurisdictions, there might be uncertainty as to whether entering into a close-out netting provision during the suspect period belongs to that category of situations. Therefore, there is a risk that an insolvency administrator or court would attempt to halt, avoid or otherwise render unenforceable a close-out netting provision entered into during the suspect period.

111. However, parties cannot know at the time when they enter into a netting provision which of them, if any, might subsequently default. Equally, they cannot know which party will be 'in the money' at the time of the potential default of one of the parties. Thus, entering into a close-out netting provision is neutral from the outset and equally beneficial or disadvantageous to the risk carried by both sides. Hence this situation is different from receiving payments or property or taking new or additional collateral which decreases the credit risk of only one of the parties. As a result, entering into a close-out netting provision should not be subject to avoidance merely on the grounds that it took place before insolvency proceedings commenced.

*In relation to the obligations covered*

112. The present principle also covers the obligations covered by the close-out netting provision. As a consequence, no obligation should be subject to avoidance solely on the grounds that it was entered into during the subject period.

113. The reasoning behind this Principle is that the insolvency administrator would typically avoid only those obligations that fall within the suspect period and are favourable to the solvent party. The result would be comparable to that described above (*cf.* Principle 7(c)(i) – 'cherry picking'). As a consequence, the solvent party would be burdened with a considerably increased credit risk which could not be foreseen at the time of entering into the contract.

*Zero-hour rules*

114. For the same reason, the enforceability of close-out netting provisions should not be impaired by the application of 'zero-hour rules', *i.e.*, rules that by way of legal fiction bring forward the commencement of insolvency proceedings to 0:00h of the day of the decision to open them.

*Safeguard against fraud, misrepresentation, etc.*

115. The above applies only to the extent that there are no other qualifying elements present (*cf.* the wording 'solely on the grounds that'). As a consequence, and in accordance with Principle 7(c)(iii), the law remains free to determine the consequences of fraud, misrepresentation and intentional granting of advantages to one creditor to the detriment of the other creditors.



### **Principle 8: Exception in respect of resolution of financial institutions**

**8. Principle 7(c)(ii) is without prejudice to any legal rule that provides the competent authorities with the power, in the exercise of their resolution powers in respect of financial institutions, temporarily to stay contractual acceleration or termination rights that might arise under a close-out netting provision.**

***This exception applies solely to acceleration and termination rights which arise simply because of the entry of the financial institution into resolution or in connection with the exercise of any resolution powers, and to the extent that such stay does not affect the enforceability of acceleration or early termination rights not related to the entry into resolution.***

#### Key considerations in respect of these Principles

- The Principles shall assist shaping domestic legal rules on close-out netting which also accommodate the special resolution regime for financial institutions as developed by the Financial Stability Board.<sup>13</sup>
- The first aspect is that the legal framework governing close-out netting should be clear and transparent and that close-out netting should be enforceable also after a resolution procedure has been started. This aspect is covered by Principle 7.
- The second aspect is that close-out netting should not hamper the effective implementation of resolution measures. In particular, the competent authority should have, under certain conditions and to a certain extent, the right to delay the operation of a close-out netting provisions by means of stay of the termination or acceleration rights occurring under such provision. As such a right would go contrary to Principle 7(c)(ii) there need to be an express exception. This is the purpose of the Principle 8.
- The exception as described in Principle 8 shall be strictly oriented at and shall be interpreted in the light of FSB Key Attributes 4.1-4.4.

#### Explanation and commentary

116. The Principles ensure enforceability of close-out netting provisions – including after the commencement of a resolution procedure in relation to a financial institution (*cf.* Principle 7, *para* 84, *supra*). Consequently, stays on close-out netting would, as a rule, not be allowed. However, the Cross-border Bank Resolution Group<sup>14</sup> has shown that the unrestricted exercise of termination rights at the occasion of the entering of a financial institution into resolution proceedings, in particular the simultaneous close-out of high volumes, have the potential of harming the competent authority's aim of orderly resolving the relevant institution.

117. The FSB, in Key Attribute 4.3 and the relevant Annex IV, has set a standard for such exceptional stays. This standard guarantees the general reliability of close-out netting despite the possibility to impose a stay, in particular by requiring that –

- the stay may only relate to termination and acceleration rights arising as a consequence of entry into resolution or in connection with the exercise of any resolution powers. Consequently, close-out netting triggered by the default of one of the parties is upheld and not subject to such stay; and

<sup>13</sup> *Cf.* Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.

<sup>14</sup> Bank for International Settlements/Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, Recommendation 9, p. 40 *et seq.*

- the stay shall be limited in time (e.g. 24-48h).

118. Reference is made to Annex IV to the FSB Key Attributes for further detail.