# Enactment of Netting Law for the Dubai International Financial Centre

Sunday, 14 December 2014 marked a milestone for the region with the enactment in the Dubai International Financial Centre (DIFC) of a new law recognising the effectiveness of close out netting provisions in contracts such as derivatives master agreements (the DIFC Netting Law). The DIFC Netting Law applies where either at least one of the parties is an entity registered in the DIFC or the contract is governed by DIFC law.

The DIFC is the first Gulf legal regime to enact a netting law.

**Clifford Chance LLP acted as counsel to the DIFCA (Dubai International Financial Centre Authority) on the preparation of the DIFC Netting Law. The International Swaps and Derivatives Association (ISDA) also participated in the preparation of this new law.**

## Background

Since February 2014, the DIFCA staff, Legislative Committee, together with ISDA and Clifford Chance LLP, have been working alongside a focus group of market participants based in the DIFC and the United Arab Emirates to agree on a draft netting law, which is based on ISDA's 2006 Model Netting Act and which has the additional feature of specifically addressing the inclusion of *Shari'a* compliant transactions.

A draft of the DIFC Netting Law was published for public consultation in July 2014 by the DIFCA under its Consultation Paper No.2 of 2014.

Following the enactment of the Netting Law as the DIFC Law No.2 of 2014, the DIFC joins 45 other jurisdictions across the world where netting legislation has been passed.

## Close-out netting

Close-out netting is one of the primary means of mitigating credit risks associated with over-the-counter (OTC) derivatives trading between two counterparties. Close-out netting provisions are typically incorporated into a master-level agreement (a "Master Agreement") regulating all the relevant individual transactions between the two parties and providing for a single net amount to be payable between the parties in the event of a close-out.

Whilst payment netting, that is the offset of payments due between two parties on a given day in a given currency, is common, close-out netting operates across transactions irrespective of when payments would otherwise have been due. Where it is usable in the insolvency of a party, it has the potential to provide a significant level of credit risk protection.

A close-out netting process involves three steps:

1. **Termination** – where the non-defaulting party calls an end to all the transactions covered by the relevant Master Agreement;
2. **Valuation** – where the value of the unperformed obligations under the outstanding transactions under the Master Agreement is determined; and
3. **Determination of net balance** – where the values owed to the non-defaulting party and the values owed to the defaulting party are aggregated and netted against each other to determine a single close-out amount owed by one party to the other.

Close-out netting therefore has the potential for limiting the exposure one party has in the insolvency of the counterparty by enabling the value of what the first party owes to the insolvent counterparty to be used in reducing the value of what the insolvent counterparty owes to the first party. However, for close-out netting to be valuable as a credit risk mitigation tool in this way, it needs to be enforceable in the insolvency of the counterparty.

## Legislative approach of DIFC Netting Law

While insolvency laws in some jurisdictions already operate in a way that would recognise the operation of the close-out process in a counterparty's insolvency, in many jurisdictions specific legislation is required.

In line with ISDA's 2006 Model Netting Act, the DIFC Netting Law seeks to confirm the effectiveness of the close-out netting process in its various phases from pre-insolvency to post-insolvency of a counterparty, where the parties have entered into qualified financial contracts which are subject to a netting agreement and where either the agreement is governed by DIFC law or one of the parties is an entity registered in the DIFC. The DIFC Netting Law, gives statutory underpinning to the effectiveness of close-out netting in the DIFC, the first such legislation in the jurisdictions of the Gulf region.

## Netting agreement and qualified financial instruments

Although ISDA Agreements are already in frequent use by DIFC firms, the definition of "netting agreements" in the DIFC Netting Law is broadly drafted to include any agreement between two parties which provides for the "netting" of present or future payment or delivery obligations arising under one or more qualified financial instruments, such as master agreements but also master-master agreements. This is intended to capture master agreements such as the ISDA Agreement, but also other market standard and bilateral netting agreements, including those applicable to Islamic hedging arrangements, in relation to which ISDA and IIFM have developed a market standard master agreement.

The list of "qualified financial contracts" under the DIFC Netting Law is a broad range of derivative products and specifically includes certain Islamic hedging products. Additionally, the Dubai Financial Services Authority is given the power to add to the list of "qualified financial contracts" from time to time.

## Pre-insolvency of DIFC counterparty

The function of the DIFC Netting Law prior to a party's insolvency is to provide for:

1. the enforceability of a qualified financial contract or netting agreement. The DIFC Netting Law specifies a qualified financial contract to be recognised under Article 9(3) of the Dubai Law 9/2004; and
2. resolving any conflict arising under any gambling, gaming, wagering laws which might otherwise operate to invalidate a qualified financial instrument or a netting agreement. The UAE Penal Code applies to the DIFC to prohibit wagering or gambling. The specific recognition by the DIFC Netting Law of qualified financial contracts and netting agreements as commercial contracts is intended to mitigate the risk of their characterisation as gaming or wagering arrangements.

## Insolvency

In the absence of netting enforceability, the main challenge to the close-out netting process arises upon the insolvency of a party, where the insolvency laws of that defaulting party's jurisdiction operate to preclude close-out netting from taking place.

The obstacles commonly posed by insolvency laws tend to be: prohibition of contract termination; powers of insolvency administrators to "cherry-pick" single OTC transactions which are in-the-money; limitations on post-insolvency set-offs; and challenge of payments or transfers made during a suspect period.

The DIFC Netting Law specifically provides that, on or following a party's insolvency:

1. **contract termination** –qualified financial contracts can be terminated to enable step one of the close-out process;
2. **"cherry-picking"** – the powers of a liquidator to select only the termination of qualified financial contracts which are in-the-money to the defaulting party are limited as a liquidator's powers may only apply at the "netting agreement level", and only after a net amount has been determined at step three of the close-out process;
3. **post-insolvency set-offs** – the set-offs required to determine a net amount are expressly permitted;
4. **payments or transfers during suspect period** – covered payments, transfers, deliveries, substitutions or exchanges of cash or collateral of the defaulting party during the suspect period cannot be set-aside unless proven to have been fraudulently made or made with the intention to deprive other creditors.

In addition, the DIFC Netting Law provides that it shall prevail over any conflict between the DIFC Netting Law and the DIFC Insolvency law 2009 or the Insolvency Regulations (with the exception of Section 7 (*Financial Markets*) of the Insolvency Regulations).

## Concluding remarks

The enactment of the DIFC Netting Act so soon after the tenth anniversary of the DIFC is an important step forward for the DIFC's commitment to developing a full-service financial centre in the Middle East. In the context of a post financial crisis market, where risk management is a matter of very considerable regulatory focus, the availability of tools like close-out netting for risk management purposes is becoming increasingly important for financial market participants, and this action on the part of the DIFCA is therefore very welcome. Market participants will hope that other authorities in the region will be willing to pursue similar initiatives.

## Key Contacts


**Habib Motani**
Partner

T: +44 20 7006 1718
E: habib.motani
@cliffordchance.com

**Tim Plews**
Partner

T: +971 56 683 3427
E: tim.plews
@cliffordchance.com

**Philip Jolowicz**
Counsel

T: +971 4 362 0742
E: Philip.jolowicz
@cliffordchance.com

**Cheuk-Yin Cheung**
Senior Associate

T: +971 4 362 0722
E: cheukyin.cheung
@cliffordchance.com