

Client Alert

Latham & Watkins
Corporate Department

UAE Funds Update: Arrival of the UAE's New Investment Funds Regulation

Eighteen months after the first draft was issued for public comment, the final text of the UAE's long-awaited new Investment Funds Regulation (the Regulation) has now been approved by the Board of the UAE Securities and Commodities Authority (the SCA). The Regulation will be effective, as SCA Board Resolution No. 37 of 2012 on the Regulation of Investment Funds, following its publication in the Official Gazette, which is expected in late August or early September 2012. Although the Regulation has been substantially revised since the draft published in January 2011 (the Draft Regulation), it nonetheless continues to include a number of provisions that significantly alter the regulatory regime governing:

- The marketing of interests in investment funds established outside the UAE (each, a Foreign Fund) to investors in the UAE
- The establishment of local investment funds domiciled in the UAE (each, a Local Fund).

This *Client Alert* follows on from our previous *Client Alert No. 1140* published following the release of the Draft Regulation in January 2011. It provides an overview of key aspects of the new Regulation relevant for fund sponsors and managers considering the UAE as a potential jurisdiction in which to domicile a Local Fund or market interests in a Foreign Fund.

It should be noted at the outset that this *Client Alert* addresses the regulatory regime governing investment funds in the UAE outside of the Dubai International Financial Centre (the DIFC). As a financial free zone, the DIFC has its own regulatory regime governing the establishment and marketing of investment funds that is separate to the "onshore" regime of the wider UAE. Unless otherwise specified, references in this *Client Alert* to the UAE do not include the DIFC. Under the Regulation, an investment fund established in the DIFC is classified as a Foreign Fund.

Summary of the Key Changes

In summary, key highlights of the new Regulation include:

- Primary responsibility for overseeing the licensing, regulation and marketing of investment funds in the UAE has been transferred from the Central Bank of the UAE (the Central Bank) to the SCA.

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- SCA approval is now required for the establishment of a Local Fund and for the marketing of a Foreign Fund to investors in the UAE.
- The marketing of a Foreign Fund to investors in the UAE requires the appointment of a locally licensed placement agent.

Background

“Twin peaks” model. Prior to adoption of the Regulation, responsibility for regulating and exercising oversight of investment funds within the UAE rested with the Central Bank. The new Regulation and transfer of responsibility to the SCA represents a step towards a “twin peaks” model of regulation. It is expected that the Central Bank will remain responsible for monetary policy, macro-economic stability and systemic risk management, while the SCA will become increasingly active in more commercial and consumer-oriented areas, including exercise of oversight over financial markets and investor protection. Article 29 of the Regulation expressly refers to the Central Bank exercising supervision over the financial position of investment funds established and licensed under the Regulation.

Tolerated practices. Historically, there has been no statutory or regulatory framework expressly governing the marketing of investment funds in the UAE (other than in or from the DIFC). In particular, the UAE has lacked a formal “private placement” regime, which would expressly permit interests in investment funds — whether local or foreign — to be offered on a private placement basis to certain sophisticated investors in the UAE without triggering licensing or approval requirements. In the absence of a formal regime, the funds industry has relied on a set of informal “tolerated practices” to avoid infringing securities laws and offering restrictions in the UAE in relation to the marketing of interests in Foreign Funds. It has generally been accepted that the UAE authorities would not seek to regulate a discreet offering of interests in a Foreign Fund made from outside the UAE to a small number of sophisticated or high-net worth investors situated in the UAE.

Draft Regulation. In January 2011, the SCA released for public comment proposed new investment funds regulations in the form of the Draft Regulation (see our *Client Alert No. 1140*). At the same time, the SCA also published proposed regulations governing investment management activity in the UAE (the Investment Management Regulation).

Unfortunately, the Draft Regulation failed to memorialize the “tolerated practices” regime and contained no private placement exemption whatsoever. Instead, the Draft Regulation introduced a requirement that any marketing of a Foreign Fund in the UAE must be conducted by a locally licensed distributor and approved by both the SCA and the Central Bank. The Draft Regulation also required SCA approval for the establishment of a Local Fund. In addition, the draft Investment Management Regulation would have required a license from the SCA in order to conduct investment management activities in the UAE.

Revised Regulation adopted. Following significant industry feedback, the new Regulation as enacted by the Board of the SCA reflects a number of revisions, but its fundamental tenets remain, including the transfer of most responsibility with regard to investment funds from the Central Bank to the SCA and the requirement for SCA approval to market Foreign Funds in the UAE (even on a private placement basis). It should be noted that the proposed Investment Management Regulation has not been adopted, and it is understood that its implementation has been deferred indefinitely. Note, however, that Article 32 of the Investment Funds Regulation contains a number of provisions setting out the obligations of an investment manager in relation to a Local Fund.

Marketing Foreign Funds in the UAE

As the UAE (outside the DIFC) is not traditionally an international jurisdiction of choice for the formation and domicile of investment funds, most funds-related activity in the UAE is focused around marketing interests in Foreign Funds to local UAE investors. As noted previously, this has historically been undertaken on the basis of industry-developed "tolerated practices". The new Regulation seeks to formalize the position with regard to the marketing of interests in Foreign Funds in the UAE.

SCA approval required. Article 36 of the Regulation provides that SCA approval is required for any promotion in the UAE of interests in a Foreign Fund. The Regulation provides no exemption for private placements, and indeed makes no distinction in this regard between a fund marketed to retail investors and a fund targeted solely at sophisticated and institutional investors. This is a significant change from the "tolerated practices" regime.

It remains to be seen how practice will develop in this area, but one potential outcome is that international sponsors will seek to conduct the marketing of a Foreign Fund such that it falls outside the scope of the Regulation altogether, by conducting the marketing entirely outside the UAE. While Article 36 is unambiguous regarding the need for SCA approval, it does not define in any detail what is meant by "*promoting a foreign investment fund in the UAE*". This potentially leaves open the door for sponsors to take the view that a discreet, reverse-solicitation marketing strategy conducted from offshore, with offering documents made available from outside the UAE, subscription agreements signed offshore and subscription proceeds wired from overseas, would fall outside the scope of the Regulation and therefore not require SCA approval.

Requirement for local agent. Article 37 of the Regulation requires the appointment of a "local promoter" or placement agent in relation to any offering of a Foreign Fund in the UAE. The placement agent is responsible for, among other things, (i) filing the application for SCA approval; (ii) liaising with the SCA on behalf of the Foreign Fund; and (iii) conducting all marketing activities in the UAE in respect of the Foreign Fund. Article 38 sets out the range of entities that may act as a local placement agent in respect of a Foreign Fund, namely:

- A bank licensed by the Central Bank
- An investment company licensed by the Central Bank
- A company holding an SCA license to act as a local placement agent.

Note that, in relation to the third category, the application process and documentation required in order to become licensed by the SCA as a local placement agent remains unclear. Article 38 also provides that, in the case of units in a Foreign Fund promoted in the UAE on a "private placement" basis targeted only at institutional investors and with a minimum subscription amount of AED 10 million per subscriber, a representative office of a foreign company established in the UAE may act as the local placement agent without any need for the representative office to hold a particular regulatory license (other than a valid trade license to conduct business in the UAE). It should be noted that, while the Regulation does not define what is meant by an "institution", this should be read as a reference to an entity investing at least AED 10 million into the relevant Foreign Fund. The Regulation does not specifically require the "institution" to be a bank or other type of licensed credit institution.

Duties of local agent. Article 39 of the Regulation imposes a series of obligations on the local placement agent, including a duty of care in selecting the Foreign Fund to ensure the protection of investors and duties in relation to record-keeping, making information available to investors and "know-your-client"-type obligations in relation to subscribers. A provision, contained in the Draft Regulation, which would

have required the local placement agent to indemnify UAE investors against all “non-commercial risk” associated with investing in a Foreign Fund, does not appear in the final form of the Regulation.

Note also that Article 39(7) of the Regulations places an obligation on the local agent to verify that each investor has been informed — before subscription — that the SCA accepts no liability in relation to the Foreign Fund and is not making any recommendation with respect to the investment. A local agent will satisfy this requirement if it obtains the investor’s signature confirming its understanding. In practice, this will likely be satisfied by including within the relevant subscription agreement (which is signed by the investor) an appropriate disclaimer in relation to the SCA.

Public vs. private placement. While the requirement for SCA approval applies to both retail and private funds, it should be noted that the Regulation makes a distinction between Foreign Funds which are (i) intended to be marketed to the public (*i.e.* retail investors) in the UAE under Article 35; and (ii) those Foreign Funds intended to be promoted in the UAE on a private placement basis only under Articles 36 and 41.

Public placement. Under Article 35 of the Regulation, interests in a Foreign Fund may not be marketed to the general public in the UAE unless the Foreign Fund is (i) established in a foreign country and subject to the supervision of a supervisory authority “equivalent” to the SCA; and (ii) licensed to be offered to the public in its home country. It is understood that the SCA has compiled, or is in the process of compiling, a list of jurisdictions whose regulators it considers to be “equivalent” to the SCA, although questions remain over whether this list will be publicly available and which jurisdictions will be included. In particular, it is not known whether the DIFC will feature on the list.

Private placement. Articles 36 and 41 of the Regulation apply when a Foreign Fund is *not* open to public subscription in its home jurisdiction. Promotion of interests in such a Foreign Fund must be by “*direct communication with pre-determined persons*” and the minimum subscription amount per-subscriber must be as set out in Article 41. Interestingly, Article 41 provides that the minimum subscription amount per-subscriber is generally AED 500,000, *except* in the case of a Foreign Fund established in a “free zone” outside the UAE, in which case the minimum subscription amount per-subscriber is AED 1 million. The use of the term “free zone” to describe a jurisdiction outside the UAE is unusual. It would appear to refer to jurisdictions such as the Qatar Financial Centre, but may also refer to traditional offshore financial centers such as the Cayman Islands, which would not describe themselves as “free zones”. It would appear that funds established in the DIFC, being a free zone situated inside the UAE rather than outside it, would be subject to the lower minimum subscription amount per-subscriber of AED 500,000.

Establishing Local Funds in the UAE

While the marketing of Foreign Funds to UAE investors will likely remain the main focus of international fund sponsors and managers, the bulk of the new Regulation is focused instead on the establishment and operation of Local Funds. It is unlikely that the wider UAE (outside the DIFC) will become a domicile of choice for international investment funds, but these provisions will be of interest to local sponsors — such as local UAE commercial banks, private equity firms and investment companies — seeking to establish Local Funds to target UAE investors.

Sponsor. Article 4 of the Regulation provides that the entity establishing a Local Fund (*i.e.* the sponsor) must be either (i) a UAE joint stock company; or (ii) a UAE branch of a foreign company. It is worth noting that a joint stock company incorporated under the UAE Commercial Companies Law of 1984 must be at least 51 percent owned by UAE nationals (or alternatively 100 percent owned by

nationals of Gulf Cooperation Council (GCC) countries). A branch of a foreign company is not subject to foreign ownership restrictions, but would require careful structuring in order to act as a fund sponsor. In particular, a branch does not enjoy a legal personality separate from its parent company. This would need to be borne in mind if the parent company has other liabilities and other interests aside from the particular fund. In any event, the Regulation provides that the sponsor of a Local Fund must have a minimum capital of AED 10 million.

Article 4(4) of the Regulation also requires that the sponsor of a Local Fund must contribute at least 3 percent (but not more than 49 percent) of the capital of the fund. This is designed to align the interests of the fund's promoters with those of the other investors. It should be noted that banks and investment companies licensed by the Central Bank are exempt from this requirement, although it is not clear which specific type of license will entitle an entity to benefit from this exemption.

Fund structure. While the Regulation specifies the types of entity that may act as the sponsor of a Local Fund, it does not prescribe a particular form of entity for the Local Fund itself, and appears to envisage a Local Fund being established by contract between the investment manager and investors. Contractually based funds are common in the GCC, although in many other jurisdictions they exist as an alternative to establishing a fund as a separate vehicle, such as a company or limited partnership.

SCA approval. The establishment of a Local Fund requires a license issued by the SCA under Article 5 of the Regulation.

Offering document. The Regulation contains detailed content requirements for the offering document for a Local Fund. In particular, the offering document must be in Arabic, and Article 9 of the Regulation provides that the Arabic version of the offering document prevails over any English translation. Article 10 sets out the minimum contents requirements for an offering document, most of which are uncontroversial. Although not expressly set out in Article 10, there is a requirement to include risk factors, as this is a required component of the "investment policy" under Article 12. An amendment to the offering document requires the approval of the investors under Article 11, although there is a carve-out to the requirement for investor approval in the case of amendments of a technical nature which do not affect the rights of unit-holders, with the implication being that such amendments may be made by the manager. However, Article 11 requires SCA approval for any amendment to an offering document, and unlike in the case of unit-holder approval, there is no carve-out for minor or technical amendments.

Investment policy. A Local Fund is required to adopt an "investment policy" in accordance with Article 12 of the Regulation, which sets out the minimum contents requirement for such a policy and a number of restrictions. No investment may be made by a Local Fund in any legal entity where the liability of shareholders is "undefined". It is unclear whether this refers only to an entity where the liability of shareholders is simply unspecified or where it is expressed to be "unlimited". It is also unclear how this would apply to an investment in an entity or vehicle that does not have a share capital and hence does not have shareholders — for example an investment in a limited partnership. Article 13 of the Regulation sets out a number of investment ratios which must be adhered to by a Local Fund unless otherwise approved by the SCA. These include:

- No more than 15 percent of the fund's total capital may be invested in securities of a single company.
- Investments in any single category (e.g. stocks or bonds) may not exceed 10 percent of the fund's total capital (which would appear to contradict the restriction above).
- Investments in a company may not exceed 15 percent of the securities issued by such investee company.

- Investments in other similar investment funds may not exceed 20 percent of the fund's total capital.
- Investments in foreign markets may not exceed 20 percent of the fund's total capital.

These restrictions make it impossible (without obtaining waivers from the SCA) to establish a Local Fund to act as a feeder fund investing in the stock of one specified company or interests in one underlying fund, or for a Local Fund to take a greater than 15 percent stake in a portfolio company, which is a significant restriction on the utility of a Local Fund. In effect, this places a Local Fund established in the UAE in a less favorable position than a foreign company (or Foreign Fund), which is able to hold up to 49 percent of a local UAE investee company. Similarly, the 20 percent limit on investments in foreign markets makes a Local Fund unsuitable for use as a vehicle to invest in markets outside the UAE, and rules out the UAE as a domicile for international investment funds. Prior approval may be obtained from the SCA in order to permit a Local Fund to invest in foreign markets above this limit (Article 13(3)), but the fund is then required to file monthly reports to the SCA as to the volume and details of its investments overseas and its financial position.

Also, it is unclear how the various investment thresholds are to be calculated. Particular questions will likely arise in the context of an open-ended fund with fluctuating membership and amount of capital. It is not clear whether the threshold test is to be applied (i) on a one-time basis; or (ii) on an on-going basis, in which case at which intervals. Also, with closed-ended funds, it is not clear whether the reference to a fund's "total capital" refers to committed capital or capital that has been drawn down.

Lastly, the provisions relating to a Local Fund's investment policy do not cater for investments that do not take the form of securities in a company. It is common for an investment fund to invest in interests of a limited partnership or other non-corporate vehicles, and it is not clear how these will be treated under the Regulation.

Other provisions. The Regulation contains a number of other provisions relating to Local Funds, including in relation to the listing and trading of funds on securities exchanges in the UAE, rules governing redemptions, circumstances in which the SCA's approval may be obtained to suspend redemptions in the case of adverse financial conditions, and rules governing service providers. Article 7 of the Regulation also restricts a Local Fund from pledging funds to repay any liabilities incurred by the fund's promoters. This will make it difficult for a sponsor to warehouse investments and subsequently transfer these to a Local Fund.

It should be noted that a number of types of fund-like arrangements are expressly excluded from the scope of the Regulation, including employee incentive programs, social security contributions, collective insurance contributions and the collection of funds for the purpose of formation of any type of company under the UAE Commercial Companies Law of 1984.

Impact of the New Regulation

The Regulation marks a significant step in the development of the regulatory framework governing investment funds in the UAE — both in terms of establishing Local Funds and the marketing within the UAE of interests in Foreign Funds — and forms part of the UAE's drive towards a "twin peaks" regulatory model.

Foreign Funds. The Regulation represents an attempt to formalize the regime governing the marketing of interests in Foreign Funds in the UAE. While the most noticeable development is the new requirement for SCA approval, it remains to be seen to what extent sponsors will seek to structure their marketing efforts so as to fall outside the remit of the Regulation altogether.

Local Funds. Insofar as the Regulation addresses Local Funds, it would appear from the various restrictions contained in the Regulation (particularly the restriction on overseas investments and the limitations on investing in any one underlying issuer) that the SCA is not seeking to attract international or regionally focused investment funds to consider the UAE as a domicile of choice. The Regulation, as far as it applies to Local Funds, appears to have been designed with the domestic UAE investor community in mind.

Grandfathering. Note that Article 47 of the Regulation grants entities already engaged in investment fund activities prior to implementation of the Regulation a period of one year to achieve full compliance.

Impact on the DIFC. The DIFC operates its own sophisticated regulatory regime governing the formation and marketing of collective investment funds that is entirely separate to the regime in the wider UAE and is overseen by the DIFC's securities regulator – the Dubai Financial Services Authority. In view of the very small pool of potential investors physically situated within the DIFC, a key selling point of the DIFC in the funds context has been as a 'gateway' to the wider UAE and the Middle East region. However, the new Regulation effectively treats the DIFC as being an entirely 'foreign' jurisdiction, offering very few concessions to funds domiciled in the DIFC. Without this 'gateway' advantage, it may be difficult for the DIFC to continue to persuade international fund sponsors and managers to set up in the DIFC.

If you have any questions about this *Client Alert* or Latham's Investment Funds Practice in the Middle East, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

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