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Dubai: New fund regulations to open ‘flood gates’?

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With the recent enactment of the Collective Investment Law regulating the managed funds industry, the law governing asset management within the Dubai International Financial Centre has been completed. The author takes a look at the new regulatory regime that aims to make Dubai a leading fund centre.

Boomtown Dubai

Mentioned in the same breath with Hong Kong and Singapore, Dubai has become the extravagant trade, economic and tourism centre in the Middle East, the buzzing hub for goods, services and finance. One of the fastest growing cities in the region and one of the world’s most prominent centres for business and leisure, only the sky seems to be the limit and ‘world-class’ the standard Dubai is headed for.

Since the formation of the United Arab Emirates (UAE) in 1971, Dubai has developed rapidly from an oil- and gas-based state to a broadly-based market economy. A 30-year development plan provided for substantial investment in education and infrastructure and has led to rapid growth in trade and inward investment.

In the context of all of Dubai’s other recent achievements, the Dubai International Financial Centre’s (DIFC’s) aim to create a world-class financial market for the region, may be a logical development.

DIFC

General

The DIFC is a relatively new international financial centre on the global finance map. Aiming to develop the same stature as New York, London or Hong Kong and position Dubai as a universally recognised hub for institutional finance and the regional gateway for capital and investment, the DIFC primarily serves the vast region between Western Europe and East Asia. Opened in September 2004, the DIFC – including the stock exchange, the Dubai International Financial Exchange (DIFX) which opened in the DIFC in September 2005 – is part of the Dubai Government’s masterplan to create an environment for progress and economic development in the UAE and the wider region. The DIFC focuses on several sectors of financial activity: banking services (investment banking, corporate banking and private banking), capital markets (equity, debt instruments, derivatives and commodity trading), asset management and fund registration, insurance and reinsurance, Islamic finance, business processing operations and ancillary services. Financial institutions may apply for licences in these sectors. Foreign firms operating within the DIFC free zone find an attractive business environment, with benefits such as 100% foreign ownership, a zero tax rate on income and profits, a wide network of double taxation treaties available to UAE-incorporated entities, no restrictions on foreign exchange or repatriation of capital/profits, a US dollar-denominated environment, and strict supervision and enforcement of money laundering laws. Last but not least, financial services in the DIFC are regulated to international standards by the Dubai Financial Services Authority (DFSA).

Laws and regulations

The DIFC has been set up as a Federal Financial Free Zone based on an amendment to the UAE Constitution and a resulting federal law concerning financial free zones granting the Government of Dubai the right to create the respective legal framework. Vested with the authority to self-legislate in civil and commercial areas, the DIFC claims to provide a regulatory regime of the highest international standards for the creation and operation of a truly global financial centre.

DIFC laws are enacted by His Highness Sheikh Mohammed Bin Rashid Al Maktoum, Vice-President and Prime Minister of the UAE and Ruler of Dubai, and are considered at the level of local legislation pursuant to the UAE Constitution.

DFSA

The DFSA is the integrated regulator of all financial and ancillary services undertaken in or from the DIFC. Created by statute, the DFSA is entirely independent of the DIFC. Using a risk-based framework, the DFSA oversees the full range of financial and ancillary services, including wholesale banking, asset management, reinsurance, Islamic finance business, securities, derivatives and commodities exchange activities, legal services, accounting services, compliance services and other similar dealings. Institutions and individuals wishing to operate within the financial free zone are required to register and apply for authorisations and licences with the DFSA which has the power to hold them to account if they fail.

The DFSA administers the Regulatory Law, which is the cornerstone of the DIFC's regulatory regime. The Regulatory Law establishes the constitution of the DFSA and enables the creation of the regulatory framework within which entities may be licensed, authorised, registered and supervised by the DFSA. Under the Law, the DFSA has the power to enforce the rules that apply to all regulated participants within the DIFC. The DFSA also administers the Markets Law – governing the activities and conduct of financial market participants – and empowers the DIFX to act as the Listing Authority in the DIFC.

Investment management

Historically, the pool of financial assets held by Middle East and regional investors has been invested offshore in markets outside the region through financial

intermediaries primarily in London, Geneva, New York and Hong Kong. Reasons for this financial drain were the perceived political and other risks assumed in investing onshore, the illiquidity of local markets in the region, which have been incapable of absorbing the large pool of wealth, the lack of local financial products (in particular, mutual funds and other collective investment schemes) in the region and the absence of sophisticated local expertise in managing this asset pool.

With the economic development in the region, the growth of Islamic finance and the demographic changes resulting in a rising demand for pensions to meet the retirement needs of the region's ageing population, Dubai has identified an urgent need for an onshore centre through which to channel the financial assets of individuals and institutions. The scope for repatriating the more than US\$1 trillion invested, managed and administered outside the region, obviously represents a huge opportunity for asset management firms, private banks, fund administrators, custodian banks, rating agencies and other ancillary service providers.

The DIFC takes up the cause of being designed to offer domicile to the widest possible range of Islamic- and non-Islamic-compliant collective investment schemes, including traditional mutual funds, exchange-traded funds, open- and closed-ended investment companies, index funds, and also hedge funds and funds of hedge funds. Furthermore, all of these types of funds can potentially be listed and traded in dollar-denominated form on the DIFX.

The Collective Investment Law

General

In April 2006, legislation to regulate the managed funds industry within the DIFC has been enacted, thereby completing the Regulatory Law governing the asset management industry within the DIFC. The Collective Investment Law 2006 (CIL) creates the legal framework for the regulation of collective investment funds and permits the operation of various types and categories of funds within the DIFC, including hedge funds, fund of hedge funds and private equity funds.

The CIL applies in the jurisdiction of the DIFC, a self-legislated financial free zone within the Emirate of Dubai, and – together with any further legislation made for the purposes of the CIL – is administered by the

DFSA. Pursuant to the Regulatory Law and the CIL, the DFSA has issued detailed Collective Investment Rules (CIR) applicable to domestic DIFC funds only. With the purpose to further the CIL and provide guidance to market participants, the CIR are, *inter alia*, governing the establishment, management, operations and activities of a fund.

Authorisation

Under the concept of authorisation, only authorised firms are permitted to provide financial services within the DIFC. To operate a collective investment fund and manage its assets in accordance with the fund's constitution, a firm must obtain authorisations for:

- operation of a collective investment fund;
- administration of a fund;
- asset management;
- arranging credit and deals in investment; and
- dealing as an agent.

In order for the DIFC to assess the suitability of firms applying to become authorised firms and carry on financial services within the DIFC, applicants are required to submit detailed information with respect to its personnel's skills and experience, compliance, capital requirements and regulatory history. The entry requirements and strict criteria for authorisation set by the DIFC aim to ensure that operators are of high quality.

Of the above-mentioned financial services, only the provision of fund administration and the management of assets of a particular fund may be delegated to third parties, but are subject to rigid rules. Since the activities of asset pricing and fund valuation, issuing and redeeming fund units as well as record-keeping and maintaining the unit holders register must be carried out within the DIFC, the administrator will need to be located in the DIFC. However, as only a few administrators have established a presence thus far within the DIFC, for a short, not-yet-determined transitional period the DIFC allows DIFC funds to be serviced by administrators domiciled outside the DIFC, as long as they are regulated and located in a jurisdiction listed in a respective publication of the DFSA as a 'recognised jurisdiction' (comprising of, *inter alia*, Australia, the EU, Hong Kong, the UK and the US, but not traditional fund jurisdictions such as the Cayman Islands or Bermuda). This means that fund promoters with established administrator relationships, where such

administrators decide not to establish a presence within the DIFC, may be forced to decide between operating in the DIFC with a different administrator and carrying on business outside the DIFC with their established administrator.

As a further requirement, the CIL provides for an eligible custodian entity separate from the operator of the fund that must hold legal title to the fund's assets at all times. The function of eligible custodian may be performed by a bank, a trustee or a firm that is authorised to provide custody services and which fulfils certain eligibility criteria.

Legislation overlap

The CIL, with its specific regulations for collective investment funds, often leads to considerable overlap with other legislation applicable within the DIFC. In order to become an authorised firm within the DIFC, applicant entities must already show they have adequate controls and systems in place to ensure ongoing compliance with all relevant laws and regulations; however, on top of this, the CIL requires that public funds establish and maintain specific oversight arrangements to monitor compliance with respect to the law and the fund's prospectus and constitution. Permissible oversight arrangements for a corporate fund involve either setting up a panel consisting of independent, non-executive members of the fund's board or an eligible custodian, and – as regards a partnership – either a committee of at least two limited partners or an eligible custodian. Another overlap in legislation entailing time-consuming procedures and additional costs exists with regard to authorised firms carrying on business in the area of Islamic finance compliant with Shari'a.

Special requirements

The CIL contains further requirements for DIFC funds that may be unknown to promoters of funds operating and established in more traditional jurisdictions for investments funds, such as, *inter alia*:

- holding of annual meetings of holders of fund units;
- keeping registers of unit holders available for inspection by other unit holders;
- provision of annual and interim reports to unit holders free of charge and in the English language; and

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- applications for fund registration must be accompanied by a sign-off from the fund's legal advisers, including a declaration that the constitution of the fund and the prospectus comply with the relevant laws.

Types of funds

Irrespective of the legal structure, the CIL differentiates between various forms or types of collective investment funds, the constitution of the latter being comprehensively defined as 'any arrangements with respect to property of any description, including money, where the purpose or effect of the arrangements are to enable persons taking part in the arrangements to participate in, or receive profits or income arising from, the acquisition, holding, management or disposal of the property or sums paid out of such profits or income, where the arrangements are such that the persons who are to participate (unitholders) in the arrangements do not have day-to-day control over the management of the property and where the arrangements are such as the contributions of the unitholders and the profits or income out of which payments are to be made to them are pooled and/or the property is managed as a whole by or on behalf of the operator of the fund'. Domestic funds are funds established or domiciled in the DIFC, whereas foreign funds are funds established or domiciled in a jurisdiction other than the DIFC. In addition, foreign funds of any type that are constituted and domiciled in a country or territory specially recognised by the DFSA are considered designated funds. Public (domestic) funds are funds that have, or intend to have, more than 100 unitholders or the units of which are, or are to be, offered by the operator by means of a public offering to potential participants (qualified investors). Private funds are funds that do not meet these criteria. Funds that are admitted to the official list of securities maintained by a DFSA-licensed authorised market institution carrying on financial services in accordance with the DIFC Markets Law 2004 are considered as listed funds. Finally, the CIL in its related CIR, differentiates between various types of so-called specialist funds, expressly and specifically regulating (including detailed prospectus requirements) the following:

- Islamic funds (Shari'a compliant);
- funds of funds;
- feeder funds;
- private equity and venture capital funds;

- property funds (closed-ended only); and
- hedge funds.

Hedge funds

Under DIFC rules, a hedge fund is characterised by:

- a broad mandate giving its operator flexibility to shift strategy;
- aimed at achieving absolute returns rather than returns relative to the market;
- employing some or all of the following techniques:
 - the pursuit of absolute returns or 'alpha', rather than measuring their investment performance relative to the market;
 - the use of short selling;
 - the use of derivative instruments for investment purposes;
 - the use of economic or debt leverage, as well as leverage embedded in financial instruments such as derivative instruments;
 - the acquisition of distressed debt with a view to its realisation at a profit; or
 - the acquisition of 'high yield' debt securities; or
- charging performance-based fees in addition to a management fee based on the volume of assets under management.

Considered specialist funds under the CIL, respectively, the CIR, domestic hedge funds are subject to specific regulations. The operator of a hedge fund must demonstrate functional separation and independence between the activity of asset pricing and fund valuation and the investment management process, otherwise the DFSA may require the operator to appoint an independent suitably competent and experienced fund administrator to perform the functions of asset pricing and fund valuation. The annual report of a hedge fund must also include a report of its eligible custodian. Further special regulations apply with respect to the required risk management and net asset value calculation process, the investment strategy to be applied by the operator or investment manager of the hedge fund, the evaluation of prime brokers and with respect to operating funds of hedge funds.

Prospectuses and any other financial promotions of both private and public hedge funds, must contain a so-called

mandatory hedge fund disclosure statement set by the DFSA regarding the particular investment risk and certain expenses and fees related to hedge funds.

Marketing of foreign funds

In addition to the applicable provisions of the CIL, the marketing, offering and sale of units of foreign collective investment funds within, or from, the DIFC by an authorised firm is subject to regulation by the DFSA's Conduct of Business Rules (COB). Provided the foreign fund is a designated fund (as already described above) or has appointed an investment manager and eligible custodian, both of whom are authorised and supervised by a regulatory authority in a 'recognised jurisdiction', offering and sale of its units within or from the DIFC by an authorised firm shall be permitted. The DFSA may recognise any country or territory and designate any type of fund constituted and domiciled in such a country or territory for the purposes of the CIL; however, the DFSA may not recognise any country or territory nor designate any fund in that country or territory for such purposes unless it is satisfied that the law and practice under which the relevant foreign funds are authorised or approved and supervised in that country or territory is broadly equivalent to the DFSA's regulatory regime as it applies to domestic funds, that the law and practice under which investment managers and eligible custodians are authorised or licensed and supervised in that country or territory is broadly equivalent to the DFSA's regulatory regime as it applies to such persons, and that adequate arrangements exist, or will exist, for co-operation between the regulatory authority in that country or territory, responsible for such authorisation, licensing, approval and supervision and the DFSA. By means of a written notice, the DFSA has published a table of such foreign 'recognised jurisdictions' and associated designated funds, listing, *inter alia*, certain US and Canadian mutual funds, UK unit trust and authorised qualified investor schemes, EU UCITS (Undertakings for Collective Investment in Transferable Securities) compliant funds or schemes and Hong Kong unit trusts or mutual funds.

Following some concerns raised by industry practitioners shortly after the introduction of the CIL and its related COB Rules that the requirements relating to the types of foreign funds that may be marketed and sold in or from the DIFC are too restrictive, the DFSA has reviewed these requirements and is proposing some changes with regard to COB, which are designed to facilitate the marketing

and selling of units of foreign funds in a wholesale market. The amendment proposals, mainly relating to alternative investment products such as hedge funds and also to the eligibility criteria for custodians, have been published in the DFSA Consultation Paper No. 34 of 7 June 2006 seeking public comment no later than 19 July 2006. As an additional ground on which a foreign fund may qualify for marketing and selling its units in and from the DIFC, the DFSA proposes to accept foreign funds that are rated or graded as at least investment grade by Moody's, Fitch or Standard & Poor's or such other international rating agency that is recognised by the DFSA.

Conclusion

Aiming to become one of the world's leading funds centres, the DIFC describes the new regulatory regime as tailor-made, meeting demand for a modern, well regulated centre for the establishment of funds and its management and administration within the Middle East, allowing for flexibility and innovation. Following the enactment of the CIL, 'flood gates' are predicted to open, attracting funds, fund managers and administrators to a region that, so far, has not even played a small role in terms of the global funds industry. As regards considering the domicile for the establishment of funds, it will be interesting to see if, in the long run, the level of regulation provided within the DIFC together with benefits such as, *inter alia*, zero tax on profits, will allow for success in competition with traditional offshore jurisdictions' minimal regulatory regimes and established infrastructures.

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