

# The DIFC Netting Law

Cherry Turcal  
c.turcal@tamimi.comu

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## Introduction

The Law explains the concept of ‘netting’ as a process of terminating, liquidating and/or accelerating any payment or delivery obligations or entitlements between two parties under one or more qualified financial instruments (as explained below) entered into under a netting agreement or to which a netting agreement applies. This is done by calculating the net balance of close-out values and/or other relevant values in respect of such accelerated and/or terminated payment or delivery obligations or entitlements, either by operation of set-off or otherwise, to form a single value or netted amount payable between the parties. The goal in netting is to eliminate the number of required payments to be made under a series of transactions by offsetting the parties’ respective gains and losses, and provides for the net settlement of all obligations by way of a single currency payment by one party to the other.

It is common for jurisdictions with sophisticated financial markets to promulgate specific law to facilitate and provide certainty to netting transactions. The initiative on the part of the DIFC to implement a legal framework for netting is beneficial for banks and financial institutions that already frequently undertake various netting transactions. In the context of credit and operational risks, netting plays a vital role in mitigating the risks in the event of a “close out” (i.e. performance of an obligation following the occurrence of insolvency or an event of default as specified in the relevant agreement or agreements, including automatic termination and netting of all financial transactions between the parties). The DIFC becoming a netting-friendly jurisdiction means less capital exposure on the participants as payment will be calculated on a net basis rather than being grossed up for each individual transaction, and greater enforceability of the collateral arrangement in the event of a close-out. This should lead to an increase of business transactions in the DIFC.

## Application of the Law

The provisions of the Law apply to any qualified financial instrument, netting agreement or collateral arrangement (including any title transfer collateral arrangement) which is governed by DIFC law or which is entered into by a person incorporated or registered in the DIFC, irrespective of the date on which such qualified financial instrument, netting agreement or collateral arrangement was entered into. This wording suggests that the Law could be applied retroactively to qualified financial instrument, netting agreement or collateral arrangement entered into prior to enactment of the Law.

The new Law sets out the following relevant concepts in relation to netting in the DIFC:

### (A) Qualified Financial Instrument

The Law defines a “qualified financial instrument” as any financial agreement, contract or transaction pursuant to which payments or obligations are to be performed, or titles to certain commodities or assets are to be transferred, for consideration at certain agreed time or within a certain period of time whether or not subject to any condition or contingency, or pursuant to which obligations to make payments or deliveries or title transfer over commodities or assets are to be entered into or incurred.

The Law provides a non-exhaustive list of qualified financial instruments that derive value from underlying

assets or commodities including, but not limited to, any asset such as currency, equity, index, interest rate, bond or debt security index, property index, and other forms of derivative products. Qualified financial instruments would also cover (without limitation) spot, future, forward or other securities or commodities transaction, commodities contract (i.e. commodities repurchase or reverse repurchase agreement, a commodities lending agreement or a commodities buy/sell back agreement), collateral agreement and/or any agreement, contract or transaction designated as such by the Dubai Financial Services Authority (DFSA), by written and published notice.

Note that a qualified financial instrument will not include insurance or reinsurance contracts entered into by companies as part of their insurance business.

It is also interesting to note that Article 7 of the Law confirms that a qualified financial instrument will not be deemed void or unenforceable by reason of being, or having the characteristics of, a wager, lottery, gambling or gaming contract. It may be noted that the UAE Penal Code which applies in the DIFC penalises any form of gambling or wagering in the UAE. The enactment of the Law may alleviate the risk of any netting provision under any qualified financial instrument, netting agreement or collateral arrangement being characterised as gambling or wagering, however, this remains untested at present.

#### (B) Netting Agreement

For purposes of the Law, a netting agreement means:

- any agreement between two parties that provides for netting of present or future payment or delivery of obligations or entitlements or obligations to make, receive or require payments or deliveries arising under or in connection with one or more qualified financial instruments entered into by the parties pursuant to a 'master agreement';
- any master agreement between two parties that provides for netting of the amounts due under two or more master netting agreements (i.e. a 'master-master netting agreement'); and
- any collateral arrangement related to or forming part of one or more agreements referred to in paragraph (1) and (2) above.

#### (C) Collateral Arrangement

The application of netting in accordance with the Law extends to any margin, collateral or security arrangement or other credit enhancement related to or forming part of a netting agreement or one or more qualified financial instruments entered into by the parties or to which a netting agreement applies, including but not limited to the following:

- pledge, mortgage, charge or any other form of security interest or collateral, whether possessory or non-possessory;
- title transfer collateral arrangement; and
- (any guarantee, letter of credit or reimbursement obligation by or to a party in respect of one or more qualified financial instruments.

Under the Law the realisation, appropriation and/or liquidation of collateral under a collateral arrangement shall take effect without any requirement of prior notice and consent between the parties unless otherwise agreed by them, and provided that such realisation, appropriation and/or liquidation of collateral is carried out in a commercially reasonable manner.

### **Enforceability of Netting in Insolvency**

The Law provides that it shall prevail in case of any conflict between the provisions of the Law and the DIFC Insolvency Law of 2009 or the Insolvency Regulations (excluding Section 7 (Financial Markets) of the Insolvency Regulations).

Pursuant to the Law the provisions of a netting agreement will be enforceable in accordance with its terms, including against an insolvent party, and where applicable, against a guarantor or any person providing security for the insolvent party. The provisions of a netting agreement will not be stayed, avoided or otherwise limited by:

- the appointment of, or an application for the appointment of, a liquidator, or any action of a liquidator;
- any provision of law relating to bankruptcy, liquidation (including compulsory winding up proceeding), reorganisation, composition with creditors, receivership, conservatorship or any other insolvency proceeding to which a party to a netting arrangement may be subject; or
- any other provision of a law that may be applicable to an insolvent party.

The Law confirms the effectiveness and enforceability of a netting agreement following the commencement of insolvency proceedings in relation to a party thereto. Notwithstanding the occurrence of any insolvency proceeding to which a party may be subject, the obligation of that party to make payments or deliveries under a qualified financial instrument, or to a transaction to which a netting agreement applies, will take effect in accordance with the terms thereof.

The Law further stipulates that the provisions of a netting agreement will not be affected by any applicable law limiting or prohibiting the exercise of the right to set off or net out obligations or payment of any such netted value between an insolvent party and the non-insolvent party. Therefore the Law permits set off even after one party to a netting agreement has been declared insolvent.

### **Limitation on the powers of a Liquidator**

The Law gives further preference to a party to whom payment is due under a netting transaction by limiting the powers of a liquidator in any insolvency proceeding to assume or repudiate contracts, transactions, claims or obligations in such a way that such powers will not prevent the close-out netting process under one or more qualified financial instruments or to which a netting agreement applies. The liquidator's powers will only apply after the netting agreement has been given effect in accordance with its terms.

Moreover the Law limits the liquidator's ability to avoid, or render ineffective, certain payments, obligations or transactions of an insolvent party in the absence of clear and convincing evidence that the insolvent party made such payment, transfer, delivery, substitution or exchange or incurred such obligation or entered into such transaction with actual intent to deprive or defraud any person or other creditors of such insolvent party.

### **Preemption**

The Law provides that no stay, injunction, moratorium or similar order or proceeding issued by a court, administrative agency, liquidator or otherwise, shall limit or delay the application or performance of a netting agreement and the transactions contemplated there under or to which an otherwise enforceable netting agreement applies.

### **Conclusion**

The Law bolsters the effectiveness of a netting provision in any qualified financial instrument, or netting agreement that includes a collateral arrangement, and recognises the enforceability of such arrangement in the event of insolvency of a party. Its enactment has made DIFC a netting jurisdiction on par with other leading jurisdictions with sophisticated financial markets around the globe. The Law once again reaffirms the status of the DIFC as the leading financial hub in the region and underpins its objective to provide an attractive business environment in the regional financial market.

Cherry Ann Turcal is a member of the Banking and Finance Department in Al Tamimi & Company's DIFC office.