

Netting Sub-Committee
of the
Companies and Securities Advisory Committee

Netting in Financial
Markets Transactions

Final Report

June 1997

Netting Sub-Committee

This Final Report has been prepared by the Netting Sub-Committee of the Companies and Securities Advisory Committee (the Advisory Committee). This expert Sub-Committee was established under the auspices of the Advisory Committee to review and make recommendations on the law concerning netting of transactions in financial markets. The Advisory Committee has approved the publication of this Final Report, in conjunction with its Final Report on *Regulation of On-exchange and OTC Derivatives Markets* (June 1997).

Membership

The members of the Netting Sub-Committee are:

Chairman

Bob Austin, Minter Ellison

Members

Brenda Berkeley, Federal Treasury
David Clifford, Allen Allen & Hemsley
Bob Daley, Oakvale Capital Ltd
Rory Derham, National Australia Bank
Tony Dreise, Sydney Futures Exchange
Kenton Farrow, Australian Financial Markets Association
Ian Gilbert, Australian Bankers' Association
Brian Gray, Reserve Bank of Australia
Leigh Hall, Companies and Securities Advisory Committee
Ted Kerr, Mallesons Stephen Jaques
Nick Korner, Blake Dawson Waldron
Andrew Lumsden, Reserve Bank of Australia
Jim Murphy, Federal Treasury
Malcolm Starr, Sydney Futures Exchange
John Stumbles, Mallesons Stephen Jaques
Ray Terkelsen, National Australia Bank
Ken Williams, Qantas Airways.

The Advisory Committee wishes to acknowledge and thank Bob Austin, Convenor of the Sub-Committee, the drafting sub-committee comprising Bob Austin, David Clifford, Ted Kerr, Malcolm Starr and John Stumbles, and the other members of the Sub-Committee for the considerable time and effort that they devoted to preparing this Final Report.

Overview

This Report proposes the enactment of legislation, as a matter of priority, to clarify the law of netting over a range of financial contracts, including on-exchange and OTC derivatives transactions. The proposed facilitative netting legislation is set out and explained in this Report.

The Netting Sub-Committee published a Draft Report *Netting in Financial Markets Transactions* in November 1996 (the Netting Draft Report), setting out a draft Close-Out and Market Netting Act and explanatory notes on that proposed Act. The Committee received submissions on this Draft Report from:

ANZ Banking Group
Australian Bankers' Association
Australian Stock Exchange
Citibank
Commonwealth Bank
Cravath, Swaine & Moore, New York
Mr M Hains, Attorney
International Banks and Securities Association of Australia
Macquarie Bank
National Australia Bank
Securities Exchanges Guarantee Corporation
Westpac Banking Corporation.

All submissions supported the enactment of a Close-Out and Market Netting Act. The Netting Sub-Committee thanks the respondents for their very useful suggestions on the drafting of that Act. The Sub-Committee closely considered all these views in preparing this Final Report.

This Report is in the following Parts:

- . Part 1: Netting Principles
- . Part 2: Proposed Close-out and Market Netting Act
- . Part 3: Explanatory Notes to the proposed Act.

During the course of its work, the Netting Sub-Committee published a Background Paper *Netting in Financial Markets Transactions* (December 1996) which analysed and discussed law and policy in this area.

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Part 1: Netting Principles

Bilateral close-out netting and market netting

1.1 The Netting Sub-Committee has reviewed the law with respect to bilateral close-out netting and market netting. Bilateral close-out netting is used in such financial markets transactions as currency (foreign exchange) and interest rate swaps. It is a process which permits a party to a financial contract to terminate the contract if the counterparty becomes insolvent, to calculate the termination values of the obligations of the parties, and to set off the termination values so calculated to arrive at a net amount payable by one party to the other. It is extremely important that these netting arrangements are effective under insolvency law.

1.2 Market netting typically arises under the rules of a stock exchange, futures exchange or clearing house. These rules commonly provide for the novation to a clearing entity of contracts entered into by exchange members, and the setting off of obligations under those contracts in the event of default by the member and for the purposes of settlement. Again, it is extremely important that these arrangements are effective in the event of insolvency of a member.

Support for expedited legislation

2.1 In this Final Report, the Netting Sub-Committee recommends legislation, as a matter of priority, to clarify the law of netting over a range of financial contracts not strictly confined to derivatives. The Advisory Committee in its Final Report on *Regulation of On-exchange and OTC Derivatives Markets* (June 1997) para 8.120 also supported the expedited enactment of facilitative netting legislation. Likewise, the Financial System Inquiry supported the introduction of legislation to give legal certainty to the netting of financial transactions (*Financial System Inquiry Final Report* Recommendation 59). Industry respondents to the Netting Draft Report also strongly supported the early introduction of netting provisions.

2.2 The Reserve Bank of Australia (RBA) has indicated that the passage of legislation along the lines of the proposed Close-Out and Market Netting Act will resolve its concerns regarding the certainty of close-out netting arrangements. This will enable the RBA to amend its Prudential Statement to recognise bilateral close-out netting for the purpose of calculating a bank's capital requirement (subject to compliance with other prudential requirements).

Need for legal clarity

3.1 The Netting Sub-Committee identified a number of legal issues, not yet clarified by case law, which have been the subject of some debate amongst lawyers. Some experienced lawyers believe that there is no basis for doubting that bilateral close-out netting and market netting arrangements are effective. Nevertheless, in the Netting Sub-Committee's view it is very desirable that the legal position be clarified beyond doubt. This is because of the high value of many of the transactions which are subject

to netting arrangements, and the potentially disastrous consequences of adverse rulings by the courts.

3.2 The thrust of the Netting Sub-Committee's recommendations is to clarify the law governing the validity and effectiveness of netting, as it applies to financial markets transactions. Reform clarifying the law of netting will minimise risks associated with the performance of certain large financial transactions. The reform will therefore make the financial position of Australian financial institutions more secure. It will make it easier for those financial institutions to obtain all the benefits of transactions which are generally regarded as an essential part of sound financial management, such as interest rate and currency swaps and other arrangements which hedge exposures.

3.3 Law reform will not oblige any entity to enter into a financial markets transaction, nor will it prevent directors, shareholders, beneficiaries or other stakeholders from exercising such rights and powers as the law gives them to restrict the financial markets activities of particular entities in which they are interested.

International comparisons

4.1 Many other countries have enacted legislation to clarify their netting laws. By doing so they not only reduce possible risks for parties to netting arrangements, but also remove an impediment to the international competitiveness of their local financial institutions. The Netting Sub-Committee's Background Paper *Netting in Financial Markets Transactions* (December 1996) (the Netting Background Paper) discusses legislative reforms in other countries, particularly in the United States, the United Kingdom and Ireland, while noting that reforms have now been adopted in a significant and growing number of industrialised countries.

4.2 The fact that clarifying legislation has been thought appropriate elsewhere, coupled with a concern that the absence of netting legislation in Australia could affect the international competitiveness of Australian financial institutions, provides a compelling case for legislation.

Legal issues to be clarified

5.1 In the case of bilateral close-out netting, the Netting Sub-Committee identified the following matters that should be put beyond doubt:

- a master agreement for bilateral close-out netting is not contrary to any public policy rule against divestment on insolvency
- a master agreement for bilateral close-out netting can effectively make the alienation of interests under a financial markets contract subject to the netting provisions
- the 'single contract' approach taken in some master agreements for financial markets transactions is effective to prevent the liquidator of a failed counterparty from 'cherry-picking' by disclaiming unfavourable contracts

- amounts payable in a foreign currency can be converted to Australian currency at the rate of exchange applicable at the time of close-out, and non-debt obligations can be converted to debts by being valued at the time of close-out in accordance with the financial markets contract
- ss 11F and 16 of the Banking Act 1959 (Cth), ss 45, 52, 53 and 187 of the Life Insurance Act 1995 (Cth) and s 86 of the Reserve Bank Act 1959 (Cth) do not interfere with bilateral close-out netting under a master agreement
- the appointment of an administrator does not inhibit close-out netting.

5.2 It is very important that the law on each of these issues be clarified beyond doubt. If, for example, the law were to allow the liquidator of an insolvent party to 'cherry-pick' by disclaiming unfavourable contracts and holding the other party to contracts which are favourable, the outcome could be disastrous for the other party. Any risk that this outcome could occur must be taken into account as part of the credit risk process when a financial institution considers whether to enter into a financial contract. The result could be to inhibit contracting and consequently deny counterparties the benefits which can flow from financial contracts such as financial derivatives, even if the apprehended disaster never occurs.

5.3 Broadly similar legal issues affect netting arrangements in market clearing and settlement systems. Additional issues arise because the payments which are to be netted are often payments of different characters, the participants frequently act for undisclosed principals, some market netting arrangements purport to apply to property other than money (for example, securities), and arrangements for taking deposits, margins and other security pursuant to the business rules of the relevant clearing organisation are inevitably imperfect.

Recommended facilitative legislation

6.1 The Netting Sub-Committee therefore recommends the enactment by the Commonwealth Parliament of a Close-Out and Market Netting Act, the substantive provisions of which are set out below. If necessary, there should be complementary State legislation. The legislation would ensure that close-out and market netting provisions would be allowed to operate notwithstanding insolvency of a party to the netting contract, on the basis that recovery of the net sum calculated under the netting provisions would be subject to the normal insolvency rules. The Netting Background Paper further explains the Netting Sub-Committee's reasoning.

6.2 The Netting Sub-Committee has given very close attention to the language of the proposed Act, taking into account all submissions on the Netting Draft Report. It considers that its provisions should be adopted in the legislation.

6.3 The proposed Close-Out and Market Netting Act would also clarify the status of netting arrangements under legislation including the Banking Act, 1959 (Cth), the Life Insurance Act 1995 (Cth) and the Reserve Bank Act 1959 (Cth). The Netting

Background Paper analyses the proposed supplementary legislation covering these matters.

6.4 The proposed Act would apply whenever Australian insolvency law governs the situation.

Other matters

7.1 Some of the legal issues which have been debated with respect to financial derivatives and other financial contracts are not problems about the law of netting. For example, a problem of lack of capacity may arise if a party to a financial contract is a specially constituted entity or an entity whose operations are subject to special restrictions. The Netting Sub-Committee believes that questions of lack of capacity, some of which need to be addressed by State legislation, should be the subject of further review. To assist in that task, the Netting Background Paper includes brief discussions of the capacity of various special entities to make financial contracts.

7.2 There is one question of authority to enter into financial contracts which deserves to be specially mentioned. Some of Australia's most significant financial entities are trusts. Counterparties have difficulty in dealing with trusts in cases where the trust instrument does not clearly give the trustee the power to enter into the transaction, and in cases where (as is very common) more than one trust is involved. The Netting Sub-Committee has devoted a substantial amount of time to considering issues raised by the participation of trusts in financial contracting, but has decided not to make any recommendations for reform in this Final Report. This is because the issues which arise out of dealing with trusts are issues of the law of trusts, rather than issues about netting and set-off as such. The Netting Sub-Committee's judgment is that the law of netting must be clarified by statute as soon as possible, and that the issues which arise for a counterparty when dealing with a trust should be given further consideration. The Netting Sub-Committee recommends that the Advisory Committee should continue to work on the trusts issues. It notes that the Advisory Committee's Final Report on *Regulation of On-exchange and OTC Derivatives Markets* (June 1997) paras 8.95-8.113 discusses the law of ultra vires, as it affects trusts and other entities.

7.3 There is, however, one additional matter which the Netting Sub-Committee believes should be addressed in the proposed legislation. Doubts have been expressed from time to time as to whether financial contracts such as currency and interest rate swaps may be invalidated by State gaming and betting laws. Although the prevailing legal opinion in Australia is that these laws do not invalidate swap agreements, it is clearly desirable that the issue be put beyond doubt. The Advisory Committee's Final Report on *Regulation of On-exchange and OTC Derivatives Markets* (June 1997) recommends that all on-exchange and OTC derivatives transactions should be expressly excluded from gaming and wagering legislation (Recommendation 50). Both the Advisory Committee and the Netting Sub-Committee agree that, if the Government's legislative response to the recommendations in the Advisory Committee's Final Report will be later than the enactment of the netting legislation proposed by the Netting Sub-Committee, this clarifying provision in relation to gaming and wagering should be introduced with the proposed netting legislation.

Part 2: Proposed Close-Out and Market Netting Act

The Netting Sub-Committee recommends the enactment of legislation in the following terms.

Section 1: Substantive provisions

s 1.1 The netting provisions of a netting contract are valid and enforceable by and against the persons bound by the contract, and are effective as between those persons according to their terms.

s 1.2 Without limiting the generality of section 1.1,

- (a) netting provisions of a netting contract under which obligations and rights of the parties are replaced by an obligation of a party to pay a net amount in Australian or foreign currency and a right of a party to be paid that amount, are valid and enforceable and are effective as between the persons bound by the contract; and
- (b) if provisions of a netting contract prohibit the disposal of rights which are or may be subject to netting, or prohibit the creation or operation of encumbrances with respect to such rights, the netting provisions of the netting contract are valid, enforceable and effective to permit netting to occur according to the terms of the netting contract, notwithstanding any disposal or purported disposal of such rights or the creation or operation or purported creation or operation of any encumbrance with respect to them.

s 1.3 Nothing in section 1 may be construed as implying that any contract or a provision of a contract would, but for section 1, be invalid, unenforceable or ineffective.

s 1.4 Nothing in a law of the Commonwealth or a State or Territory about gaming and wagering prevents the entering into of, or affects the validity or enforceability of, a netting contract or a financial contract, whether made before or after the commencement of this Act.

Section 2: Scope

s 2.1 Section 1 overrides the rules of law relating to insolvency, liquidation, bankruptcy, receivership and voluntary administration, other than:

- (a) Part 5.7B Division 2 of the Corporations Law;
- (b) Sections 120, 121 and 122 of the Bankruptcy Act 1966.

s 2.2 The net amount due after applying the netting provisions of a netting contract and any other set-off which otherwise operates, including under the Corporations Law or Bankruptcy Act 1966, is provable as a debt in any liquidation or bankruptcy.

s 2.3 The Banking Act 1959, the Life Insurance Act 1995 and (unless the context otherwise requires) any other rule of law which relates to an asset, entitlement, right, liability or obligation, must be taken to refer, in the case of assets, entitlements, rights, liabilities and obligations to which the netting provisions of a netting contract have been applied, to the net amount calculated after applying the netting provisions of the netting contract, and any other set-off which otherwise operates, including under the Corporations Law or the Bankruptcy Act 1966.

s 2.4 Part 5.7B Division 2 of the Corporations Law and sections 120, 121 and 122 of the Bankruptcy Act 1966 do not affect the validity, enforceability or effect of a market netting contract.

Section 3: Definitions - General

s 3.1 **'Netting'** means close-out netting or market netting.

s 3.2 **'Netting contract'** means a close-out netting contract or a market netting contract, whether made before or after the commencement of this Act.

s 3.3 **'Netting provisions'** means close-out netting provisions or market netting provisions.

s 3.4 **'Obligations'** include monetary and non-monetary obligations.

Section 4: Definitions - Close-out Netting

s 4.1 **'Close-out netting'** means the setting-off, under close-out netting provisions of a close-out netting contract, of financial obligations of persons bound by the contract.

s 4.2 **'Close-out netting contract'** means a contract or master contract (other than a market netting contract) binding two or more persons which contains close-out netting provisions and comprises or relates to one or more financial contracts.

s 4.3 **'Close-out netting provisions'** means provisions dealing with each of the following:

- (a) the termination, on the happening of specified events, of covered obligations for the time being in existence, and
- (b) the calculation of the termination values of those covered obligations, and
- (c) the set-off of the termination values so calculated to arrive at a net amount payable by one person to another.

s 4.4 **‘Covered obligation’** means an obligation to which the close-out netting provisions of a close-out netting contract apply, and includes:

- (a) an obligation to pay money in Australian or foreign currency, and
- (b) an obligation which does not relate to payment,

to which the contract applies, but excludes an obligation acquired from a third party with notice that the obligor is insolvent.

s 4.5 **‘Financial contract’** means:

- (a) a swap contract;
- (b) a futures contract;
- (c) a spot, forward or other foreign exchange contract;
- (d) a cap, collar or floor contract;
- (e) a forward contract (including a forward rate contract);
- (f) a contract for differences;
- (g) a reciprocal or reverse reciprocal purchase contract or a repurchase or reverse repurchase contract;
- (h) a spot, forward or other commodity contract;
- (i) a contract to buy, sell, borrow or lend securities;
- (j) a derivative contract based on any index or reference factor;
- (k) a credit derivative contract;
- (l) an electricity derivative contract;
- (m) an option relating to a commodity, a security or any contract or matter referred to in paragraphs (a) to (l);
- (n) a derivative or combination in respect of, or a contract similar to, a contract referred to in paragraphs (a) to (m);
- (o) a prescribed contract;

where:

- (a) the expressions listed in paragraphs (a) to (o) shall have the meaning which they bear in the financial markets in which those expressions are used, and are not necessarily mutually exclusive;
- (b) the inclusion of any of paragraphs (a) to (o) must not be construed as implying that the matter included would, but for that paragraph, fall outside the definition;
- (c) where a financial contract forms part of a larger contract, close-out netting provisions must be applied as if the only covered obligations in the contract are obligations which arise with respect to that part of the larger contract which would, if standing alone, properly be described as a financial contract.

s 4.6 '**Insolvent**' has the meaning given to that word by the *Corporations Law*.

Section 5: Definitions - Market Netting

s 5.1 '**Market netting**' means the setting off of obligations (including obligations with respect to deposits and margins and the giving of security) under the rules of a market body.

s 5.2 '**Market netting contract**' means a contract which:

- (a) binds persons who, under the rules of a market body, are members of the market body and any other persons who according to the rules are bound by the rules, and
- (b) arises under the rules of the market body, and
- (c) includes market netting provisions.

s 5.3 '**Market netting provisions**' means provisions (including provisions with respect to deposits and margins and the giving of security) of the rules of a market body which relate to the setting off of obligations identified by the rules.

s 5.4 '**Market body**' means a stock exchange, futures exchange or clearing house authorised under the Corporations Law, and a prescribed market body.

s 5.5 '**Prescribed market body**' means a body corporate or an unincorporated body declared by regulations to be a prescribed market body.

Section 6: Regulations

s 6.1 The Governor General may make regulations not inconsistent with this Act prescribing matters:

- (a) required or permitted by this Act to be prescribed, or
- (b) necessary or convenient to be prescribed for carrying out or giving effect to this Act.

Part 3: Explanatory Notes to the Proposed Act

The Netting Sub-Committee sets out the following explanatory notes for the proposed Close-Out and Market Netting Act. All references are to sections of that proposed Act (unless otherwise indicated).

Section 1: Substantive Provisions

s 1.1 This is the principal provision. It is intended to clarify the law relating to close-out and market netting, and in particular to remove doubts about the application of insolvency laws prior to completion of the netting process. Consequently, s 1.1 enables the netting provisions of a netting contract to operate notwithstanding insolvency laws. The special status is given only to the netting provisions of a netting contract, and these terms are defined. The expression 'netting contract' is used rather than 'netting agreement' (the term used in the Irish legislation) to signify the intention that the netting arrangement must be part of a valid contract. If, for example, a particular contract containing netting provisions is void for statutory illegality or is otherwise affected by statutory requirements (for example, by Part 3.2A of the Corporations Law with respect to financial benefits to related parties) and the netting provisions cannot be severed and saved, clause 1.1 will not apply. This outcome is reinforced by clause 1.3.

This provision applies to the netting provisions of a netting contract. It does not refer expressly to netting between master agreements. This additional reference is unnecessary. Prior to insolvency, netting of amounts outstanding between master agreements (those amounts being determined after the application of the close-out netting provisions in each master contract) will be regulated by the contract between the counterparties. Upon an insolvency, the close-out netting provisions of each contract will operate to produce a net obligation. The amount so determined will be provable in a liquidation or bankruptcy (see s 2.2). If, in consequence of the operation of each master agreement, mutual provable claims arise between the counterparties (pursuant to the separate master agreements), those mutual claims would be subject to set-off in an insolvency by virtue of s 553C of the Corporations Law or s 86 of the Bankruptcy Act 1966 (Cth). Furthermore, the set-off between master agreements would operate in respect of claims valued at the time the close-out provision operates, not at the time of the commencement of the winding up.

s 1.2(a) This provision has two aspects. First, it is a more specific application of the principle in clause 1.1, making it clear that the obligation to pay and the right to receive the net amount calculated under netting provisions are effective notwithstanding insolvency law. The second aspect is to make it clear that:

- the legislation will apply whether the obligation to pay which is generated by the netting provisions is an obligation to pay in Australian or foreign currency, and

- the netting provisions to which the legislation refers include provisions for the calculation of termination values where some but not all obligations are expressed in foreign currency and a conversion is needed.

s 1.2(b) This is intended to overcome doubts as to whether netting provisions might be rendered ineffective by an assignment of rights under a contract to which the netting provisions apply.

s 1.3 This clause reinforces the point that the legislation is not intended to alter the current law in relation to contracts except to the extent that it ensures that the netting provisions of a valid and enforceable netting contract are not affected by insolvency law.

s 1.4 This provision is based on ss 778 and 1141 of the Corporations Law, but extends to all netting contracts, including all exchange-traded derivatives and financial contracts in over-the-counter financial markets. The purpose of the provision is to clarify the existing Australian law so that there can be no doubt that State gaming and wagering laws do not invalidate these contracts, whether made before or after the commencement of the Close-Out and Market Netting Act.

Section 2: Scope

s 2.1 The effect is that whenever Australian insolvency law governs the situation, any insolvency laws other than the Australian laws which are specified are overridden, so that the netting provisions are valid, enforceable and effective according to their terms. Thus, for example, s 468 of the Corporations Law, under which a disposition of property after the commencement of winding up may be void, does not invalidate the netting provisions of a netting contract, or any 'disposition of property' which may be involved in the netting process. However, payment by a company of the net amount calculated under those provisions after the commencement of the winding up will be void if s.468 otherwise applies. Similarly, in the case of a company under administration, the netting provisions of a netting contract to which the company is a party are permitted to operate notwithstanding s 437D, but the payment of the net amount may be invalidated by that section if it otherwise applies.

The effect of clause 2.1 should be reinforced by inserting in the Corporations Law a provision which makes it clear that the operation of Chapter 5 is subject to the Close-Out and Market Netting Act.

The provisions of Australian insolvency law dealing with voidable transactions are preserved and are capable of applying when parties enter into a netting contract or covered obligations under a netting contract, in the circumstances specified in the voidable transactions provisions. If a covered obligation is avoided under these insolvency principles, the close-out proceeds on the basis that the avoided obligation is disregarded. If the obligation is avoided after a close-out which has included it, the close-out calculation must be repeated, excluding the avoided obligation.

s 2.2 This provision is intended to confirm the right of proof in respect of the amount arising after applying the netting provisions of the netting contract. The reference to

"any other set-off" enables insolvency set-off to apply prior to the determination of the value of an asset for the purposes of the Banking Act 1959 and any other Acts under s 2.3.

s 2.3 This provision is intended to overcome the risk that the 'assets' to which ss 11F and 16 of the Banking Act refer may not be assets calculated on a net basis after the operation of the netting provisions in the netting contract and any other operative set-off. Similarly, ss 45, 52, 53 and 187 of the Life Insurance Act and s 86 of the Reserve Bank Act operate, by virtue of this provision, on net assets and liabilities after the application of the netting provisions of a relevant netting contract and any other operative set-off.

s 2.4 In the case of a market netting contract, the voidable transactions provisions of Australian insolvency law are overridden, for the reasons given in the Netting Background Paper.

None of the contract definitions ('netting contract', 'close-out netting contract', 'financial contract' and 'market netting contract') requires that the contract be in writing.

A provision should be inserted in the Bankruptcy Act 1966 (Cth) cross-referring to the Close-Out and Market Netting Act.

Section 3: Definitions - General

s 3.1-3.4 The definitions of 'netting', 'netting contract', 'netting provisions' and 'obligations' are self-explanatory. The netting process is defined in terms of the setting-off of obligations, with the consequence that the correlative rights of the parties become rights to performance of the net obligations.

Section 4: Definitions - Close-Out Netting

s 4.1 'Close-out netting' is defined to refer, specifically, to the setting-off under the relevant netting provisions, rather than to the whole process of termination, valuation and close-out. The expression 'close-out netting provisions' refers to the provisions of the contract which cover the full process.

'Close-out netting' is defined by reference to the financial obligations of the parties, in contrast with market netting, which can involve the set-off of non-monetary obligations. However, the covered obligations to which close-out netting provisions refer need not be obligations to pay money - the definition applies where the initial obligation is of any kind, provided that the close-out netting provisions include provisions for valuation of the obligation in monetary terms and the set-off of that value against other values calculated under those provisions.

s 4.2 The definition of 'close-out netting contract' is confined to financial contracts, which are also defined. It includes master contracts. Although the principle underlying the legislation is clarification of the law of market and close-out netting as a whole, it is thought appropriate to confine the legislation with respect to close-out

netting to the field of financial contracts. This is to ensure that the reform does not have any unexpected impact in another area of the law in ways which might be amenable to manipulation.

‘Close-out netting contract’ is defined as a contract binding two or more persons. The Netting Sub-Committee has taken the view that it is unnecessary to limit the expression to contracts between only two persons (compare the Irish Netting of Financial Contracts Act). The fact that, for example, a guarantor may be a party to the contract should not prevent it from satisfying the definition.

The definition excludes a market netting contract, as the provisions governing bilateral close-out netting and market netting are intended to be mutually exclusive.

The definition says nothing about the capacity in which the parties enter into the contract. This has several aspects. If a party to a netting contract lacks the corporate capacity to make the contract (like the local authority in *Hazell v Hammersmith & Fulham London Borough Council* [1991] 2 WLR 372), nothing in the Close-Out and Market Netting Act will save the contract from the consequences of that lack of capacity. Secondly, if a party to the contract is a trustee who has entered into it in breach of trust, the consequences of the breach of trust are unaffected by the Close-Out and Market Netting Act. The netting contract is valid but the counterparty’s access to the trust assets and the personal assets of the trustee will be determined by the law of trusts.

The Close-Out and Market Netting Act will override rules of law relating to the insolvency of a trust, as well as rules of law relating to the insolvency of a trustee. The netting provisions will operate according to their terms whether or not some of the covered obligations relate to the trustee party as trustee of one trust, while other covered obligations relate to the trustee party as trustee of another trust. If the trustee party has entered into the netting contract without the authority to set off all of the covered obligations to which the netting provisions relate, the trustee is in breach of trust but the netting provisions are effective. Consequently the question whether trust assets are available to the counterparty will depend on the law of trusts (and in particular, the law governing a creditor’s right of subrogation to the trustee’s rights of indemnity and recoupment out of trust assets).

The Close-Out and Market Netting Act will not override the principles of the law of trusts according to which a person dealing with a trustee may become liable as a constructive trustee for knowingly assisting the trustee in a breach of duty or for receipt of trust property with notice of a breach of trust. Under the Close-Out and Market Netting Act, the netting provisions of a netting contract are effective as between the persons bound, but beneficiaries may have a claim under the law of trusts to hold the trustee’s counterparty liable as a constructive trustee. In an appropriate case, the netting contract itself might be set aside on equitable principles.

Similarly, where a party contracts as agent (common in the case of market netting and not unusual in the case of close-out netting contracts), the netting provisions are effective according to their terms and any claims which a third party (such as a client) may have cannot disrupt the operation of the netting provisions. Sometimes whether

an agent or the principals for whom the agent is acting are liable will depend on the general law of agency, including rules relating to disclosed principals and those relating to disclosed but unnamed principals and undisclosed principals. However this will not disrupt the operation of the netting provisions, unless the netting contract itself is not enforceable.

s 4.3 The definition of ‘close-out netting provisions’ is central to the scope of the Close-Out and Market Netting Act so far as it relates to close-out netting, for the reasons explained in the Netting Background Paper. The definition requires provisions dealing with the calculation of termination values. A device of the kind used in *Ex parte Mackay* (1883) 8 Ch App 643 would not fall within the definition because it would not reflect any attempt to calculate the true termination value of the obligation under consideration.

s 4.4 ‘Covered obligation’ is defined broadly, to encompass monetary obligations arising under a financial contract such as an interest rate or currency swap, or a market contract such as a purchase or sale of securities or of a futures contract, and other obligations such as an obligation generated by the netting provisions of a netting contract. Since the definition of ‘financial contract’ extends to a master contract and the definition of ‘covered obligation’ is otherwise very broad, the Close-Out and Market Netting Act will apply to ‘super-netting’ under a master netting contract. The definition also clearly extends to obligations to pay money in foreign currency, and to non-monetary obligations such as the obligation to deliver commodities under a commodity derivative contract or securities under a stock market contract. The ‘obligations’ to which the definition applies may include contingent obligations.

The exclusion of an obligation ‘acquired from a third party with notice that the obligor is insolvent’ is intended to prevent a party to a close-out netting contract from buying in debts with a view to setting them off against its obligation under the netting contract, in circumstances where the counterparty is or is newly insolvent.

s 4.5 The definition of ‘financial contract’ is intended to have the legislation, so far as the legislation concerns close-out netting, operate in relation to swaps and other over-the-counter derivatives and financial contracts in over-the-counter financial markets.

Section 5: Definitions - Market Netting

s 5.1 As with close-out netting, ‘market netting’ is defined to refer to the setting off of obligations. The set-off must be under the rules of a market body, and therefore the legislation will apply only where the set-off is achieved under rules authorised under the Corporations Law. Market netting can occur where the rules novate market contracts to a clearing entity, to which deposits and margins are paid and security is provided. Where the rules require the set-off of deposits and margins and the realisation and set-off of securities, those set-offs are covered by the legislation.

s 5.2 Typically the rules will bind members of the market body either contractually or (if made in or under the constitution of the market body) by virtue of the statutory contract under s 180 of the Corporations Law, or in other cases by virtue of other

provisions of the Corporations Law (for example, ss 777 and 779F). The observations made at s 4.2 above with respect to the capacity and authority of contracting parties (including corporate capacity, authority in the case of a trustee, and authority as an agent) also apply to clause 5.2.

There is no market netting contract unless the contract binds members of a market body, in any of the ways described above. However, if that criterion is satisfied the market netting contract may extend to parties other than members of the market body (for example, non-broker participants in the case of the Securities Clearing House Business Rules), and consequently the market netting provisions are effective with respect to every person who is, according to the rules, bound by the rules of the market body. However, the market netting contract would not extend to others (such as clients of members of the market body) unless the rules expressly so provide.

s 5.3 The defining characteristic of ‘market netting provisions’ is that they are provisions in the rules of the market body relating to set-off obligations.

s 5.4 The definition of ‘market body’ makes it clear that the special exemption from insolvency law given in the case of market netting provisions is confined to cases where the rules are made by a regulated body such as a stock exchange, futures exchange or securities or futures clearing house.

Section 6: Regulations

s 6.1 Clauses 5.5 and 6.1 make it clear that regulations may extend the class of market bodies. It may be appropriate, for instance, to extend the class of market bodies to include international clearing arrangements such as ECHO (the Exchange Clearing House).