New DIFC Netting Law: A boost for derivatives?

AFRIDI & ANGELL
LEGAL CONSULTANTS

Jumeirah Emirates Towers
Office Tower, Level 35
Dubai, United Arab Emirates
Tel: +971 4 330 3900
Fax: +971 4 330 3800
Email: dubai@afridi-angell.com
www.afridi-angell.com

By Vivek Agrawalla, Afridi & Angell

Towards the end of 2014, the Dubai International Financial Centre (DIFC) enacted the DIFC Netting Law, which is the first of its kind in the Middle East. The Netting Law is based on the International Swaps and Derivatives Association model law.

The Netting Law gives certainty to close-out netting provisions, particularly in an insolvency situation. The concept of close-out netting is designed to operate at a master agreement level, allowing a party (usually the non-defaulting party) to terminate all the transactions, including those transactions that have not yet matured, with a counter-party; set off the dues and liabilities between the parties on a particular day; and arrive at a net amount payable by one party (usually the defaulting party) to the other party.

Enforceability of close-out netting, particularly in a situation of potential or actual insolvency of a counter-party, is one of the key credit-risk considerations for any party entering into a derivative or similar transaction. The Netting Law provides ample clarity and certainty on this front.

Salient features of the law

Applicability: The Netting Law applies to any "qualified financial instrument", netting agreement or collateral arrangement which is entered into by a DIFC entity or which is governed by DIFC law. A "qualified financial instrument" is widely defined to include derivative transactions, securities contracts and similar Shari'a compliant contracts or undertakings. It does not include insurance and reinsurance contracts.

Validity: In a major boost for the perception of derivative transactions in the region, the Netting Law clarifies that a "qualified financial instrument" cannot be held void or unenforceable on the grounds that it is a wager, lottery, gambling or gaming contract. In this context, it is pertinent to note that in the past, the courts in Abu Dhabi have held commodity and currency futures and spot trading to involve unenforceable contracts of risk, on the basis that the intent of the parties is not to engage in the physical transfer of the underlying subject matter of the contracts at issue but to cash settle the profit or loss on the contract to reference movements in value of the related commodity or currency.

Limitation of Insolvency Law: Save one exception, the Netting Law clarifies that in the event of any contradiction between the provisions of the Netting Law and the DIFC Insolvency Law of 2009 or the DIFC Insolvency Regulations, the provisions of the Netting Law will prevail. The powers of a liquidator to cherry pick specific transactions have been curtailed, and now the liquidator is required to apply the close-out netting provisions at the master agreement level only. It would, however, be curious to see how a UAE court (outside the DIFC) dealing with liquidation of a UAE company (incorporated outside the DIFC) would interpret the provisions of Netting Law in a situation when the company in question has entered into a qualified financial instrument governed by DIFC law.

Enforceability: The netting and set-off provisions of a qualified financial instrument will be enforced as per its terms against the counter-party, guarantor and any other security provider. The provisions of the Netting Law will be enforceable irrespective of appointment of any liquidator or any insolvency proceedings. Any claw-back or similar provision of law, or any court order will not render a provision of the Netting Law unenforceable.

Liquidation of collateral: The Netting Law provides wide scope for realization, appropriation and liquidation of collateral under a collateral arrangement in relation to a qualified financial instrument provided the steps are taken without prejudice to any agreement between the parties and are taken in a commercially reasonable manner as per the applicable laws.

Conclusion

Derivatives and securities transactions involving netting and set-off are not unknown in the UAE. The Netting Law brings a degree of certainty in relation to these transactions.

With the enactment of the Netting Law the DIFC joins a league of select jurisdictions in the world with such legislation. It is likely to provide the impetus required for derivatives and securities transactions in the region. The new law will apply by default to DIFC entities, and it is likely that entities in the region will increasingly opt for DIFC law as the governing law to attract the benefits of the Netting Law.

Comprehensive insolvency proceedings are rare in the UAE, and there is hardly any reported instance where the close-out netting provisions of a financial instrument were tested in an insolvency situation. It will be interesting to see how the new law is applied by the DIFC courts, as and when the occasion arrives. While the application of the Netting Law should be reasonably straightforward in relation to a DIFC entity, it could create challenges when applied in relation to a non-DIFC entity undergoing liquidation proceedings.

Vivek Agrawalla is an associate at Afridi & Angell, a UAE-based law firm with offices in Abu Dhabi, Dubai, the DIFC and Sharjah.