THE FRAGMENTED APPROACH TOWARD CLOSE-OUT NETTING PROVISIONS IN AUSTRALIA, INDONESIA, MALAYSIA AND SINGAPORE COMPARED

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The fragmented approach toward close-out netting provisions in Australia, Indonesia, Malaysia and Singapore compared

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Abstract
Close-out netting provisions are a relatively new addition to the financial legal framework. Their primary objective is to strengthen the regulation and manage the risk associated with over-the-counter derivatives. They have been adopted by the financial industry and used in financial transactions to assist in controlling and allocating financial risks. They are becoming an effective tool that provides an efficient process in calculating and settling on a net balance. However, they have been criticized for being unable to save some of the larger financial institution throughout the 2008 Global Financial Crisis. This paper examines how close-out netting provisions are applied under the UNIDROIT Principles which serves as the benchmark on how jurisdictions have incorporated them into national law. It examines the current approach taken by Australia, Indonesia, Malaysia and Singapore, stressing their importance in the increasing interconnected financial markets across Southeast Asia and Oceania. While this paper is limited in its scope only referring to the international framework and four national countries, the analysis undertaken can arguably be applied to other national and supranational legal systems. The paper challenges the fragmented approach to regulation of close-out netting provisions in a global setting. It highlights the divergent approaches currently adopted in defining, negotiating, drafting, interpreting and enforcing close-out netting provisions. It argues that nation states should adapt the UNIDROIT Principles in light of their national law and policy. It also presents a way forward in enforcing close-out netting provisions within contracts.

Keywords close-out netting provisions · Australia · Inodnesia · Malaysia · Singapore

Introduction

> Close-out netting provisions are a relatively new addition to the finance regulatory toolbox. A "Close-out netting provision' means a contractual provision on the basis of which, upon the occurrence of an event predefined in the provision in relation to a party to the contract, the obligations owed by the parties to each other that are covered by the provision, whether or not they are at that time due and payable, are automatically or at the election of one of the parties reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other." (UNIDROIT Principles, Principles on The Operation of Close-Out Netting Provisions, December 11, 2013).

The globalization and in some cases regionalization of financial markets and institutions have grown significantly over the past five decades. There has been an unprecedented economic integration of world international (banking and finance) markets. The cross-border flow of money and capital continues to grow, particularly throughout Southeast Asia. The paper begins by discussing the financial markets, which today have increasingly relied on close-out netting provisions as a legal mechanism to manage and reduce the risk of financial loss. Close-out netting provisions provide that the obligations owed by the contracting parties are automatically, or at the election of one party, reduced or replaced by a single net obligation. They have become an important

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part of the regulatory tool box, in providing financial security to a party closing out the future obligations of another party who is likely to default. The provisions support and underpin elements of the United Nations Commission on International Trade Law (UNCITRAL), Legislative Guide on Insolvency Law.[1] Close-out netting has become effective in minimizing any potential down flow instability in the financial market.

Any discussion regarding close-out netting provisions should begin with the International Institute for the Unification of Private Law (UNIDROIT) Principles on close-out netting provisions.[2] This paper applies the definition and enforcement of close-out netting provisions as provided in the UNIDROIT Principles, as the basis for adoption in national law. The paper also highlights the current approach, taken within the respective national laws of Australia, Indonesia, Malaysia and Singapore, in defining and enforcing such provisions. It will be argued that the current approach has departed from, and not fully embraced the international legal framework. Even though this paper is somewhat limited in its scope and choice of countries analyzed, the analysis and research indicate that a similar approach needs to be undertaken and applied to other national laws, to better understand the level of uncertainty and divergent approaches. This is particularly important for the management of risks in such volatile financial markets—these days. Nonetheless, the paper focuses on how differently these provisions are construed and applied across financial markets. The goal is to demonstrate the currently fragmented approach to the development of close-out netting provisions within national laws. The further purpose is to provide a more coherent and consistent pathway in the enforcement of close-out provisions in contracts throughout the region. However, it is out of scope to examine the enforcement of close-out netting provisions by national courts.

The first section discusses the massive increase in the volume of financial transactions arising from technological innovation and its significance for close-out netting. The second section discusses the international framework for close-out netting provisions. The third section examines the national laws of Australia, Indonesia, Malaysia and Singapore in light of the UNIDROIT Principles. The fourth section provides a pathway forward to address the inconsistent approach taken by these states in embedding important elements of the UNIDROIT Principles such as the definition of close-out netting provisions and the enforcement of them, into the respective national laws. The fifth section provides a clear pathway for the cross-border enforcement of close-out netting provisions. The sixth section concludes by arguing that more work needs to be undertaken throughout the Asia Pacific and Oceania, to develop a more coherent and consistent approach in regulating close-out netting provisions.

The significance of close-out netting provisions

The use of the Internet has created, not only a huge jump in transaction volumes, but also the utilization of highly complex financial innovations. The effects of financial globalization on state sovereignty raise concern among both academics and practitioners in financial sectors. Insop Pak argues that the process of financial globalization, computer and telecommunication technology has made it possible to use integrated financial system and programs for conducting highly complex financial transactions.[3] In addition, there has been an explosion in the immediate and systemic exploitation of available information that may be relevant to financial operations.[4] As a result, regulators, government, policy makers and the financial sector have had to craft legal mechanisms that enable financial risk in capital markets to be managed so as to avoid catastrophic domino effects—and potential market collapses. This is where close-out netting provisions now play an important role in ensuring a level of financial (market) stability nationally, regionally and globally.

Close-out netting provisions serve as a central mechanism in terminating a course of dealings between parties to a master agreement. They serve as contractual means for the closing out of future dealings between parties to occur through an acceleration of obligations.[5] Such provisions ordinarily provide that, on default by one contracting party, the time for performance of obligations reverts to the time of default, leading to the conversion of non-cash obligations into debts, and set-off obligations.[6] In other words, the ability to close out and net obligations and set them off promptly after the commencement of insolvency proceedings against a defaulting party, allows a counterparty to terminate the contract including future obligations arising under it. Should such set off not be possible, a counterparty would be unable to ensure satisfaction of future obligations on the default of the debtor.

[1] United Nations Commission on International Trade Law—*UNCITRAL Legislative Guide on Insolvency Law 208-215,* https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf. At 208, it states that financial contracts have become an important component of inter- national capital markets.

[2] UNIDROIT Principles on the Operation of Close-Out Netting Provisions which were adopted by the UNIDROIT Governing Council at its 92nd session, Rome, 8–10 May (2013).

[3] Pak [9].

[4] Giovanoli [4].

[5] Johnson [7].

[6] Ibid.

Importantly, too, should that debtor fail to perform its contract (or perform only those obligations that are profitable) this could lead to financial repercussions for downstream parties and indeed, to market dislocation.[7] These risks are attenuated by a series of defaults in back-to-back transactions, causing financial distress to multitudes of market participants and leading to the domino effect of financial collapse of other counterparties, including regulated financial institutions.[8] This domino effect is often referred to as systemic risk and is cited as a significant policy reason for permitting participants to close out, net and set off obligations in a way that normally would not be permitted under national laws governing insolvency laws.

A close-out netting provision comes into operation either through a declaration by one of the parties when a predefined event occurs, in particular default or insolvency of a party, or it is triggered automatically when such an event occurs.[9] Additionally, a close-out netting provision can extend to a number, often hundreds, of outstanding transactions between the parties that are contractually included in a netting provision.[10] Once the close-out netting mechanism is triggered, whether automatically or by means of a declaration by one party, all transactions that are covered by the close-out netting provision are terminated.[11] Subsequently, a value is determined for each under a predefined valuation mechanism. This may also take into account the identity and credit standing of the party responsible for this determination and any existing credit support and other material terms of the parties' agreement.[12]

For all the benefits that close-out netting provisions have bought to the financial sector, they have not come without criticism. Michael Simkovic argues that close-out netting does not provide a totally stable economic environment,[13] and it is unclear whether close-out netting increases or decreases risk in the financial system.[14] These criticisms have arisen, as Vincent Johnson puts it, because, as a legal mechanism, close-out netting provisions often do not protect those entities that are in financial difficulties and heading toward insolvency. Rather, they protect those entities that are solvent, and thereby fail to satisfy a central purpose underlying the close-out netting regime.[15] For instance, throughout the 2008 Global Financial Crisis, close-out provisions within contracts were unable to save Lehman Brothers.

The ability for close-out netting provisions to be abused may not be well understood, but in practice there are other issues that need to be considered, such as transparency and the need to adhere to other laws. Johnson also argues that there is a lack of transparency because the law in many countries minimizes legal formalities for the creation of close-out netting agreements. The result is a lack of required public declarations or filings.[16] He argues further that it is unlikely that the general creditors of a financial institution will ever know the magnitude of the risks to which they are being subjected by close-out-netting agreements between that institution and its favored counterparties. This is particularly true where transactions underlying such agreements are used, such as credit default swaps, which are an "ideal vehicle for hidden leverage and secret liens because of their inherent complexity… [and] limited disclosure."[17] In addition, basic information about over-the-counter derivatives is often difficult to obtain, while mandatory disclosures are rare in financial practice. Therefore, creditors are forced to bear a larger share of the losses that occur soon after default by a party that is protected by a close-out agreement.[18] Furthermore, abuse can be undertaken by parties that use these provisions to circumvent the rules of insolvency. Lidija Šimunović highlights that close-out netting provisions need to be monitored so that existing solution (s) do not become

[7] United Nations Commission on International Trade Law—*UNCITRAL Legislative Guide on Insolvency Law at 213,* https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.

[8] Ibid.

[9] Ibid. Close-out netting is often understood as resembling the classical concept of set-off applied upon default or insolvency of one of the parties. Traditionally, the concept of set-off applies only to parties with mutual debts of the same kind that are already due and payable, and that are legally distinct. Whether set-off occurs by contract, by unilateral declaration by one party or by operation of law, the parties' existing debts are set off against each other, such that the party with the smaller debt owes nothing, and the party with the larger debt owes only the difference between the two obligations. Even though overlap can occur between the concepts of set-off and close-out netting, they are neither functionally nor conceptually identical.

[10] Ibid.

[11] Mallesons Stephen Jaques, *Australian Finance Law*, Lawbook Co (2008) pp. 795–797. Close-out netting provisions can operate at various levels such as to payments generally (particular transaction), to all payments (type of transaction), to all payments (in a defined class of transactions) and can apply to all payments in all transactions. Additionally, there are bilateral and multilateral netting.

[12] Ibid. The sum value of all such transactions is then aggregated, resulting in a single net payment obligation.

[13] Simkovic [10].

[14] Bliss and Kaufman [2].

[15] Johnson [7]. Close-out netting puts creditors into a position of super-priority far preferable to the position of most creditors of a bankrupt estate. Thus, close-out netting between A and B transfers credit risk from A to B's general creditors, and from B to A's general creditors. This shift is unfair because A and B will retain, to a great extent, the potential benefits of the underlying transactions, while their general creditors, who do not directly benefit from the creation of those positions, will bear much of the cost if the transactions fail.

[16] Ibid.

[17] Ibid.

[18] Ibid.

subject to abuse, for example, unauthorized persons falsely concluding financial dealings only to avoid the strict rules of the insolvency proceedings and thereby causing damage to insolvency creditors.[19]

Yet, as Johnson highlights in referring to Hupke, financial lenders, scholars, regulators, and policy makers generally support close-out netting. However, Johnson points out that their role in the operation of modern financial markets has now become a questionable truism.[20] This problem is accentuated with the establishment and recognition of close-out netting provisions within transnational contracts. The disparate role of such agreements is likely to become increasingly important but also difficult to manage in financial markets notably in the recognition and enforcement of foreign judgements.

The countries studied in this paper are increasingly significant to the region. Singapore alone has established a strong financial industry that is interconnected with its neighbours. Australia and Singapore, together, have the highest rate (s) of cross-border financial and banking transactions within the region. Malaysia, not unlike Australia and Singapore, continues to develop its financial sector, reflecting its strong financial links to Singapore and more extensively, to Australia. Indonesia, on the other hand, continues to emerge more slowly as a market, which is problematic given its proximity to Australia and Singapore and their financial markets. In addition, unlike Australia, Singapore and Malaysia, Indonesia is not a common law country, and has adopted the civil law. As a result, Australia and Singapore remain dominant markets and account for most of regional financial transactions, together with Hong Kong, New Zealand and Japan.[21]

A more pervasive issue is whether and to what extent close-out netting provisions, as defined by the UNIDROIT Principles, have been adopted by national legal systems in regulating their financial markets. A related issue is whether there is a consistent approach taken in the recognition of enforcement of foreign judgements, and how enforcement of these provisions could be rendered more transparent, sustainable and financially effective. Moreover, the national financial systems across the Asia–Pacific Region, Europe or North America are fragmented, muddled and not universally accepted. Importantly, too, is how such legal divergence can be meaningfully redressed.[22] These concerns apply not only to close-out netting provisions, but to finance law more generally in which there is a lack of legal convergence and harmonization. This is on the backdrop of the rise of financial transactions within interdependent markets that are locally, regionally and globally connected.

[19] Šimunović [11].

[20] Hupke [6].

[21] Loon and Lan [8].

[22] Benjamine [1].

International framework for close-out netting provisions

The international community has recognized the need to develop a framework to minimize the risk of economic and political shocks to the finance market. Subsequently, the UNIDROIT Principles on Close-Out Netting Provisions provide a foundation upon which nation states can establish a consistent framework for regulating such provisions. Firstly, this section examines the close-out netting provision—Principles, established by UNIDROIT. Secondly, it evaluates the UNIDROIT Convention on Substantive Rules for Intermediated Securities and determines its role in close-out netting provisions. Thirdly, it highlights how the recent work of the International Swaps and Derivatives Association has expanded the scope by which nation states can develop their laws to harmonize close-out netting provisions and redress their current destabilizing impact on international financial markets.

UNIDROIT—Principles on Close-Out Netting Provision

The UNIDROIT Principles on Close-Out Netting Provisions [the Principles] aim to provide detailed guidance to national legislatures of implementing states that seek to develop national legislation to regulate this financial sector. The importance of the Principles cannot be underestimated because the UNCITRAL has established the Legislative Guide on Insolvency Law.[23] That Guide states that it may be desirable for an insolvency law to include specific exemptions from the operation of avoidance powers for certain types of transaction.[24] It elaborates that finance contracts include, among other attributes, security contracts, commodity contracts, forward contracts, options, swaps, securities repurchase agreements, master netting agreements and related contracts.[25] Importantly, the Guide promotes the idea and process by which, on the commencement of insolvency proceedings, counterparties can seek to "close-out" open

[23] United Nations Commission on International Trade Law—*UNCITRAL Legislative Guide on Insolvency Law 208-215,* https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf. At 208, it states that financial contracts have become an important component of inter- national capital markets.

[24] Ibid.

[25] Ibid, at 209, Debtors often enter into multiple financial contracts with a given counterparty in a single course of dealing and the availability of credit is enhanced if rights under those contracts are fully enforceable in accordance with their terms, thereby permitting counterparties to extend credit based on their net exposure from time to time after taking into account the value of all "open" contracts.

positions and "net" all obligations arising from finance contracts with debtors.[26]

Notwithstanding the above, the UNIDROIT Principles also serve to strengthen legal convergence and harmonization in the development of close-out netting provisions within national laws, including enforcement across national borders. They provide an international framework for states to apply. However, the Principles are limited and should not be adopted by private parties to govern close-out netting provision in general.[27] Principle 1 provides that the ensuing Principles deal with the operation of close-out netting provisions that are entered into by eligible parties in respect of eligible obligations. Moreover, and except as otherwise expressly indicated in the Principles, it provides that the term "operation" encompasses the creation, validity, enforceability, effectiveness against third parties and the admission into evidence of a close-out netting provision. This creates a directional dilemma. On the one hand, the Principles promote the idea of legal convergence and harmonization. On the other hand, they allow nation states flexibility in developing their respective laws on domestic public policy grounds. As a result, the Principles do not try to delineate the scope of harmonization or impose them on signatory states. Additionally, they do not prevent or restrict implementing states from adopting a legal and financial framework that extends beyond the Principles.[28] This limitation in the application of the Principles should still not be overstated. The nature and application of a state's public policy are often unavoidably fluid and highly politicized in nature. It is therefore arguable that the Principles may impede the process of legal harmonization. However, they should be viewed broadly as providing states with a framework to adopt that provides greater legal certainty to the financial sector when states are consistent in their approach.

In support of this contention, the Principles provide significant guidance on financial and legal issues that signatory states should consider when developing their laws in the sector. This would further strengthen the legal protection against systemic risk to financial systems across national boundaries; and the value of close-out netting provisions as an instrument of counterparty risk management in interrelated (and interdependent) financial markets.[29]

Moreover, the Principles also have the virtue of establishing a stable financial relationship between close-out netting provisions and practices, given that insolvency priorities unavoidably diverge across implementing states. Their further virtue is in promoting certain, stable and predictable financial practices in otherwise disparate financial markets. They also provide states with flexibility, to exercise their discretion in recognizing all, or only some of the Principles. States can thereby to apply the Principles to situations of insolvency only, or to financial transactions more generally. Importantly, states can arrive at the most effective regulatory approach, not only in response to the Principles' framework, but to satisfy their divergent financial needs. The benefit is in providing them the opportunity to develop "best" or at least "preferred" practice by adopting those Principles in response to their shared as well as differentiated financial environments.

Noteworthy, too, is the guidance which the Principles provide in defining a close-out netting provision and the legal and financial implications arising from that definition. As noted in the introduction to this article:

> A 'close-out netting provision' means a contractual provision on the basis of which, upon the occurrence of an event predefined in the provision in relation to a party to the contract, the obligations owed by the parties to each other that are covered by the provision, whether or not they are at that time due and payable, are automatically or at the election of one of the parties reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other.[30]

The application of this definition provides safeguards in resolving regimes of dispute resolution adopted by financial institutions.[31] Its purpose is to guide states in shaping domestic legal rules on close-out netting to accommodate the "resolution regimes" of financial institutions, including through enforcement procedures.

[26] Ibid, at 2010, "Close-out netting" embraces two steps: firstly, termination of all open contracts as a result of the commencement of insolvency proceedings (close-out); and secondly, the set-off of all obligations arising out of the closed out transactions on an aggregate basis (netting).

[27] UNIDROIT Principles on Close-Out Netting Provisions, https://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf.

[28] Ibid, Explanatory Comments 16.

[29] Ibid, Explanatory Comments 17, Consideration should also be given to the general principle that the law should not treat similar situations differently without justification, and the specific principles against discrimination between domestic and foreign creditors in insolvency (UNCITRAL Model Law on Cross-Border Insolvency, Article 13).

[30] Ibid, Principle 2.

[31] Ibid, Principle 8.

Enforcement

The operation of close-out netting provisions provides that the law of the implementing state should ensure that a close-out netting provision is enforceable in accordance with the terms of those provisions.[32] More importantly, the law of the implementing state should:

> (a) not impose enforcement requirements beyond those specified in the closeout netting provision itself;
>
> (b) ensure that, where one or more of the obligations covered by the close-out netting provision are, and remain, invalid, unenforceable or ineligible, the operation of the close-out netting provision is not affected in relation to those covered obligations which are valid, enforceable and eligible.

However, the Principles do not render enforceable a close-out netting provision or an eligible obligation that would otherwise be unenforceable, in whole or in part, on grounds of fraud or conflict with other requirements of general application affecting the validity or enforceability of contracts.[33] Explanatory Comment 118 provides further guidance on these enforcement requirements. It states that, in accordance with Principle 6(1)(a) "and conditions for the enforcement, the practical value and effect of close-out netting would be significantly diminished or even rendered void, if the law were to impose any additional requirements as conditions for the enforcement of close-out netting provisions that went beyond those to which the parties might have contractually agreed."[34] This comment is significant in providing that these additional requirements for the realization of security interests, including pledges, charges and mortgages, should not apply to close-out netting. They should rather apply to enforceable action only when prior notice is given to the defaulting party that the close-out netting provision may be put into operation. The enforceability of such action in relation to close-out netting provisions is also limited by the requirement that:

- approval of the terms of the realization or operation of the close-out netting provision [by given] by a court or other public authority; or
- the realization be conducted by public auction or in any other prescribed manner; or
- the close-out netting provision be operated in a legally prescribed manner; or
- the close-out netting provision be subject to the requirements that may apply in the context of enforcing set-off.[35]

Notwithstanding these provisions for enforcing close-out netting provisions, there are several potential obstacles to enforcing them in relation to the obligations that are covered. Firstly, one or several of the obligations covered might flow from a particular type of transaction which is invalid, unenforceable or ineligible.[36] Secondly, given that the close-out netting provision and all these obligations are often treated as integral parts of one contract, difficulties might arise in applying general principles of commercial law to the enforcement of the close-out provisions in particular.[37] As a result, careful construction of the terms of the contract(s) is required to ensure that the netting mechanism are not subject to a range of obligations, extending beyond enforcement.

UNIDROIT Convention on Substantive Rules for Intermediated Securities

The UNIDROIT Convention on Substantive Rules for Intermediated Securities [Geneva Convention] sets out an optional framework for the protection of collateral transactions, particularly in Capital Markets. The importance of the Geneva Convention cannot be underestimated as it fills gaps in the substantive law governing security transactions. Its protection extends to close-out netting provisions, provided they are concluded as part of a collateral transaction. Importantly, the Geneva Convention not only defines close-out netting. It also provides a key rule on the enforceability of such close-out out netting provisions. Article 31 defines such a provision, as meaning:

> a provision of a collateral agreement, or of a set of connected agreements of which a collateral agreement forms part, under which, on the occurrence of an enforcement event, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise: (i) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount; (ii) an account is taken of what is due from each party to the other in relation to such obligations,

[32] Ibid, Principle 6.

[33] Ibid.

[34] Ibid.

[35] Ibid, Explanatory Comment 118.

[36] Ibid, Explanatory Comment 120–122.

[37] Ibid. 122. Even if in principle eligible, an obligation may be unenforceable for various reasons. A prominent case relates to wagering or gaming prohibitions which might apply in relation to certain derivatives transactions in some jurisdictions.

> and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.[38]

However, there are notable differences between the UNIDROIT Principles and the Geneva Convention in their definitions of close-out-netting provisions. The Geneva Convention refers to close-out netting provisions as part of a collateral agreement or set of agreements, whereas the UNIDRIOT Principles refer to them as contractual provisions, or as contracts more generally. Nevertheless, both definitions, arguably, aim to arrive at a similar conclusion, namely, to ensuring that each party fulfills its financial obligations, and in particular its contractual obligations to pay the other party.

Like the UNIDROIT Principles, Article 33 of the Geneva Convention also provides for enforcement. It states that, on the occurrence of an enforcement event, the collateral taker may realize the collateral securities delivered under a security collateral agreement. Importantly, this result can only be achieved by selling the collateral securities and applying the net proceeds of sale in discharging the relevant obligations. This raises a chicken and egg dilemma. On the one side, a close-out netting provision can be made dependent on the sale of collateral securities to discharge the relevant obligations.[39] On the other side, if an enforcing event occurs while any obligation of the collateral taker to deliver equivalent collateral under a collateral agreement remains outstanding, these obligations may be the subject of a close-out netting provision.

International Swaps and Derivatives Association [ISDA]

The ISDA have played a fundamental role in also developing a framework to reduce the risk to financial markets: firstly, the national or international legal framework that will govern those provisions; secondly, the court with jurisdiction to determine the legitimacy of those provisions; and thirdly, the model agreements upon which parties will base their financial transactions, including in response to the first two considerations. These considerations are dealt with briefly below.

Generally, parties to financial transactions choose either English or New York law to govern their close-out netting provisions.[40] The jurisdiction of courts responsible to apply those provisions is usually based on the 1968 Brussels Convention on Jurisdiction, or the 1988 Lugano Convention.[41] However, neither choice of law or jurisdiction is exclusive, with counterparties relying on national systems of law and jurisdictions.

Importantly, the most recent addition to the international framework for close-out netting provisions was released in 2018. The ISDA[42] released a *Model Netting Act and Guide*[43] [Model Act]. It defines close-out netting provision in the same way as the UNIDROIT Principles.[44] The Model Law also replicates the UNIDROIT Principles in enforcing obligations.[45] As a general rule, the Model Law requires that the provisions of a netting agreement will be enforceable in accordance with the terms of that agreement, including against an insolvent party.[46] In addition, and where applicable, "it provides that a netting agreement will be enforceable against a guarantor or other person providing collateral or security for any obligation of the insolvent party."[47] It maintains further that this enforceable obligation may not be stayed, avoided or otherwise limited by any action taken or power exercised by the insolvency practitioner. This

[38] UNIDROIT Convention on Substantive Rules for Intermediated Securities, (2009) Article 31.

[39] Ibid, Article 33, Further, when appropriating the collateral securities as the collateral taker's own property and setting off their value against, or applying their value in or toward the discharge of, the relevant obligations, provided that the collateral agreement provides for realization in this manner and specifies the basis on which collateral securities are to be valued for this purpose.

[40] Ibid.

[41] International Swaps and Derivatives Association, *Model Netting Act and Guide, 2018,* https://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf.

[42] International Swaps and Derivatives Association, https://www.isda.org/membership/, ISDA has more than 900 member institutions from 69 countries.

[43] International Swaps and Derivatives Association, *Model Netting Act and Guide, 2018,* https://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf. The 2018 MNA is a model law intended to set out the basic principles necessary to ensure the enforceability of bilateral close-out netting, including bilateral close-out netting on a multibranch basis, as well as the enforceability of related financial collateral or margin arrangements.

[44] Ibid, Principle 2 of the MNA provides that a close-out netting provision means a contractual provision on the basis of which, upon the occurrence of an event predefined in the provision in relation to a party to the contract, the obligations owed by the parties to each other that are covered by the provision, whether or not they are at that time due and payable, are automatically or at the election of one of the parties reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other.

[45] Ibid, Principle 6 - Operation of close-out netting provisions in general relates to the law of the implementing State should ensure that a close-out netting provision is enforceable in accordance with its terms.

[46] Ibid, Point 4 (a) Enforceability of Netting Agreement.

[47] Ibid, Point 4 (b) Limitation on obligation to make payment or delivery.

also applies to any other legal provision applicable to the insolvent party by virtue of it being subject to insolvency proceedings.[48] However, it is arguable, but less definitively so, that the Model Law has considered the Geneva Convention, notably in relation to the enforceability of collateral agreements.[49]

In addition to the above, importance also attaches to the antecedents to the Model Law, namely the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement [Master Agreements]. These two Master Agreements, notably the 2002 Master Agreement, significantly influence the choice of law and jurisdiction adopted by parties to cross-border financial transactions, including in modeling close-out netting provisions. Combined, they have become important models in facilitating cross-transaction payments and close-out netting provisions. Moreover, they have established a framework to standardize the terms of such provisions.

The 1992 Master Agreement provides the basis Local Currency - Single Jurisdiction version. Its purpose is to apply to transactions between parties in the same jurisdiction, using the same currency. However, the scope of the 1992 Master Agreement is limited. Even if the parties within the same jurisdiction have entered into single currency agreement, they can still extend (or restrict) the scope of their transactions, including in regard to close-out provisions, and disregard their original agreement.[50] Nevertheless, the 2002 ISDA Master Agreement responds to some of these limitation in the 1992 Agreement. In addition to updating *force majeure* provisions in the Agreement as grounds for terminating financial transactions, it modifies the methodology used to make close-out calculations. By doing so, it reduces the grace period from three to one business days, for the failure to pay or deliver on default.[51] Based on New York law, the 2002 Master Agreement is widely used globally by international financial institutions and banks.[52] It is also the preferred model used to regulate transactions between parties in different jurisdictions and/or involving more than one currency.[53] However, not unlike the UNIDROIT Principles, neither the Model Law nor the two Master Agreements are universally adopted in law or in practice. Nation states continue to apply their national laws to financial transactions, including close-out netting provisions. Parties to financial transactions are often subject to those laws, and frame contracts according to them.

National law

Australia, Indonesia, Malaysia and Singapore have attempted to address financial market risk by establishing national laws that specifically deal with close-out netting provisions. However, and as this section will demonstrate they vary greatly and it is our view that the current departure from the international legal framework, is not addressing the broader economic risks. While it is understood that this paper is limited by focusing on Australia's place in and within Asia, a much broader study is required to also analyze Australia's place within other jurisdictions such as the UK and European Union, particularly where BREXIT is concerned. Nonetheless, due to their diversity and complex application, it will be confirmed or otherwise as to the extent to which states have adopted the UNDROIT Principle and/or the ISDA Model Law. Beginning with how each state has defined close-out netting provisions becomes important, because it provides the basis for such provisions to be underpinned and support the international framework. Therefore, by exploring common threads between the respective states, enables a pathway to be identified, which calls for greater legal convergence, particularly as the Asia and Pacific/Oceania region become a greater focus for the financial markets. That is, Indonesia and Malaysia economies are rapidly emerging as being on par with Australia and Singapore in the coming decade. Moreover, there is arguably a need to unify dysfunctionality in the treatment of close-out netting provisions, to evaluate variations from the UNIDROIT Principles; and to comment on the significance of these variations.

Australia

The legal framework of Australia has gone someway to adopting the international framework on close-out netting provisions. Moreover, without these important provisions, insolvency administrators could immediately trigger contracts where the defaulted party is owed money but would require counterparties with opposite contracts to get in line with other creditors. The resulting effect would see any resolution take years and significantly reduce any payout.

An examination of Australia's *Payment Systems and Netting Act 1998* [The Netting Act - No. 83] highlights the lack of any definition of close-out netting provisions. Instead, the Netting Act defines close-out netting contracts. The Netting Act also makes no reference to either the 1992 or 2002 ISDA Master Agreements, nor to the UNIDROIT Principles, nor to the definitions espoused in these instruments. It provides for payment systems and close-out netting of contracts on

[48] Ibid. Limitation on right to receive payment or delivery.

[49] Above, n 39.

[50] FieldFisherWasterhouse, https://www.fieldfisher.com/media/1979379/Commentary-ISDA-master-agreements.pdf, accessed 24 January 2019. ISDA User Guide to 1992 ISDA Master Agreement, https://www.isda.org/a/cFEDE/UG-to-1992-ISDA-Master-Agreement.pdf.

[51] Ibid.

[52] Goode [5].

[53] Ibid.

the occurrence of particular events. In such cases, the obligations of the parties are terminated or may be terminated, and the value of the obligations is calculated or may be calculated. By ensuring that termination values be also netted, it provides a level of certainty to the market, whereby, a net cash amount (whether in Australian currency or some other currency) is payable. Arguably, this becomes important to protecting parties to the contract.

Australia's Netting Act focuses directly on the contract and contractual arrangements between the parties, unlike both the UNIDROIT Principles and the Model Law. Furthermore, it identifies a contract as being declared by its regulations (the Netting Act) to be a close-out netting contract for the purposes of the Act. However, the Netting Act does not apply to a close-out netting contract that constitutes, or is part of, an approved netting arrangement.[54] Additionally, the Netting Act doesn't apply to a contract in relation to which a declaration under section 15 of that Act[55]; or a contract declared by the regulations to not be a close-out netting contract for the purposes of the Act.[56] In other words, the Reserve Bank of Australia has the power to declare in writing that section 14 does not apply to a close-out netting contract if it is satisfied that systemic disruption in the financial system could result if a party to the contract went into external administration. It must be noted that in Australia, the Reserve Bank is a separate entity to the Australian Government and makes its decisions based on the public interest for the entire economy. They play a key role in stabilizing and managing risk to the broader economy, not only the finance sector.

The significance of the definition of close-out netting provisions has been clarified by the courts. In *Re Opes Prime Stockbroking Ltd,*[57] the Australian Federal Court reinforced the definition of close-out netting contract as defined in section 5 of the Netting Act. It emphasized that the definition of netting in the Act was directed at ensuring that close-out netting contracts used in a variety of financial market transactions are effective under Australian insolvency law.[58] It drew attention to the Explanatory Memorandum which accompanied that Act providing that: "The definition is intended to operate broadly to encompass super - netting under a master netting contract."[59] As a result, the scope of a close-out netting under the Netting Act is portrayed as expansive both in its nature and scope of application, and in covering a range of different kinds of financial transactions. However, the enforcement of close-out netting provisions under that Act is limited to sections 14 1(ca) and 14 2(fa).

Subsequently, and as a result of the drafting of Australia's netting laws, a dilemma has arisen. On the one side, the effectiveness of a close-out netting contract can only be substantiated as a contract where Australian law so determines and there that contract is enforceable by an Australian court. On the other side, the contract determines when the obligations of the parties may be terminated, how the termination values may be calculated, and when the net amount owed may become payable. More importantly, the enforcement of close-out netting contract only applies when security for a parties' contractual obligations is given over financial property, where such enforcement accords with the terms of that security, and where the terms of that security are evidenced in writing.[60] Moreover, the enforcement of such a contract encompasses security given over financial property in respect of obligations owed by party to that contract which may be enforced in accordance with the terms of the security that is evidenced in writing.[61] Interestingly, the above provisions do not replicate each other, but apply to different issues such as those covered by the Australian constitution and those that relate to the individual person in accordance with section 14 1 (ca). However, section 14 2 (fa) applies to a person who is, or has been, a party to a close-out netting contract and goes into external administration.

Nevertheless, in *Re Opes,* the court sought to explain these tensions in the Netting Act. It stated that the first question the administrators seek to have answered is whether the SLA is a "close-out netting contract" as defined in section 5 of the Netting Act.[62] The case highlighted how section 5, relevantly, defines a close-out netting contract as "a contract under which, if a particular event happens: (1) particular obligations of the parties terminate or may be terminated; and (2) the termination values of the obligations are calculated or may be calculated; and (3) the termination values are netted, or may be netted, so that only a net cash amount (whether in Australian currency or some other currency) is payable." Furthermore, it was stated that section 14 provides that a close-out netting contract will be effective when the obligations of the contract imposes, both outside

[54] Payment Systems and Netting Act 1998. section 15.

[55] Ibid.

[56] Payment Systems and Netting Act 1998, section 5.

[57] (2008) 171 FCR 473.

[58] Ibid.

[59] Ibid, at 37. The obligations referred to in the definition are intended to apply broadly to encompass monetary obligations arising under a financial contract such as an interest rate or currency swap, and to non-monetary obligations such as an obligation to deliver commodities under a commodities derivative contract or securities under

Footnote 59 (continued)

a securities derivative contract. The obligations covered by the definition are also intended to cover contingent obligations.

[60] Ibid, section 14 1 (ca).

[61] Ibid, section 14 2 (fa)..

[62] (2008) 171 FCR 473.

external administration[63] and in external administration,[64] and despite any other law.[65] The close-out netting contract is further explained in s 14(2).[66]

However, a lingering question arises over the applicable jurisdiction when parties in Australia have entered into one or the other Master Agreements (1992 or 2002), and where the parties, one of which has become insolvent, have selected a currency that is not in Australian dollars, but which is to be used as part of the termination process. In another words, can the enforcement of the agreement be in another currency, such as Singapore dollars, and be enforced? Arguably, this is not a fully settled position in Australian law. However, under Australia's *Foreign Judgement Act 1991,*[67] foreign judgements are enforceable in Australia. The rationale underlying such enforceability applies, not only in the above scenario, but to transborder contracts more generally. In effect, a foreign judgement is enforceable when the contract is entered into between parties, one of whom is located in Australia and the other in Singapore, and when the contract provides for its enforcement including by a court outside Australia.

This enforceability of contracts extra-territorially was discussed in *Who Ya Gonna Call Bark Busters Pty Ltd v Brooke*.[68] In referring to the Transfer Agreement, the Court observed at:

> "1. Transfer Payment - 1.1 Brooke shall pay Licensor a Transfer Payment in the amount of $500,000 U.S. Dollars which represents 12.5% of the Redemption Proceeds received by Brooke from the Stock Redemption.
>
> 1.2 Licensee acknowledges that Brooke will receive the Redemption Proceeds in two separate transactions: (1) $3,000,000 on or about the date that Brooke tenders all of his Common Stock to Licensee ("Closing Date"), and (2) $1,000,000 upon the payment by Licensee of the promissory note ("Promissory Note") issued to Brooke on the Closing Date.
>
> 1.3 Brooke shall tender the Transfer Payment as follows: a, $375,000 within 30 days of the Closing Date ("Initial Transfer Payment"), b. $ 125,000 within 30 days of Brooke's receipt of final payment under the Promissory Note ("Financed Transfer Payment").[69]

The court elaborated that the law of the agreement is governed by the substantive law of the State of New South Wales, Australia, without regard to its conflict of law rules. Less clearly articulated is whether an Australian court has the jurisdiction under Australian Law to award damages in a foreign currency. From this case, it is unclear when a court would do so, and what rate of exchange it would apply to that foreign currency.[70] Nevertheless, it is well understood that under conflict of law rules in Australia, a foreign judgement in relation to a contract is enforceable in Australia. A further challenge posed by section 14 of the Netting Act and the enforceability for close-out netting provisions arises under section 14 A (5).[71] Section 14A(5) (ii) states that the intermediary must not comply with instructions given by the grantor in relation to the financial property, without seeking the consent of the secured person (or a person who has agreed to act on the instructions of the secured person). The operative word is "consent," and the determinative requirement is "seeking consent" of the secured person. A difficulty is in delineating the scope and application of such consent along a slippery slope between "seeking consent" as required by section 14 A (5) (ii) and securing that consent. A more material problem is the nature of the need for such "consent" in the first place, as is elaborated upon by the Australian Financial Markets Association [AFMA] below.

The AFMA has raised concerns over the meaning and application of section 14A (5). Their concern is that uncertainty in the drafting of that subsection potentially undermines the effectiveness of security given for contract obligations under the Netting Act, especially with regard to the right to consent in subsections 4 and 5.[72] They explain that the confusion in its drafting arises from section 14A (5) being expressed as not limiting the scope of subsection 14A 1(b). Section 14A 1(b) applies to the enforcement of security over financial property, in respect of obligations of a party to a close-out netting contract, when the financial property is transferred or otherwise dealt with so as to be in the possession, or under the control of the secured person or another person, and the arrangement is evidenced in writing.

However, the AFMA argues that it is difficult to identify any other construction of 14 A (5). The AFMA concludes that difficulty is likely to be confusion in interpretation unless the legislative drafting intention is made clear.[73] The AFMA elaborates that 14A (5) paragraph 1(b) is taken not to be satisfied if column 2 of the table sets out a condition

[63] Above, n 59, section 14(1).

[64] Ibid, section 14(2).

[65] Ibid, section 14(4).

[66] Ibid, at 37.

[67] Foreign Judgements Act 1991, Part 2. However, a judgment given by a court of New Zealand is only registrable under the Foreign Judgments Act if it is given before 11 October 2013.

[68] (2013) 16 DCLR (NSW) 366.

[69] Ibid, at 6.

[70] Ibid, at 67.

[71] Above, n 30, 14A (1)(b).

[72] Australian Financial Markets Association, *Resilience and Collateral Protection Law Amendments*, 2016, https://afma.com.au/policy/submissions/R01-16%20Treasury%20Collateral%20Bill.pdf.

[73] Ibid.

which is not satisfied. The conditions in subsections 4 and 5 state that the secured party must have the right to consent.[74] Nonetheless, these subsections contend that a condition of consent is neither necessary nor desirable; and that it is contrary to market practice. Of note, in the ISDA Credit Support Annexes under New York law, consent to substitution is not typically required by market participants, and the secured party's consent is not part of the procedure by which excess collateral is withdrawn.[75] The AFMA maintain further that the secured party is protected in respect of substitutions, as the substitute collateral must be received prior to release of the original collateral.[76] Additionally, the secured party may dispute any calculations under the Credit Support Annex, including in respect of return amounts. Therefore, what remains unclear is the extent to which the enforceability of close-out netting provisions will extend within the Australian legal framework. This lack of clarity is exacerbated by a lack of judicial jurisprudence in this area of Australian law. There is also the potential to over-extend protection by providing for the consent of secured parties which is not required, nor recognized, not clarified by the UNIDROIT Principles.

Finally, Australia provides the recognition and enforcement of foreign judgements under the Foreign Judgements Act 1991 [FJA]. The FJA provides for such enforcement, through registration of judgments rendered by the superior courts (and specified inferior courts) of those countries that are listed in the Foreign Judgments Regulations 1992.[77] These measures, directed at recognizing and enforcing foreign judgements such as in respect of close-out netting contracts, have a stabilizing impact on international financial markets. However, that impact is blunted by restrictive constructions of close-out contracts in some other jurisdictions in the region, including in the enforcement of such contracts and their provisions. In contrast, the judgement of a court of Singapore is enforceable in Australia, in accordance with Singapore's Foreign Judgements Regulations 1992. However, such enforcement is notably absent in the laws of Indonesia and Malaysia. Subsection B directly below explores the law of Singapore, followed by legal developments in Indonesia and Malaysia.

Singapore

Singapore is widely seen as an international finance and trading hub of Southeast Asia. Their economy is largely services based, and the finance sector accounts for a large percentage of economic activity. In 1997, they were not immune from the Asian economic crisis, and since then, they have arguably been working hard with regional partners to establish legal frameworks and mechanisms to reduce risk to the financial sector. Since the early 2000s, they have been proponents of netting laws, and in 2003 they implemented the *Payment and Settlements Systems (Finality and Netting) Act*[78] (Singapore Netting Act). In Singapore, netting means the "conversion into one net claim, or one net obligation of claims and obligations resulting from transfer orders which a participant either issues to, or receives from, one or more other participants, with the result that only a net claim can be demanded or a net obligation cam be owed."[79] The Netting Act of Singapore does not adopt a specific definition of close-out netting provisions/clauses of contracts, unlike the UNIDROIT Principles or Australian Law. Nevertheless, it is our view that the manner in which Singapore's Netting Act defines netting and the implied obligations that arise from it, relates to a contract or an agreement. This is on the backdrop that the scope of close-out netting is limited to one net claim, or one net aggregation of claims and obligations.

Nonetheless, close-out netting has not gone unnoticed by the Singapore courts. In *Tan Poh Leng Stanley v UBS AG*[80] the court highlighted several areas of dispute. One such area was that the Bank did not conduct the close-out in a manner that was consistent with the exercise of reasonable care and did not provide the Claimant with statements of a calculation, as is required in the ISDA Master Agreement. A threshold question was whether the Bank had a duty of care owed in both contract and tort to conduct the close-out exercise promptly and with reasonable care. The court elaborated by holding that the ISDA Master Agreement must be interpreted in a manner that allows the parties to customize their rights by amending the relevant agreement

[74] Ibid.

[75] Ibid.

[76] Ibid.

[77] Foreign Judgements Act 1991 – Foreign Judgement Regulations 1992, the basis of such enforcement is "substantial reciprocity" in the enforcement of judgments between Australia and each country. The statutory regime applies to the following jurisdictions: Bahamas, British Virgin Islands, Canada, Cayman Islands, Dominica, Falkland Islands, Fiji, France, Germany, Gibraltar, Grenada, Hong Kong, Israel, Italy, Japan, Korea, Malawi, Montserrat, PNG, Poland, St Kitts and Nevis, St Helena, St Vincent and the Grenadines, Seychelles, Singapore, Solomon Islands, Sri Lanka, Switzerland, Taiwan, Tonga, Tuvalu, UK and Western Samoa.

[78] Payment and Settlements Systems (Finality and Netting) Act 2003, Act 39 of 2002, Most recently amended by Act 4 of 2018 wef 06/06/2018.

[79] Ibid, section 2.

[80] [2016] SGHC 17, at 7, The plaintiff, Stanley Tan Poh Leng ("ST"), was a private wealth client of the defendant, UBS AG ("the Bank"). Between October 2007 and August 2008, ST invested in 16 equity accumulators ("the Accumulators") on a margin trading basis. At one time, ST owned equity stocks with a combined market value in excess of S$100 million in his account with the Bank ("the Account").

or through a separate agreement. This determination is necessary, as the ISDA Master Agreement often forms part of a broader transactional relationship. The Court added that the Bank and the Claimant were, not only counterparties in a derivatives transaction, but were also, among their other functions, the Chargor and Chargee in relation to the Charge Over Assets.[81] This is an important determination because Singapore's Netting Act does not provide any direction or guidance on the enforcement of close-out netting provisions. Nonetheless, the Court noted that the Bank, rather than relying on an ISDA Master Act, had in fact established a Credit Services Notice Letter [CSNL], relying on its Enforcement Procedure. The Court went further highlighting that the CSNL Enforcement Procedure is not inconsistent with the 2006 ISDA[82]

Moreover, section 13 of Singapore's Netting Act states that, notwithstanding any provision of the law of insolvency, if a court has made an order for bankruptcy or winding up of a participant in a designated system, or a resolution for the voluntary winding up of such participant had been passed, the operator of the designated system may affect the netting of all obligations owed to or by the participant incurred. The operator may net those obligations up to and including one business day after the court has made the order for bankruptcy or winding up of the participant, or the resolution for the voluntary winding up of the participant was passed. The obligations that are netted shall be disregarded in the bankruptcy or winding up proceedings.[83] The Court added that any net obligation owed to, or, by the participant that has not been discharged—is payable to the participant. Additionally, any net obligation owed may be recovered for the benefit of the creditors; or if that obligation is provable in the bankruptcy or winding up proceedings. Nevertheless, as the case may be, the netting made by the operator of the designated system and any payment made by the participant pursuant thereto shall not be voidable in the bankruptcy or in winding up proceedings.[84] Subsequently, section 15 of Singapore's Netting Act therefore accords the creditor with a wide scope of protection.

The economic relationship between Australia and Singapore has grown significantly over the past 30 years. Today, they work collaboratively in many areas of the law. This is reflected in the netting laws, whereby, the enforcement of an ISDA Master Agreement and/or contract, and close-out netting provisions are comparable to the conflict of law rules in Australia. The fact that Singapore is a central hub for international commercial arbitration constitutes a further forum for resolving broader contractual disputes relating to the Master Agreements. However, international arbitration is unlikely to be provided for in the Master Agreements, particularly close-out netting provisions, so the default will be the conflict of law rules. This is consistent with Singapore's *Arbitration Act 2002*, whereby the tribunal can apply the law in accordance with the conflict of law rules.[85] Importantly, where there is an express conflict of law clause in the contract, Singapore courts will recognize that choice of law. However, that choice of law is subject to the following limitations. Firstly, the application of the law chosen by the parties should not be contrary to the public policy of the forum, for example, Singapore. Secondly, the choice of law should be bona fide and legal[86]; and thirdly, the application of that public policy should be subject to overriding mandatory provisions if the forum is Singapore.[87] Notably, Singapore construes these provisions and principles narrowly in order to maintain their certainty identified with the state's commitment to maintaining a business friendly environment.

In conclusion, Singapore's Netting Act and the judicial interpretation of it articulate the nature and scope of netting clearly, as elaborated upon by the Court in *Tan Poh Leng Stanley v UBS AG*.[88] Singapore law recognizes choice of law provisions in netting contracts, subject to domestic public policy requirements where Singapore is the forum. The overriding regulatory aim of Singapore Law on the subject is to satisfy domestic business demands for creditor protection in the face of bankruptcy or winding up of a participant in a designated financial system. In our view the close-out netting laws underpin the current national policy of Singapore to maintain and grow its status as a central business and finance hub in Southeast Asia.

Malaysia

The economic development across Malaysia is important to the region. The success of the banking system in Malaysia has resulted in their banks attaining a leading position within the market, which can now be seen in neighboring countries such as Singapore. Moreover, Malaysia is a common law jurisdiction, not unlike Australian and Singapore. Malaysian law and the Malaysian legal system are also rooted in English law and legal principles. There are, however, significant differences, which arise from local Malaysian

[81] Ibid, at 184.

[82] Ibid, at 189 and 200.

[83] Above, n 56, section 13.

[84] Ibid.

[85] Singapore Arbitration Act 2002, section 33.

[86] *Peh Teck Quee v Bayerische Landesbank Girozentrate* [199] 3 SLR(2) 842 at 12.

[87] Ibid.

[88] [2016] SGHC 17, at 7.

legislation, such as the *Contracts Act 1950,*[89] along with local the judicial interpretation of that Act and its sequela. Similar to common law Australia and Singapore, it is settled law in Malaysia that, where a contract has foreign elements, such that the contract is international, and the parties expressly make a choice of law by the contract, that choice will be given legal effect.[90] However, parties cannot invoke the choice of foreign law to avoid mandatory provisions of domestic Malaysian law. To date, there have been no decisions by any Malaysian court on the operation of the new netting laws or close-out netting provisions.

Nonetheless, Malaysia is the only country studied to recently adopted specific netting legislation. Its *Netting of Financial Agreements Act* (Malaysian Netting Act) came into force on 30 March 2015. Malaysia defines netting to mean a provision in a qualified financial agreement which provides that, upon the occurrence of the events specified by the parties in the agreement, all obligations owed by one party to another party under a qualified financial transaction are reduced to, or replaced with, a single net amount in accordance with the qualified agreement.[91] Furthermore, the Act specifies that any other mechanism which has the effect of determining a single net amount prescribed by the Minister, is a netting provision.[92]

Part II, section 3 of the Malaysian Netting Act provides the basis for the enforceability of netting provisions in qualified financial agreements. Section 3 states that, notwithstanding the provisions specified in Part I of the Schedule, the netting provision in a qualified financial agreement in respect of the qualified financial transactions referred to in section 5 shall be enforceable in accordance with the terms of the qualified financial agreement. This process of enforcement may take place in stages, namely: termination of qualified financial transactions entered into under the qualified financial agreement; and calculation of termination values owed by the parties to each other in respect of each of the qualified financial transaction. In addition, enforcement can take place upon the determination of a single net amount of the termination values, which amount becomes payable by one party to the creditor.

The result of these developments is that the Malaysian Netting Act, while not yet judicially interpreted, recognizes netting provisions in relation to selected financial transactions. It provides a process for netting, including calculating termination values; and it recognizes choice of law provisions in, *inter alia*, netting agreements, but subject to domestic public policy requirements where Malaysia is the forum.

Indonesia

Indonesia, in part, has had stable economic growth year on year for the past decade. The World Bank identifies Indonesia as having exhibited strong macroeconomic performance.[93] However, they highlight the need for the financial sector to play an even greater role in raising the social and economic standards of large population dispersed over thousands of islands. On the backdrop of this, it will be highlighted that Indonesia also need to do more to stabilize their financial sector by fully adopting the international framework for close-out netting.

Indonesia takes a different road to the other states. In other words, there are no specific close-out netting laws in Indonesia. Cross-border transactions are governed instead by various laws. These include the Bank Indonesia Regulation,[94] along with the Act of the Republic of Indonesia Number 3. 2011 Concerning Funds Transfer and the Law of the Republic of Indonesia,[95] on the Currency. Neither of these laws define close-out netting provisions nor provide for enforcement mechanisms. The Bank of Indonesia has issued guidelines for the use of standardized contracts by Indonesian parties, otherwise known as *Perjanjian Induk Derivatif Indonesia*[96] [PIDI], or as the Master Agreement for Indonesian derivatives transactions. Provisions in the PIDI are based primarily on the 2002 ISDA Master Agreement.

[89] GAR Know How Construction Arbitration – Malaysia Contract Law, https://www.rajahtannasia.com/media/3101/gar-know-how-construction-arbitration-malaysia-aug-2018.pdf.

[90] *James Capel (Far East) Ltd v YK Fung Securities Sdn Bhd* [1996] 2 MLJ 97.

[91] Netting of Financial Agreements Act 2015. The Act was passed in order to bring Malaysia's regulatory regime in line with international Netting law and practice. The further purpose was to redress the pre-existing uncertainty in Malaysian Law over the enforceability of netting arrangements.

[92] Ibid, paragraph 6[1][a].

[93] World Bank, Financial Sector Assessment, Republic of Indonesia, (2017), http://documents.worldbank.org/curated/en/104191505745150824/pdf/Indonesia-FSAP-Update-FSA-07072017.pdf.

[94] No. 14/15/PBI/2012.

[95] Number 7. 2011.

[96] Bank Indonesia issued two Bank Indonesia Regulations regarding foreign exchange transactions against Rupiah: (i) Bank Indonesia Regulation No. 18/18/PBI/2016 on Foreign Exchange Transactions against Rupiah between Banks and Domestic Parties ("PBI 18/18") and (ii) Bank Indonesia Regulation No. 18/19/PBI/2016 on Foreign Exchange Transactions against Rupiah between Banks and Foreign Parties ("PBI 18/19"). As a general rule, to conduct a foreign exchange transaction against Rupiah, banks must satisfy the following requirements: those imposed by the banking authority(ies) under which only a certain category of bank is allowed to conduct foreign exchange transactions; implement risk management as required under the banking authority(ies) regulations on the implementation of risk management in banks; provide training on foreign exchange transactions against Rupiah to customers; and comply with the Bank Indonesia regulation on the mandatory use of Rupiah.

However, like many other countries, the PIDI was been prepared for local purposes, to render Indonesian laws and the Indonesian language into the governing law, and the Indonesian Rupiah as the termination currency. This intention is based on the assumption that the contracting parties are Indonesians, and that the Rupiah, ought to be the termination currency. The aim of the PDPI is to assist banks in preparing certain contracts specific to derivatives. Nevertheless, the PDPI neither refers to, defines nor provides the basis for enforcement of close-out netting provisions.

A further piece of the Indonesian jigsaw puzzle on netting is evident in Indonesian Law No. 7 of 2011 on Currency [Law No. 7]. Article 21 and 23 of that Law appear to contradict other areas of the PDPI. According to Article 21 of Law No. 7, the national currency, the Rupia must be used in every transaction, settlement obligation, where money is used, provided that the transaction is undertaken within the territory of Indonesia. However, where a transaction involves international trade, a foreign exchange deposit in an international financing transaction, Article 21 is not applicable. In other words, any currency other than the Rupia can be used in international transactions that operate in or outside of Indonesia. Adding to the complication is Article 23 of the Currency Law No. 7. It prohibits an entity to refuse to use the Rupiah as a currency of tender where the transfer is intended as payment, or as the settlement obligations that must be fulfilled in Rupiah and/or in other transactions. This is not applicable where the transaction has been agreed to in writing (by contract or other agreement) that another currency can be used. It remains to be seen whether this provision will be challenged before Indonesian courts. Furthermore, it is not conclusive whether the courts will settle the law based on a literal or liberal interpretation of Law No. 7, the PDRI and Master Agreement; or whether they will resort to further legal construction of that law.

The choice of arbitration under Indonesian Law is potentially significant in relation to the development of netting law and practice in Indonesia. Law No. 30 of 1999 concerning Arbitration and Alternative Dispute Resolution ["New Arbitration Law"] implements the New York Convention on the Recognition and Enforcement of Foreign Judgements. In regulating the adoption of the ISDA Master Agreements, the Central Jakarta District Court *Bankers Trust Company & Bankers Trust International v. PT. Mayora Indah*[97] refused to enforce an London Court of International Arbitration [LCIA] arbitral award in favor of Bankers Trust [BT], because the South Jakarta District Court had issued a decision in favor of the Respondent, Mayora.[98] The underlying dispute related to derivative trading between BT and Mayora under the ISDA Agreements, which contained an arbitration clause. Mayora defaulted on certain payment obligations under the ISDA Agreements. Subsequently, it filed a case before the South Jakarta District Court, seeking annulment of those agreements on the grounds that the agreements were contrary to Indonesian law or public policy. Mayora argued that these agreements dealt with swap trading, an activity similar to gambling, which was strictly prohibited under Indonesian law.[99] In response to this suit against it in Malaysia, BT commenced LCIA arbitration proceedings against Mayora in London. Eventually, BT obtained an arbitral award in its favor, while the South Jakarta District Court decided in favor of Mayora. Subsequently, BT registered the arbitral award at the Central Jakarta District Court for the purpose of its recognition and enforcement.[100] Soemartono noted that BT also appealed the decision of the South Jakarta District Court. It argued that the South Jakarta District Court did not have jurisdiction to hear the case because the parties had agreed to settle their disputes through arbitration. However, the Central Jakarta District Court refused to enforce the arbitral award and held that any enforcement of the arbitral award was contrary to the public interest, since the decision of the South Jakarta District Court had not yet become *res judicata*.[101] The Supreme Court of Indonesia affirmed the decision of the Central Jakarta District Court.[102] The Supreme Court's decision might have been appropriate had the parties referred their case to the courts of Malaysia. Yet, in this case, there was a written agreement to arbitrate which should have prevented the state court from entertaining the lawsuit.[103] Soemartono has argued further that the law in Indonesia does not expressly draw a distinction between international public policy and domestic public policy, even though Indonesian authors have made such a distinction. The New Arbitration Law simply states that a foreign arbitral award can only be enforced in Indonesia if the arbitral award is not contrary to public policy.[104]

Summary of national laws

The regulation of close-out netting provisions varies among Australia, Indonesia, Singapore and Malaysia. Malaysia is a recent addition to the Netting regulation club, with Australia and Singapore having specific laws

[97] Decisions of the Central Jakarta District Court No. 001/Pdt/Arb. Int/1999/PN.JKT.PST, No. 002/Pdt/Arb.Int/1999/PN.JKT.PST, and No. 002/Pdt.P/2000/PN.JKT.PST issued on 3 February 2000, in Soemartono [12].

[98] Ibid.

[99] Ibid.

[100] Ibid.

[101] Ibid.

[102] Ibid.

[103] Ibid.

[104] Ibid.

in place for some time. Indonesia to date has taken a different path all together; it does not have a specific netting law and deals with netting issues across several areas of law.

However, the countries that adopt a definition of close-out netting have done so to meet their own discrete sovereign needs. The UNIDROIT Principles and ISDA have adopted the same definition of close-out netting. Yet, Australia, Singapore and Malaysia have diverged from both the UNIDROIT Principles and one another in defining close-out netting contracts and/or transactions. As such, all the countries studied take minimal lead from the UNIDROIT's international definition of close-out netting. Australia's netting laws are arguably closest to the international ISDA Model Law and UNIDROIT Principles, with Singapore not far behind. While Australia, Indonesia and Malaysia refer specifically to contracts or agreements, Singapore is less prescriptive in its definition of "netting." Despite Singapore Law not referring to a contract or agreement, the implied meaning of netting and the reference to net obligations and the obligation(s) owed would include a netting contract or agreement.

The countries studied diverge further in their enforcement of a netting contract or agreement. Only Indonesia specifically refers to the applicability of its national currency for enforcement purposes. However, an Australian court has considered the currency that applies to a settlement. Still, the law on setting, settlement and enforcement is unsettled in Australia, Singapore and Malaysia. To date, there remains a significant lack of judicial jurisprudence that directs, or construes, future settlement and enforcement of netting contracts.

Particularly significant is the divergence among the countries studied over the nature and manner of enforcement. No state has adopted the available international framework significantly or comprehensively. Australia has replicated that framework more than the other countries studied, by adopting many elements of the UNIDROIT Principles governing the termination of obligations under contract and the enforcement of that termination. Singapore on the other hand has not replicated the UNIDROIT Principles, but has instead aligned enforcement with its insolvency law. It has specifically applied that law where a court has ordered the bankruptcy or winding up of a debtor corporation. In further contrast, Indonesia does not provide for any enforcement mechanism. Lastly, Malaysia takes a similar approach to Australia in providing for a netting provision to be enforceable, provided settlement is provided for in a qualified financial agreement or more loosely, in a financial arrangement. Despite the lack of consistency across the respective states' laws on enforcement, they provide, expressly or impliedly, that close-out netting provisions will form part of a contract. That being the case, the ability to adequately enforce a contract, whether under the common or civil law, falls under the rules of private international law. These rules apply to both national and cross-border contracts.

Moving forward

There are significant gaps in the respective laws of the countries studied. Further work is needed to ensure that the illustrative countries are consistent in their regulation of netting provisions and agreements. Arguably, Indonesia should consider establishing specific netting laws that are consistent with the international framework, but more importantly, they are in line with its geographic neighbours, Australia, Singapore and Malaysia. Doing so would provide greater clarity and enhance Indonesia's place in the financial and banking sector within the Asian region, but also globally. An obstacle, albeit not insurmountable, is that Indonesia has adopted civil law, whereas the other countries studied all subscribe to the common law.

Even though there is inconsistency in the national laws analyzed, where close-out netting provisions form part of a contract, their enforcement is similar to the approach taken in Australia, Singapore and Malaysia. As a result, these countries have adopted roughly comparable processes, legal principles and norms in relation to the construction, performance and enforcement of cross-border contracts. While Indonesia has adopted the civil law, it still regulates contracts in a manner that is comparable to the other common law countries. In contrast, each country has adopted the well-established private international law rules that pertain to cross-border conflicts of law. This resort to private international law encompasses contracts that provide for litigation, international commercial arbitration or other methods of international dispute resolution. The issue arising from countries adopting such a private international law approach will remain, namely, where a financial institution or bank is part or fully owned by a nation state. Additionally, the enforcement and recognition of foreign judgements may not arise automatically across these countries, not least of all because of the different construction of public policy that the courts in each country are likely to adopt in declining to recognize and enforce a foreign judgement on settlement. However, the relevant Master Agreement to which each country subscribes could render the recognition and enforcement of net close-out settlements clearer and more predictable in contractual and legal practice.

Where the Master Agreement fails to specify the process for enforcement clearly, the default of referring to national laws is likely to remain challenging. This challenge is accentuated for several reasons. Firstly, there has been no or little national court jurisprudence on the enforcement of close-out

netting provisions to date. Secondly, the national laws of the regional countries studied are not clear in providing for enforcement, and other than Australia, do not significantly subscribe to the international regulatory framework. Even countries that have developed legal enforcement mechanisms have been subject to criticisms. For example, an Australian regulator has raised concerns in relation to the Australian netting laws and their enforcement,[105] despite Australia adopting the international regulatory framework more extensively than the other countries studied.

Notwithstanding the above, in preparing an ISDA Master Agreement, countries are generally expected to apply either New York or English law. This state practice is likely to prevail, unless the parties draft clear clauses specifying an alternative law that will apply to the settlement and enforcement of netting and other agreements and attendant obligations arising under those agreements. Subject to this expectation, a level of consistency and legal harmonization already exists across Australia, Singapore and Malaysia. It is also conceivable that states may prefer to adopt domestic laws and rely on standardized contract, rather than subscribe extensively to the evolving international legal framework.

There are formidable arguments that the UNIDROIT Principles and ISDA Model Law provide a viable framework for legal harmonization and convergence of disparate laws on settlement and enforcement of close-out netting contracts and transactions. Of note, the value of legal convergence and harmonization has been recognized for centuries, particularly in response to changing state borders and diverging laws and practices across nation states. Alan Watson aptly describes the practice of states engaging in legal convergences and harmonization (borrowing) as the most fruitful source of legal change.[106] He maintains further that "borrowing" can take different forms, for example, including borrowing from within a legal system, or borrowing from an external legal system,[107] such as from other common law systems, or from civil law, and vice versa.[108] John Gillespie refers to this harmonization process as being horizontal and/or vertical.[109] In his view, comparative lawyers generally engage in the transfer of legal norms and legislation horizontally and/or vertically, to enable states to engage in effective law reform. In the case of Australia and its ASEAN counterparts, the benefit of such legal convergence and harmonization is to assist in the future management, governance and enforcement of close-out netting provisions. Doing so will strengthen financial markets from economic and geopolitical shocks, both regionally and globally.

Malaysia, Australia and Singapore have different cultural and political backgrounds and values. Indonesia differs in its linguistic, cultural and legal distinctiveness, notably its adoption but also domestication of civil law in response to localized needs, not least of all to accommodate its conceptions of public policy. Still, it is arguable that, in the contemporary world, extending over the past 50 years, the intersection between common and civil law is increasingly minimalized. The result is the effectiveness of legal convergence internationally, notably in regard to trade and investment law, but also finance law. This propensity of states to move toward convergence therefore ought to be strongly encouraged and to be seen nor dealt with as an obstacle.

Final remarks

The globalization of the financial sector has and continues to advance significantly. It is argued that this sector of the global economy is more integrated than most other sectors. Given new technologies, the number of cross-border transactions is expanding geometrically. However, the 2008 GFC has highlighted and exposed many deficiencies arising from the lack of regulation and oversight of global financial transactions. This paper has examined the UNIDROIT Principles and ISDA Model Laws that apply to close-out netting provisions and contracts. It has also demonstrated the varied approach adopted by Australia, Singapore, Malaysia and Indonesia to adopting these international laws and model frameworks. The fact that these countries have not adopted the ISDA Model is quite understandable, given its release in late 2018. Even so, the ISDA Model largely replicates the UNIDROIT Principles. The Geneva Convention has gaps in its regulation of close-out netting provisions internationally, while providing a viable basis for regulating capital markets, but it varies materially from UNIDROIT Principles and ISDA Model Law.

This paper has argued that countries, illustrated by the four countries studied, should be encouraged to adopt the principles espoused by the international framework. The purpose is to promote greater legal harmonization, consistency of and transparency in drafting, interpreting and regulating close-out netting provisions in contracts. It is asserted that the issues raised in this paper are not unique and specifically limited to a single country, or, group of countries. It is contended that the regulation of close-out netting provisions is a global issue, which requires a global response. Reinforcing this contention is the fact that the ISDA Master Agreement already provides for a level of harmonization by specifying for the use of English law of the law of New York. This issue could arise where parties incorporate theses

[105] Above, n 56.

[106] Watson [13].

[107] Ibid.

[108] Ibid.

[109] Gillespie [3].

templates, while modifying them to comport to their national legal frameworks, regulatory norms and specific laws. What this paper has not addressed is the enforcement and recognition of close-out netting provisions by national courts.

Legal convergence and harmonization in relation to close-out netting will also provide greater coherence for entities that invoke and are subject to close-out provisions. The functional value of increasing legal certainty, while an abstract goal, is nevertheless fundamental to the global market in financial services. Moreover, legal certainty is increasingly important where global financial markets are continually exposed to global economic and geopolitical shocks.

The worst-case scenario is that, in the absence of continual pursuit of legal harmonization, the global financial system will be subject to massive upheaval arising from divergence in regulating financial transactions, including its manipulation by acquisitive states and more particularly, by acquisitive creditors. The prospective result of such financial upheaval is bankruptcies and insolvencies that are otherwise avoidable when they are regulated by laws that are not only clear and consistent in nature, but also effective and fair in their application.

The overall benefit of such convergence in regulatory norms and practice is greater confidence in local, regional and global markets. The economic advantage is greater liquidity in transacting within and across national boundaries. The pervasive accomplishment is for much needed financial stability in an often destabilized, and destabilizing, international economic order

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