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Close-out Netting in Private International Law

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GENERAL CHARCTERISTICS OF THE RESEARCH

Relevance of the thesis topic. The thesis is dedicated to close-out netting in international private law. Close-out netting is treated as a concept that emerged in international financial market in recent decades[1]. Being the key component of market economy, financial market is defined as the sum of markets for various type of assets – from securities to cryptocurrencies[2]. Its objective is the turnover of capital between its participants[3]. The obligations on financial markets may arise between the parties that belong to the same jurisdiction while the main emphasis in the research work is made in this research shall me made on the studies of netting relations in the international segment of financial market.

Close-out allows to settle the obligations under financial transactions within insolvency or other events connected, in broad terms, with the decrease of payment ability of one of the parties to such transactions[4]. Notwithstanding the possibility to carry out close-out netting during the exchange trading sessions (for instance, in case of insolvency or withdrawal of license of a trading participant) the main attention is attracted to the provisions on close-out netting present in standard framework (master) netting agreements. In the first place, it applies to the agreements published by the *International Swaps and Derivatives Association* (hereinafter – "ISDA") which make the golden standard of contractual regulation in the market for derivative financial instruments[5]. Moreover, an important subject of

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[1] Concept (*conceptio* in Latin) is a specific method of understanding or interpretation of certain subject, phenomenon, process, main point of view on a subject or the idea for their systematic survey, See: Philosophic Encyclopedic Dictionary / chief editor L. F. Ilichev, et al. M.: Soviet Encyclopaedia, 1983. P. 278. [Filosofskij enciklopedicheskij slovar' / gl. red. L. F. Il'ichev i dr. M: Sov. Enciklopediya, 1983. S. 278.]

[2] Financial market is formed by the capital market, commodities market, money market, market for derivative financial instruments, futures markets, currency market, cryptocurrency market, spot market and the market of interbank loans [Electronic resource] available at URL: https://en.wikipedia.org/wiki/Financial_market (date of access: 31.05.2022).

[3] *Molyneux Ph., Valdez S.* An Introduction to Global Financial Markets, 6th ed. Plagrave Macmillan, Chippenham and Eastbourne, 2010. P. 3.

[4] The term settlement (*uregulirovaniye*) with respect to close-out netting was used by T.Yu. Safonova and in our opinion is quite useful for providing a general introduction into the topic *Safonova T.Yu.* Close-Out Netting as a Way of Settlement of Obligations under Derivative Financial Instruments // Business Law. 2016. No. 1. P. 17.

[5] Article-by-article Commentary to the 2011 Model Conditions of the Agreement on Term Transactions in Financial Markets / Edited by L.I. Vil'danova, R.N. Murovec, N.D. Chugunov //

legal analysis is represented by the contractual standards made by the *International Capital Markets Association* (hereinafter – "ICMA") and *International Securities Lending Association* (hereinafter – "ISLA").

Such agreements will be further referred to as the standard master netting agreements characterized by the presence of three features – firstly, they assume continuous application, secondly, their publication is made by professional associations active in international financial markets, and., thirdly, they contain provisions on at least one type of netting. The research covering the activities of professional associations in the area of preparation of such agreements represents a tradition rooted in the international private law[6]. Having said that, the relevance of the thesis topic is determined by the following factors:

1. the publication of UNIDROIT Principles for the Operation of Close-out Netting Provisions in 2013 (hereinafter – "2013 UNIDROIT Close-out Netting Principles") which have not been considered in domestic jurisprudence within a broader context of the international standards in the field of close-out netting regulation as well as the new piece of model legislation in the area made by ISDA with the issuance of the latest version of ISDA Model Netting Act (hereinafter – "ISDA MNA").

2. the change of regulatory paradigm with respect to derivative financial instruments which on macro level lead to the transition to centralized clearing and wide implementation of the use of financial collateral in transactions involving derivative financial instruments, and on micro level resulted in the transition from

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M.: Statut, 2021. P. 13. [Postatejnyj kommentarij k Primernym usloviyam dogovora o srochnyh sdelkah na finansovyh rynkah 2011 / Pod redakciej L. I. Vil'danovoj, R. N. Murovca, N. D. Chugunova// M.: Statut, 2021. S. 13.]

[6] Back in 1968 K. Schmithoff devoted a publication to standard contracts and general conditions. In the publication the scholar gave two features of standard contracts – written form and preliminary publication See: *Schmitthoff C. M.* The Unification or Harmonisation of Law by Means of Standard Contracts and General Conditions // The International and Comparative Law Quarterly. 1968. Vol. 17. No. 3. P. 551. B. Goldman refers to the standard publication documentation activities of one of professional associations (*International Corn Trade Association*) as a basis for the existence of contemporary *lex mercatoria* See: *Goldman B.* Frontieres du droit et lex mercatoria [Electronic resource]. Available at URL: https://www.isda.org/a/USiDE/netting-isdaresearchnotes-1-2010.pdf (date of access: 31.05.2022).

limitless functioning of close-out netting provisions of standard master agreements to limiting the possibilities for netting with respect to financial institutions for the purposes of achieving financial stability.

3. constant development of the domestic legislation in the field of close-out netting functioning amidst insolvency and the necessity to evaluate the existing tendencies in Russian regulation in that domain from international standards compliance perspective.

4. existence of multiple publications in foreign legal scientific literature devoted to close-out netting including those containing a critical approach on the privileges and immunities provided to financial transactions within the insolvency proceedings by setting out exceptions from otherwise imperative rules of insolvency laws.

5. enormous volume of financial transactions including transactions involving derivative financial instruments and securities repurchase agreements which leads to the necessity of risk mitigation via various means including close-out netting.

6. existence of foreign case law (mostly produced by English courts) which requires analysis and is aimed at filling the gaps existing in close-out netting provisions present in the standard master netting agreements and their court interpretation.

7. involvement of the Russian Federation as a state as well as Russian legal entities as private law subjects into relations in the international financial markets which is expected to be present in the coming years.

Degree of scientific elaboration. A constant interest of Russian legal scholars to standard master netting agreements existed throughout the 2000s especially with respect to ISDA Master Agreement[7]. While it is impossible to

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[7] See, *e.g., Burkova A.Yu.* Framework Agreements: International and Russian Law Practice // Vestnik Arbitrazhnoy Praktiki. 2015. No. 6. P. 58-62; Efimova L.G. Framework (Organizational) Contracts on Over-the-Counter Interbank Securities Market // Laws of Russia: Experience, Analysis, Practice. 2006. No. 7. P. 46-53. [*Efimova L.G.* Ramochnye (organizacionnye) dogovory na vnebirzhevom mezhbankovskom rynke cennyh bumag // Zakony Rossii: opyt, analiz, praktika. 2006. No. 7. S. 46-53]; *Lvov A.* ISDA Master Agreement Type of Contract (General Agreement ISDA) // Banking Law. 2001. No. 2 P. 50-55. [*L'vov A.* Soglashenie tipa ISDA Master Agreement

imagine standard master netting agreements as well exchange trading without the mechanism of netting, this fact served as the factor for Russian publications solely devoted to netting to appear. Among those articles by A. Burkova[8] (*А. Буркова*), M.N. Grekov[9] (*М.Н. Греков*), V.V. Dragunov[10] (*В.В. Драгунов*) and A.L. Komolov (*А.Л. Комолов*) are especially worth mentioning[11]. Theses authored by L.A. Garslian (*Л.А. Гарслян*)[12] и V.N. Lipovtsev (*В.Н. Липовцев*)[13] represent an valuable source of knowledge with respect to financial transactions and netting. Besides, the topic of close-out netting is partly covered in monographic works. In particular, monograph by A.V. Shamraev (*А.В. Шамраев*)[14] and collective monograph prepared by the employees of the Institute of Legislation and Comparative Law (the author of respective chapter – T.P. Lazareva (*Т.П. Лазарева*))[15].

(General'noe soglashenie MASD) v praktike rossijskih bankov // Bankovskoe pravo. 2001. No. 2. S. 50-55]; *Khabarov S.A.* General (Framework) Agreements at the Financial Derivatives Market// Jurist. 2015. No. 6. P. 4-8.

[7] *Burkova A.Yu.* Close-out Netting // Law and Economics. 2011. No. 4. P. 10-12; *Burkova A.* Legal Fundamentals of Netting // Banking Law. 2010. No. 2. P. 7-8.

[8] *Burkova A.Yu. Close-out Netting // Law and Economics. 2011. No. 4. P. 10-12; Burkova A. Legal Fundamentals of Netting // Banking Law. 2010. No. 2. P. 7-8.*

[9] *Grekov M.N.* Legal Nature of Netting in the Derivative Contracts // Actual Problems of Russian Law. 2015. № 2. P. 84-91.

[10] *Dragunov V.V.* Unilateral and Contractual Set-off: Russian Practice and International Experience // Law and Economics. 2003. No. 11. P. 62-66.] [*Dragunov V.V.* Odnostoronnij i dogovornyj zachet: rossijskaya praktika i mezhdunarodnyj opyt // Pravo i ekonomika. 2003. No. 11. S. 62-66.]

[11] *Komolov A.L.* Closeout Netting in Russia: The Concept, Meaning and Implementation Procedure // Finansovoe pravo. 2020. № 11. P. 34-37; *Komolov A.L.* Liquidation Netting In The Russian Federation: Legal Structure And Development Of Legal Regulation // Russian Justice. 2020. № 11. P. 5-8.

[12] *Garslyan L.A.* Legal regulation of the OTC derivatives market in Russia, the USA and the European Union (EU): Candidate of legal science thesis. M., 2019. [*Garslyan L.A.* Pravovoe regulirovanie rynka vnebirzhevyh proizvodnyh finansovyh instrumentov v Rossii, SSHA i Evropejskom soyuze (ES): Dis. … kand. yurid. nauk. M., 2019.]

[13] *Lipovcev V.N.* Lex Mercatoria on International Financial Market: Candidate of legal science thesis. M., 2013. [*Lipovcev V.N.* Lex mercatoria na mezhdunarodnom finansovom rynke: Dis. … kand. yurid. nauk. M., 2013.]

[14] International and Foreign Financial Regulation: Institutions, Transactions, Infrastructure: Monograph in 2 parts / edited by A.V. Shamraev. M.: KNORUS, CIPSiR , 2014. 640 p. [Mezhdunarodnoe i zarubezhnoe finansovoe regulirovanie: instituty, sdelki, infrastruktura: monografiya: v 2 ch. / pod red. A.V. SHamraeva. M.: KNORUS, CIPSiR, 2014.]

[15] Certain Types of Obligations in International Private Law / edited by V.P. Zvekov. M.: Statut, 2008. 602 p. [Otdel'nye vidy obyazatel'stv v mezhdunarodnom chastnom prave / pod red. V.P. Zvekova. M.: Statut, 2008. 603 s.]

However, the topic of close-out netting received the level of development in the works of foreign scientists. The German doctrine is represented by such researches as M. Benzler, O. Böger, M. Böhm, P. Werner, Ph. Paech, C. Paulus, G. Reiner, S. Rauch and F. Fuchs. As for academics from the United Kingdom of England and Wales, the works published by J. Benjamin, G. Yeowart, P. R. Parsons, and Ph. Wood are particularly worth noting. The problems of close out-netting were also considered by researchers from the United States of America such as R. Bliss, P. Kaufmann), V. Jonson, S. Wasser and A. Hudson.

The theoretic basis of research is composed by the works of domestic and foreign scientist in the field of private international law (V. Asoskov (*А.В. Асосков*), K.P. Berger, A. Briggs, M.M. Boguslavskij (*М.М. Богуславский*), J. Collier, G. van Galster, G.K. Dmitrieva (*Г.К. Дмитриева*), A.N. Zhil'cov, I.S. Zykin, N.Yu. Erpyleva (*Н.Ю. Ерпылева*), E.V. Kabatova (*Е.В. Кабатова*), A.S. Komarov (*А.С. Комаров*), V.A. Kanashevskij (*В.А. Канашевский*), A.A. Kostin (*А.А. Костин*), M.V. Mazhorina (*М.В. Мажорина*), S.N. Lebedev (*С.Н. Лебедев*), L.A. Lunts (*Л.А. Лунц*), P. P. Rogerson, P. Stone.

Empiric base of research consist of two components. Firstly, in light of the growing significance of contractual regulation of international commercial operations[16] the dissertation contains the analysis of 1992 ISDA Master Agreement (Multicurrency – Cross Border) (hereinafter – “1992 ISDA MA”)[17] and 2002 ISDA Master Agreement (hereinafter – “2002 ISDA MA”)[18]. As an empiric base of research the provisions Global Master Repurchase Agreement (hereinafter – “GMRA”)[19] prepared by ICMA and Global Master Securities Lending Agreement

[16] The growth of civil law agreements significance which form the international commercial operations of economic subjects is evidenced by N.G. Vilkova See: *Vilkova N.G.* Contractual Law in International Turnover M.: Statut, 2004. P. 116. [*Vilkova N.G.* Dogovornoe pravo v mezhdunarodnom oborote. M.: Statut, 2004. S. 116.]

[17] [Electronic resource]. Available at URL: // URL: https://www.isda.org/book/1992-isda-master-agreement-multi-currency/ (date of access: 31.05.2022)

[18] [Electronic resource]. Available at URL: https://www.isda.org/book/2002-isda-master-agreement-mylibrary/ (date of access: 31.05.2022)

[19] [Electronic resource]. Available at URL: https://www.icmagroup.org/market-practice-and-regulatory-policy/repo-and-collateral-markets/legal-documentation/global-master-repurchase-agreement-gmra/ (date of access: 31.05.2022)

(hereinafter – “GMSLA”)[20] published by ISLA are also used as the empirical base of research. When studying the contractual regulation practice of close-out netting in European Union countries the Master Agreement for Financial Transactions known as the European Master Agreement (hereinafter – “EMA”)[21] was examined.

Secondly, the empiric base of the present research is shaped by the case law of foreign courts, primarily related to the operation of close-out netting under 1992 ISDA MA and 2002 ISDA MA. To a lesser degree, the present research considers English case law on GMRA and GMSLA standard master netting agreements. The decision of the German Federal Court of Justice (*Bundesgerichtshof*) will be used as an illustration of the consequences of complete unification of the legal regulation of close-out netting in the European Union.

As a **research normative base** of the study, the thesis employs Russian legislation, particularly the provisions of the third chapter of the Civil Code of the Russian Federation containing the rules on obligations, the Federal Law “On Securities Market”[22] and the Federal law “On Insolvency (Bankruptcy)”[23], as well the UNIDROIT Convention on Substantive Rules for Intermediated Securities (hereinafter – “Geneva Securities Convention”)[24]. Apart from that the normative base of the research is represented by a variety of directives adopted in the European Union and influencing the operation of close-out netting, in particular Directive 98/26/EC on settlement finality (hereinafter – “Settlement Directive”)[25], Directive 2001/24/EC on the reorganization and winding up of credit institutions (hereinafter – “Winding-up Directive”)[26], Directive 2002/47/EC on financial collateral

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[20] [Electronic resource]. Available at URL: https://www.islaemea.org/gmsla-title-transfer (date of access: 31.05.2022)
[21] [Electronic resource]. Available at URL: https://www.ebf.eu/home/european-master-agreement-ema/ (date of access: 31.05.2022)
[22] Sobranie Zakonodatel'stva Rossijskoj Federacii. 1996. № 17. Art. 1918.
[23] Sobranie Zakonodatel'stva Rossijskoj Federacii. 2002. № 43. Art. 4190.
[24] [Electronic resource] Available at URL: http://www.unidroit.org/english/ conventions/ 2009intermediatedsecurities/ convention.pdf. (date of access: 31.05.2022)
[25] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.
[26] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions.

arrangements (hereinafter – "Financial Collateral Directive")[27], Directive 2014/59/EC establishing a framework for the recovery and resolution of credit organizations and investment firms (hereinafter – "Bank Recovery and Resolution Directive")[28].

The objective of the research. The general purpose of the research is the development of concept of cross-border close-out netting regulation in international financial markets using instruments of local and international nature. The objective is supposed to set out the following research **aims of the research**:

- formation of general legal characteristics of various types of netting , determining the peculiarities of close-out netting as well as determination of economic nature of those contractual instruments;

- determination of the law applicable to cross-border close-out netting as well as the degree of the influence of insolvency procedures on its operation;

- analysis and characteristics of ISDA Master Agreement close-out netting provisions and determination of problems when those provisions are applied in practice according to available case law;

- analysis and detailed characteristics of other standard master netting agreements applied in international financial market and having cross-border potential as well as determination of main problems of close-out netting application on the basis of case law materials;

- study of the main international netting harmonization instruments and major regularities typical for harmonization process in that particular area;

- finding out the differences between the generally accepted standards of netting harmonization and the Russian law rules;

[27] Directive No 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

[28] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance.

- the analysis close-out netting unification process in the European Union as an example of regional unification from regulatory and contractual perspective.

The study object is determined as the private law relations with an international element which arise in the process of close-out netting operation.

The subject of the research is represented by the regularities inherent in close-out netting in private international law context as well as doctrinal sources, national and international instruments as well as the case law.

The **scientific novelty** of the work consists of the fact that on the basis of an analysis of close-out netting complicated by a foreign element carried out based on standard documentation widely used in international financial markets two models of liquidation netting used in cross-border standard master netting agreements two models were identified - the set-off and conditional novation models. The gap existing in the Russian scientific literature in terms of studying the main problems of close-out netting functioning on the basis of materials of foreign judicial practice has been filled. Also, the novelty of this study is evidenced by the determination of the main method of convergence of legal regulation in the studied area, which, in absence of international treaties that have entered into force, has become the harmonization of legal regulation based on model laws, principles and guides.

Methodology and methods of research. As, from an economic point of view, close-out netting is a risk reduction tool with respect to risks arising from the conclusion of financial transactions, one of the distinguishing features of the research methodology is the use of economic and statistical methods of analysis. The modeling method has found application in the course of designing and highlighting the key features of out netting models used in cross-border standard master netting agreements. A feature of the methodology used by the author was also the use of the historical method to unveil the main trends in the process of improving the instruments for harmonizing and unifying the legal regulation of close-out netting, which took over several decades. The comparative legal method, traditionally used to analyze the differences and points of contact in the legal systems of individual countries, was employed by the author to compare the

provisions of contractual documentation elaborated by various professional associations and governed by the law of different countries. In the course of the research, the author also widely employed general scientific methods (analysis, synthesis, deduction, induction), without which no legal research can be made.

The conducted research has made it possible to formulate and substantiate **the following main propositions and conclusions to be defended:**

1. Close-out netting is a method of obligation termination consisting of several stages that is invoked upon the introduction of insolvency proceedings or the occurrence of other circumstances preliminary agreed between the parties to financial transactions. The stages of close-out netting include (i) acceleration, liquidation or termination of obligations under financial transactions (ii) their valuation и (iii) determination of net balance with respect to the portfolio of terminated transactions. The external form of expression of close-out netting is the close-out netting clause embedded into a framework agreement or trading rules. The sphere of close-out netting application is limited to transactions involving derivative financial instruments, securities repurchase agreements, securities lending arrangements and interbank deposits. The difference of close-out netting and other types of netting (payment netting and netting by novation) is its dependence on the existence of insolvency or other events which largely evidence the deterioration of credit quality of a counterparty. As for the economic nature of close-out netting, the instrument serves as a risk mitigation tool in financial markets, in particular with respect to credit and systematic risk.
2. As evidenced by the standard master netting agreements, contractual practice suggests two models of close-out netting – the model of *set-off* and the model of *conditional novation*. In the former case close-out netting is exercised through the acceleration of obligations under financial transactions and further offsetting of resulting amounts, while in the latter case – by early termination of financial transactions obligations and their

replacement by a single net obligation. Irrespectively of close-out netting applied in practice, the solution of conflict-of-laws problem with respect to close-out netting cannot be based on the private international law rule on independent set-off as close-out netting is contractual in nature. At the same time, the determination of applicable law by means of *lex contractus* is complicated in absence of provisions on applicable law withing the agreement containing close-out netting provisions due to the complexity of determining the party carrying out the characteristic performance. However, the practice of studying cross-border standard master netting agreements demonstrated the existence of choice-of-law provisions within such agreements. Therefore, *lex voluntatis* serves as the major conflict-of-laws connecting factor with respect to close-out netting.

3. Close-out mechanism as stipulated in ISDA master agreements is extremely important for international financial markets due to their wide use. Close-out netting provisions proposed by this association changed over time, and according to the newest version of ISDA master agreement provide an opportunity to apply close-out netting to both parties of financial transactions and have a single methodology for the calculation of mutual obligations. Case law has demonstrated the drawbacks of close-out netting according to standard master agreements published by ISDA in scenarios when a party to financial transactions choses to abstain from triggering close-out netting and simultaneously relies on the opportunity for non-performance of transactions referring to contractual provisions. The correction of this drawback is possible by introducing amendments into ISDA agreements on the basis of amendment agreement prepared by the association.

4. Harmonization of legal regulation of netting aimed at the neutralization of *lex fori concursus* rules which hinder close-out netting in insolvency proceedings became the main method of law convergence in the research area. The instruments of harmonization for close-out netting are extremely

diverse and are represented by model laws, guides, and principles of legal regulation. Within the process of improving of close-out netting harmonizatoion instruments the unhindered operaton of close-out netting was changed by a more balanced approach. In accordance with the said approach a certain limitation on close-out netting is possible with respect to financial institutions for the sake of financial stability. Nevertheless, the efficiency of the harmonization campaign remains high based on the number of countries embracing legal reform to achieve smooth functioning of close-out netting.

5. Russian legislation on close-out netting being the part of domestic law on insolvency, in general follows the model outlined in harmonization standards in that area. However, it is necessary to broaden the list of recognized netting agreements by including standard master agreements EMA and GMSLA as well the variety of framework agreements of the Foreign Exchange Committee. Apart from limiting the list of recognized master agreements, the peculiarities of Russian legislation on close-out netting regulation are represented by the implementation of the conditional novation model on statutory level resulting in the necessity to adopt the agreements traditionally based on the set-off model to Russian legal requirements. The peculiarities of Russian close-out netting regulation also consist of the existence of providing information to the repository, the limited list of agreements recognized for the purposes of close-out netting, the absence of limiting close-out netting operation with respect to systematically important financial institutions.

6. Notwithstanding the commitment to harmonization as the main model of achieving common legal regime of close-out netting as well as the limited sphere of application and of the Geneva Securities Convention the unification of close-out netting proved to be possible on a regional level in the countries of the European Union. The drawbacks of close-out netting regulation in the European Union include the fragmentation of legal

regulation (absence of a single netting statute) as well as the partial unification (the protection to close-out netting is provided depending on the parties and the use of financial collateral). In the meantime, within the European Union the tendency is present to the full unification of standard documentation regulating close-out netting procedure by means of using the single standard master netting agreement prepared by European Banking Federation throughout the European Union.

The theoretical significance of the study allows to expand the scope of scientific knowledge about the concept of close-out netting in a cross-border context. The results of the study can be used in theoretical developments in the field of conflict and substantive regulation of contractual obligations, competition law, as well as in the field of harmonization and unification of private law in general. In the latter case, the work can become a starting point for further research on the impact of professional associations not being international intergovernmental organizations on the course of harmonization of private law on a global scale. Also, the study is significant for the further development of the concept of the modern *lex mercatoria* due to the presence of a detailed analysis of the provisions of the standard master netting agreements, which are often considered to be among the sources of the *lex mercatoria*.

Practical significance of the study. The implementation of the results of the study is possible in banking operations, business of other financial organizations and other participants of the civil turnover, carrying out close-out netting operations. In particular, the Russian banking industry will be able to make a more balanced risk assessment when choosing cross-border standard master netting agreements offered by their foreign counterparties for financial transactions, after reviewing the study. In addition, the results of the study can be accepted by the legislator for further improvement of the legal rules on close-out netting in the Russian Federation in order to bring them in line with international standards. Finally, the materials presented in this dissertation can by applied in the educational process, including while teaching special disciplines.

Reliability and approbation of the results of the thesis. The thesis was completed at the Department of Legal Regulation of Business, the Faculty of Law, National Research University Higher School of Economics. Besides, the research results were approbated during the scientific conferences at Moscow State University, National Research University Higher School of Economics and Peoples' Friendship University as well as in the course of teaching the discipline "Securities and Derivative Financial Instruments in Private International Law". Authenticity of the results obtained is achieved by the use of Russian as well as foreign doctrinal sources, statutory instruments and case law.

The structure of the research is predetermined by its subject, purpose and aims and consists of an introduction, three chapters comprising six paragraphs, conclusion and references.

MAIN CONTENT OF THE WORK

The **introduction** reflects the relevance of the chosen topic, the degree of its analysis in domestic jurisprudence as well as the purpose and objectives of research. Furthermore, the introduction contains research object, subject and applied methods of research as well as the justification of the scientific novelty with respect to the propositions to be defended and the approbation of the research results.

First chapter "General characteristics of close-out netting" consists of two paragraphs. According to the *first paragraph* the "Concept of close-out netting in financial markets" the sphere of close-out netting application is limited to securities repurchase agreements, securities lending transactions, transactions involving derivative financial instruments, as well as interbank deposits. The definitive peculiarities of financial transactions are its belonging to financial market rather than extending financing as well as their enormous volume. The latter leads to the necessity of searching risk mitigation opportunities arising due to conclusion and performance of obligations under financial transactions.

The first paragraph contains the classification of netting based on various grounds such as the netting performance procedure, presence of the foreign element,

the subjects of close-out netting and types of transactions whose obligations are discharged through netting. The most wide spread classification of netting in scientific literature and the most significant form scientific viewpoint is the classification based on the procedure of netting performance which allows to single out netting by close-out as a separate type of netting. In contrast to payment and novation netting, this netting type requires the commencement of insolvency procedures, non-payment or other ground related, either directly or indirectly, to the solvency deterioration of a party to financial transactions. Apart from that, the uniqueness of close-out netting is related to the possibility of its application to non-homogeneous obligations with different execution terms including monetary obligations and obligations on delivery of securities.

The mechanism of close-out netting has a complex character which reflects itself in the existence of consecutive operations that are carried out during the use of netting. The said paragraph contains the general characteristics of the stages (phases) of close-out netting. The external form of netting as a contractual instrument is the close-out netting clause which is reflected in the exchange rules, clearing rules or contractual documentation which is used to regulate the relations under financial transactions.

The first paragraph of the first chapter contains the basic economic characteristic of netting which allows to understand its legal nature and the reasons for the global harmonization of netting relations. Netting has a crucial significance for the financial system and from economic perspective it can be considered an instrument of risk mitigation with respect to credit, settlement and other risks arising on financial markets due to the conclusion of financial transactions and the performance of obligations thereunder. The wide use of financial transactions leads to the necessity of risk mitigation, and the close-out netting suggests the most perfect means of reaching such mitigation as it contributes to the minimization of systematic risks of financial system.

Second paragraph of the first chapter “Cross-border close-out netting and the issues of applicable law” is fully devoted to the finding solution to the conflict-of-

law problem with respect to close-out netting with a foreign element. The paragraph contains the reasoning in line with the view of some researchers for the refusal to use the independent set-off conflict-of-laws rule to close-out netting on over-the-counter market in favor of *lex contractus*. If the choice of law provisions are present in the agreements on netting the governing law determination issue does not seem to be complicated as close-out netting is regulated by the law chosen by the parties which is typical for standard master netting agreements.

In absence of such choice of the parties the solution to conflict-of-laws issue with respect to netting is complex because of the rights and duties of the parties to netting agreements being identical. The difficulties in determining applicable law is typical for those financial transactions which give rise to obligations terminated by close-out netting (swaps, options and other transactions) apart from netting itself. Due to the wide spread of standard master netting agreements in the international financial market and its high degree of contractual standardization, there is currently no need to adopt a statutory conflict-of-laws rule for the determination of the law applicable to close-out netting in absence of express or implied choice of law by the parties either contractually or in the rules of an exchange.

Russian rules on close-out netting provide for the use of standard master netting agreements subject to the foreign law exclusively in those cases when a foreign legal entity is a party to such contract. Therefore the existence of a foreign element in the form of the object of the relation (for instance, Eurobonds in repurchase transactions or foreign equity securities in share forwards) does not allow Russian parties to such transactions to use foreign transaction documentation. Hence, the mandatory rules of domestic legislation on securities and insolvency do not allow the application of *lex voluntatis*, the main conflict-of-law principle in international private law with respect to contractual obligations, which is spreading to other areas.

The second chapter of the thesis “Cross-border standard master netting agreements” is devoted to the mechanism of close-out netting under the documentation used in international financial markets in according to standard

documentation. The methodological basis for the study of such agreements is their classification into those based the contractual model of close-out netting. While the model of conditional novation assumes the termination of obligations under all or part of financial transactions between the two parties and their subsequent reduction to single net claim, the set-off model presumes the acceleration of transactional obligations and is pretty close to payment acceleration in debt relations.

First paragraph of the second chapter is fully devoted to the ISDA MA as an etalon of the conditional novation model and the most widely spread standard agreement in financial markets. As evidenced by some estimates ISDA MA is the most significant achievement of ISDA and is considered an example of contemporary *lex mercatoria* in international financial markets. In the course of standard documentation evolution ISDA from the preparation of standard terms codes for certain types of derivative financial instruments to the publication of full-fledged master agreements covering the whole variety of this financial instruments.

The paragraph contains a description of 1992 and 2002 ISDA MA architecture consisting of the master agreement itself and a schedule thereto allowing the parties to set out individual parameters on their interaction and introduce necessary amendments into the standard contractual provisions. The character of parties' interaction in present and absence of events of default or termination events varies as in the first case netting by close-out may be triggered either automatically or at the will of one of the parties. Distinction between the two grounds of close-out netting evidences the high level of drafting technique demonstrated by the authors of ISDA MA. The presence or absence of a party's will in the occurrence of a relevant event served as the criterion for the distinction between these types of events.

Among the events of default studied during the research, one would single out an insolvency event, the violation of payment or securities delivery obligations, cross-default, false representation, violation or repudiation of the agreement, credit support default and default under specified transactions. The event of default list is

closed while the termination events list may be broadened by the parties by stipulating an additional termination event within transactional documentation.

Within the development of standard documentation ISDA considered the practice of application of its standard agreement published in 1992 and enhanced close-out netting methodology that was reflected in 2002 ISDA MA. In particular, the parties to the updated standard master netting agreement lost the opportunity to use alternative methods of net amount calculation arising upon the occurrence of events of default and termination events (*Loss* and *Market Quotation*). Apart from that, both parties to the master agreement received the right to claim for the net amount while previously they could agree that only one party is allowed to receive the sum that arises under close-out netting. Besides, the tenure of grace period following the failure to pay or deliver was decreased from three to one day.

To illustrate the practice of ISDA application the paragraph contains the characteristics of the most significant court cases for close-out netting considered by the courts in Anglo-Saxon jurisdictions. For instance, in *BNP Paribas v Wockhardt EU Operations (Swiss) AG* English court refuses to consider the net amount as a penalty taken into consideration as a restful of close-out netting while in the case of *MHB-Bank AG v Shanpark Ltd* the court refused to allow the set-off ignoring close-out netting provisions of the ISDA MA. The said court decisions onsds had the definitive meaning in providing the enforceability of close-out netting because under English law contractual provisions on penalties are considered invalid while the operation of set-off in breach of netting provisions could have undermined its functioning.

However, the most principal meaning in terms of close-out netting have the provisions of article 2(a)(iii) of ISDA MA which allows a non-defaulting party to refuse to perform the obligations under transactions involving derivative financial instruments in case an event of default is present. Meanwhile, the operation of close-out netting procedure in line with the documentation of ISDA under the basic rule is up to the non-defaulting party which loses the incentives to terminate obligations thorough netting with the net obligation arises on the non-defaulting side. In fact,

the cumulative effect of Section 2(a)(iii) of ISDA MA and close-out netting provisions contributes to the same effect as the First Method with close-out netting present in the 1992 documentation which does not allow the payment of the net amount to the defaulting counterparty.

In the case of *Lomas v JFB Firth Rixon, Inc*. English court came to conclusion that the obligations of ta non-defaulting party under 1992 ISDA MA are stayed until the event of default is cured. Theoretically such a party may abstain from invoking close-out netting for an indefinite period of time. In Australian case *Enron Australia v. TXU Electricity Ltd.* the High Court of the New South Wales applied the same approach whole in *In re Lehman Brothers Holdings, Inc.*, the New York Bankruptcy court came to completely different conclusions and obliged the parties to the standard master netting agreement to make the payments under a swap transaction to the Lehman Brothers bank that was under bankruptcy proceeding at the time.

Second paragraph of the second chapter consists of the analysis of other standard master netting agreements of cross-border nature based on the conditional novation model, and also contains the description of standard master netting agreements built on the set-off model and facilitating the debt-type financial transactions. Apart from ISDA MAs conditional novation type of close-out netting is embedded in the agreements of the Foreign Exchange Committee (FXC), which are elaborated in the USA with the support of the Federal Reserve Bank of New York. In contrast to ISDA documentation, standard master netting agreements of the FXC do not distinguish between default and termination events when triggering close-out netting. Among close-out netting triggers present in FXC agreements, one would single out the failure to pay or deliver, other violation of contractual covenants, voluntary and forced bankruptcy, the disclaim of the conclusion of a transaction, breach of a representation, credit event upon merger, cross-default and default on obligations under financial transactions as well as the default on the credit support arrangement.

As for standard master netting agreements that use the set-off model of close-out netting, the paragraph contains legal analysis of close-out netting provisions of GMRA and GMSLA framework contracts as well as the agreement for interbank deposits.

The third chapter “Harmonization and unification of the legal regulation of close-out netting” is devoted to the methods of close-out netting regulation convergence. *The first paragraph* of the third chapter includes the analysis of the close-out netting harmonization instruments development from historical perspective and provides grounds for its necessity given the imperative rules of *lex fori concursus*. In particular, many researches treat the cherry picking rights of insolvency administrator as the main hindrance to achieving close-out netting enforceability in insolvency context when a party to close-out netting arrangement is in default. In that case the insolvency administrator, driven by economic reasons, picks the non-profitable transactions from the defaulting party perspective and refuses to perform them while insisting on the due performance of transactions having positive intrinsic value.

Implementation of *cherry picking rights* undermines the operation of close-out netting, whereas its purpose is the crystillazation of a single net obligation arising on the side of a party to a cross-border standard master netting agreement that committed a default, or on the side of its counterparty. In the process of net obligation formation transactions having positive value are taken into consideration along with those trades that are considered non-profitable. According to the alternative view on cherry picking, the significance of the issue is overestimated, however the majority of researchers do not share that view.

The authors of standard documentation treat cherry picking as a real problem having included the provisions on single agreement clause into the relevant master agreement. According to the single agreement clause, the master agreement and transactions thereunder from one singe contract between the parties. Thus, according to the idea of international association involved in the elaboration of the leading cross-border standard master netting agreements, the insolvency

administrator should refuse from the standard agreement as a whole and not from single financial transactions united by the master agreement. However, contractual drafting techniques proves to be insufficient to achieve the neutralization of *lex fori concursus* rules. What is more, insolvency rules having adversary potential for close-out netting are extremely diverse and are not limited to refusal to perform unprofitable transactions. Apart from cherry picking those rules are represented by the ban on ipso facto clauses prohibiting automatic termination of contracts due to insolvency commencement.

Non-entry into force of the Geneva Securities Convention, the sole international treaty partly aimed at the unification of law with respect to close-out netting, led to the domination of harmonization as a major method of convergence in the legal regulation of close-out netting. Apart from that, Geneva Securities Convention addresses close-out netting enforceability in subject to the presence of collateral in the form of securities. This limited treatment of close-out netting would not guarantee necessary degree of unification should the said international treaty entered into force.

First steps in the netting harmonization process were taken long time before the Geneva Securities Convention was prepared by UNIDROIT. The first full-fledged research document on netting, Report on Netting Schemes, was prepared by a group of international experts on international payment system under the auspices of the Bank for International Settles in 1989. An valuable contribution to the harmonization of close-outs netting was made by the Basle Committee on Banking Supervision that recognized the influence of netting on banking capital in 1994, and as well as by the Group of Thirty and the International Organization of Securities Commissions (IOSCO). Both organizations called for a legislative reform in the area of netting.

However, these institutions did not formulate the legal rules leading to close-out netting enforceability that should have been implemented into national laws. The said task was first solved by ISDA that developed ISDA MNA in 1996 and later contributed to its implementation in certain countries through the dialog with

the legislatures and financial markets regulators. For a long period of time, ISDA MNA remained the only international standard of close-out netting harmonization. Consequently, netting regulation requirements were reflected in UNIDROIT and UNCITRAL documents although the main role in the harmonization process that obtained a truly global reach belongs to ISDA. This leads to the existence of a "private" harmonization phenomenon when the convergence in law is reached through the efforts of an association of financial market participants rather than international organizations in the area of private law unification.

The financial crisis of 2006-2008 became the turning point in the development of netting harmonization instruments and led to the mass "testing" of close-out netting mechanism in practice. The relevant paragraph contains, among other things, the consideration of 2013 UNIDROIT Close-out Netting Principles alongside 2008 ISDA MNA that became a key harmonization documents addressing close-out netting in a post-crisis era. The definitive feature of that stage of netting harmonization campaign is the opportunity to limit the contractual freedom of close-out netting with respect to financial instruments in order to secure financial stability.

Second paragraph of the third chapter contains the legislation of the European Union analysis as an example of regional unification of close-out netting relationships. One can find the consistent analysis of statutory acts adopted in the European Union and regulation the issues of settlement finality, winding up, resolution, and financial rehabilitation of financial institutions as well as the utilization of financial collateral. The fragmentation of close-out netting as well as partial character of unification are also considered. The fragmentation is viewed as the existence of a variety of directives treating the different aspects of close-out netting while partial nature of unification is reflected in the close-out netting enforceability being dependent on the participation of financial institution in the netting relation and or the existence of financial collateral in the form of securities or cash within the relevant financial collateral arrangement.

The evolution of unification of legal regulation of close-out netting in the European Union legislation in many aspects is similar to the global evolution of harmonization instruments in the this area. Settlement Directive, Winding-up Directive and Collateral Directive are considered to by the unification instruments aimed at the smooth functioning of close-out netting and represent the consensus of the regulators, academics and financial market participants which arose before the commencement of the 2006-2008 global financial crisis. Meanwhile, the Bank Recovery and Resolution Directive reflects the new consensus shaped in the post-crisis era which takes the possible increase of systematic risk due to the mass termination of financial transactions on the basis of close-out provisions into consideration.

Article 68 of the Bank Recovery and Resolution Directive contains provision that the introduction of measures provided by the directive themselves is not considered an enforcement event under the Collateral Directive and bankruptcy proceedings under the Settlement Directive. Upon the introduction of financial recovery or resolution measures obligations on payments, delivery and transfer of collateral shall remain in force. Thus the European Union law in fact was broadened by the addition of an overriding mandatory rule which effectively limits the contractual freedom to the parties to netting arrangement. In absence of other grounds for triggering close-out netting, the solvent party will not be able to close-out transactions with a financial institution which is subject to financial recovery or resolution measures.

Under article 71 of the Bank Recovery and Resolution Directive the resolution authority is able to stay the termination of contractual obligations from the moment when the publication on the introduction of relevant measures is made until the end of the day following the publication date. Thus, in case of existence of the grounds for close-out netting such as non-performance of obligations to pay or deliver violation of financial covenants and other circumstances the solvent party will not be able to promptly liquidate transactions and calculate the amount of net obligation arising as a result of close-out netting.

Apart from statutory level, the need for unification is also relevant with respect to contractual regulation of close-out netting within the European Union. France, Spain, Germany and Switzerland use their own standard master netting agreements for local markets, and the relevant contractual provisions governing the procedure for close-out netting may be different. For close-out netting unification purposes, the European Banking Federation has carried out the preparation and publication of a single standard master netting agreement for all types of financial transactions including derivative financial instruments, repurchase transactions, securities lending agreements and interbank deposits.

The **conclusion** summarizes the main findings of the dissertation research, outlines major tendencies in the area of contractual documentation development, court practice and legal regulation of close-out netting.

The **main conclusions of the dissertation** are contained in articles published in scientific journals included in the list of recommended journals of the National Research University Higher School of Economics (list D) and in other journals.

Publication in journals included into the HSE list (list D):

Klementyev, A.P. (2021) Close-out Netting in the European Union: Contract Practice and Unification of Legal Regulation. RUDN Journal of Law. 25 (3), 634-653.

Klementyev A.P. On the Legal Nature of Payment Netting in Financial Transactions // Proceedings of Voronezh State University. Series: Law. 2020. No. 3. 137-147.

Klementiev A.P. (2019) Cross-Border Close-Out Netting and the Choice of Applicable Law. Pravo. Zhurnal Vysshey shkoly ekonomiki, no 2, pp. 209–232 (in Russian).

Klementiev A.P. (2017) International Instruments for Close-Out Netting Laws Harmonization. Pravo. Zhurnal Vysshey shkoly ekonomiki, no 4, pp. 300–312 (in Russian).

Publication in other journals:

Klementyev A.P. International Netting Agreements as an Instrument of Mitigation of Credit Risk Related to Financial Transactions of Credit Institutions. Bankovskoe pravo. 2021. No 2. 64-71.