The Unidroit Principles on Close-out Netting

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The Unidroit Close-out Netting Principles

• 8 Principles with Commentary
• 2 sessions Governmental Conference
• Adopted March 2013
• 26 States + EU
• ECB + WB + BIS + IMF + EBRD + UNCITRAL + Hague
• Industry observers
• Preparations: Study Group (4 sessions), incl. Regulators, Practice, Academia, Fin. Industry
Mission:
Improve enforceability and legal certainty

The Principles
- Policy background
- Concept and architecture
- Some details
Why does the world need them?

THE POLICY BACKGROUND
What is the purpose of the Principles?

Domestic view
- Netting-friendly law
- Liquidity / Safety
- Guidance

International view
- 2 or more jurisdictions
- Netting is sometimes unsafe
- Harmonisation
- Benchmark
What is the purpose of the Principles?

Domestic view

• Jurisdictions adopt netting friendly laws
  – Attractiveness of their financial market
  – Basel II: net risk means less capital is blocked as underlying capital and collateral
  – Close-out netting unavailable means close-out netting makes own financial institutions less attractive

• Netting friendly means that close-out netting works reliably.

• The Principles provide guidance on what it exactly needs to be ‘netting friendly’.

• They are non-binding on jurisdictions.
What is the purpose of the Principles?

International view

- If a jurisdiction is netting-friendly, close-out netting works reliably in purely domestic situations.
- As soon as international elements are present (parties or their branches in different jurisdictions) insolvency proceedings could be opened in different jurisdictions.
- If the netting-agreement is geared towards the law of one jurisdiction, it might be unenforceable should insolvency occur in the other jurisdiction because the law may be different.
- Purpose 1: harmonisation of a number of fundamental parameters so that it becomes easier to comply with the law of all jurisdictions where insolvency proceedings could potentially be opened.
- Purpose 2: the principles serve as an international benchmark used by the financial industry and regulators.
Who is the addressee/beneficiary?

Legislators and regulators

Financial industry
Addressee/beneficiary?

• Primary addressees are legislators wishing to make their laws netting-friendly. The Principles provide guidance.

• National and international regulators can use the principles as benchmark in the process of determining whether close-out netting used by the industry is legally robust in a given jurisdiction or cross-border.
Addressee/Beneficiary?
Are they industry-friendly?

• Yes ... but ...

• Yes – because the consolidation and harmonisation of standards of ‘netting-friendliness’ makes cross-jurisdictional close-out netting easier, cheaper and safer.

• But – the scope of close-out netting is not widened (as wished by the industry) as compared to an aggregate view of pre-existing netting-friendly regimes.

• Provides best practice legislative standard on the basis of current legal frameworks.
## Main policy decision

<table>
<thead>
<tr>
<th>Scope of close-out netting</th>
<th>Definition of close-out netting</th>
<th>Relation to insolvency</th>
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</thead>
<tbody>
<tr>
<td>• Within the confines of aggregate existing legal frameworks</td>
<td>• Functional and neutral</td>
<td>• Pari passu: netting <em>alone</em> is not a preference</td>
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<tr>
<td>• Certain types of parties entering certain types of contracts</td>
<td>• Not tied to standard master agreements</td>
<td>• No cherry picking</td>
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<td>• No stay (except bank resolution)</td>
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</table>
How do the Principles look like?

BASIC CONCEPT AND ARCHITECTURE
Close-out netting is a Risk Mitigation Tool.

Risk materialises at the moment of insolvency and crisis.

Close-out netting agreements must be ENFORCEABLE.
<table>
<thead>
<tr>
<th>Principle 2</th>
<th>Principle 3</th>
<th>Principle 4</th>
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</thead>
<tbody>
<tr>
<td><strong>What mechanism exactly?</strong></td>
<td><strong>Who shall benefit?</strong></td>
<td><strong>Which transactions?</strong></td>
</tr>
<tr>
<td><strong>Definition close-out netting</strong></td>
<td><strong>Definition eligible parties</strong></td>
<td><strong>Definition eligible transactions</strong></td>
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Principles on enforceability

Privilege

Valid against 3rd parties

Pari passu etc?
### The 4 Principles on enforceability

<table>
<thead>
<tr>
<th>Principle 5</th>
<th>Principle 6</th>
<th>Principle 7 (rule-exception)</th>
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<tbody>
<tr>
<td>Certain typical contract law threats</td>
<td>Certain typical insolvency law mechanisms</td>
<td>Shall not hamper enforceability</td>
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<td>Formal requirements</td>
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SOME DETAILS ON ...
Personal and material scope

• Principles 3 and 4 intertwined
• Always in:
  – ‘Qualifying financial market participants’
  – Public authorities
• Other corporations when contracting with the aforementioned
• ... when entering into certain standard financial contracts (4.1.a), etc.
• Options for States to widen scope
  – In relation to non-financial corporations
  – In relation to other types of contracts
• Comparable to EU Financial Collateral Directive
Enforceability in insolvency

• Principles 7

• Generally disapplied:
  – Insolvency stay (7.1-a)
  – Cherry picking (7.1-b)
  – Avoidance for preferences (7.1-c)
  – Zero-hour and suspect period rules (7.1.d)

• BUT: *actio pauliana* etc survive! (7.2)
Bank resolution powers

• Principle 8
• Provides that Principle 7 is without prejudice to regulatory stay and similar measures in the context of bank resolution
• Includes a reference to regulatory work (FSB Key Attributes)
• *Dynamic* reference