

New UAE Funds Regulation substantially change the marketplace

by Lynette Brown - l.lynette@tamimi.com -
Dena El khatib - d.elkhatib@tamimi.com -

September 2012

Introduction: In August 2012, the UAE Securities and Commodities Authority (“SCA”) issued Board Resolution No. 37 of 2012 concerning the rules of investment funds (the “Regulation”), which will become effective upon publication in the Official Gazette.

Such publication is expected to occur during . The issuance of the Regulation has been expected for some time and is the culmination of a number of changes taking place in the relationship between the UAE Central Bank (“Central Bank”) the SCA and in relation to financial regulations generally in the UAE. This changing relationship has been earlier evidenced by an arrangement entered into between the Central Bank and the SCA in 2010 to determine the responsibilities of each governmental entity relating to particular financial activities. Following this arrangement, the SCA undertook the responsibility of fund regulation and in January 2011, the SCA circulated an initial draft regulation as to the establishment, marketing and operation of investment funds in the UAE. This draft regulation prior to the issuance of the Regulation been applied informally by the SCA in relation to local investment funds and the marketing and promotion of foreign funds by UAE Central Bank licensed banks and investment companies.

The Regulation will have a substantial impact on both the establishment of local investment funds and the marketing and promotion of foreign funds in the UAE, particularly where these are being marketed and promoted by foreign entities located off-shore or from a representative office located in the UAE. Such institutions will need to re-evaluate their current practices in order to ensure compliance with the Regulation. Previous reliance on ‘tolerated practices’ will no longer be available to such foreign financial institutions – including their representative offices and financial institutions located in the DIFC as well as abroad.

Local Investment Funds

In our view, the impact on the establishment of local investment funds will be substantial. Under the earlier Central Bank regulations local banks and investment companies had a high degree of flexibility when establishing local funds as the regulations were very light and the emphasis was on approval by the Central Bank. With the Regulation, we now have a highly regulated and prescriptive environment with a number of mandatory third party service providers. We would expect that the cost of managing funds will increase and that the ability for funds to be flexible and target small numbers of investors will be more difficult.

A local fund is defined as one that is established in the UAE (excluding the DIFC) and is licensed by the SCA. Existing funds which have been approved by the Central Bank have a period of one year from the date of publication of the Regulation in the Gazette to become compliant with the provisions of the Regulation (including obtaining the approval of the SCA). It is specifically stated that an investment fund established in a free zone in the UAE (i.e. the DIFC) will be considered to be a foreign fund for the purposes of the Regulation.

The definition of a local fund is potentially very wide as it is defined as a financial pool which engages in the activity of collecting monies from investors in return for the issuance of investment units of equal value and rights for the purpose of investment. The Regulation does however

exclude from this definition various activities outlined specifically such as, but not limited to, the pooling of monies in a joint bank account, collective insurance contracts, and monies collected for the establishment of an entity in accordance with the UAE Commercial Companies Law.

In order for any local fund to be established or promoted within the UAE (excluding the free zones), such local fund is to be duly approved and registered with the SCA in accordance with the Regulation. The Regulation provides for specific requirements for the establishment of the local fund (i.e. management, daily monitoring of activities, offerings, etc) and the limitations on the promotion of such local funds. Of note, each local fund will be required to appoint an Investment Manager (although this may be the same entity as the fund founder), an Administrative Services Company, a Custodian and an external auditor. It is unclear if a commercial bank may undertake the functions of fund founder, investment manager, administrative services company and the custodian (as would be the case with a Central Bank regulated fund) but it would appear that at least the role of administrative services company and the custodian would need to be separate given the oversight function of these two service providers.

In addition to the service providers there are other specific requirements which will impact a financial institution looking to establish a local fund in the UAE:

1. The company establishing a local fund must invest at least 3% of the local fund's capital but not invest more than 49% of the capital of the fund unless the fund is closed ended and does not allow offering or trading of its units to the public.

It is unusual for a bank or investment company to be expected to invest in the establishment of a local fund. However, this requirement in the Regulation is clearly noted and will be a new factor to consider when establishing a local fund in the marketplace.

2. It isn't clear if the fund will be a separate juridical entity from the fund founder.

Certain provisions imply that the governance of the fund will be subject to similar rules as a corporate entity (i.e. meetings of unitholders', liquidation etc.) however, it is unclear from the Regulation. Note that the current UAE Commercial Companies Law does not provide for the establishment of fund companies so it may be the intention that the local fund would not be a separate legal entity (at least until there is a change to the UAE Commercial Companies Law).

In relation to the capacity and authority of the local fund, the Regulation notes that the local fund will be governed by a board of directors appointed by the board of the company to oversee the fund. It is important to note that each member of the local fund board of directors is to be approved by the SCA and may not be removed without such approval. The Regulation details the responsibility of the local fund board of directors, including the capacity to conclude contracts with the service providers to the fund, but it is unclear how it will in fact be effected if the fund is not a legal separate entity.

Under the current Central Bank regulations there is also this problem and the better view has been that the local fund is really an investment account held with the financial institution which manages the local fund. It isn't clear if this will also be the case with local funds established under the Regulation.

3. Each local fund appears to be required under the Regulation to have an investment manager, an administrative services company, a custodian and (if investing in real estate) a valuer.

The condition of each appointment is to ensure that each appointed entity and/or person is suitably licensed to fulfill the responsibilities of the requisite task. There is a requirement that the investment manager and administrative services company be licensed to practice their respective activities and presumably this means a UAE license as the activities will be undertaken in the UAE.

For the custodian, the license required will be an SCA license to provide custodial services.

In each case, we assume that a DFSA license will be insufficient.

4. There are extensive reporting requirements for the investment manager and administrative services company to comply with in relation to the fund. Accounts are required to be audited quarterly as well as annually.

5. It is anticipated that there will be further regulations issued in relation to specialist funds (i.e. REIT, exchange traded funds).

Marketing and Promotion of Foreign Funds

The Regulation also provide restrictions on the marketing and promotion of foreign funds in the UAE. The definition of a foreign fund will include any funds established in the DIFC as well as funds established outside of the UAE, even if being marketed by a Central Bank regulated representative office in the UAE. No foreign fund may be marketed or promoted in the UAE without first being approved by the SCA.

In order to be eligible for approval by the SCA for a public offering, the fund must be established in a foreign country (including the DIFC) and be subject to the control of a supervisory authority similar to the SCA and licensed to promote a public offering. A private offering of a fund must also have the SCA approval and marketing activities will be limited to direct contact with pre-determined people.

The approval process is to take 30 days from submission of all information and documents to the SCA. The SCA may however impose any conditions on such approval or may suspend any decision in its sole discretion. Any decision may be appealed with the SCA in accordance with the SCA guidelines and a final decision may be obtained in UAE court, if necessary.

While the approval process should not be problematic, the main changes will be seen in relation to the operation of what has been called a 'tolerated practice' in relation to the marketing and promotion of foreign funds in the UAE. Under the Regulation, a foreign entity (including a DIFC entity) wishing to promote a foreign fund in the UAE will not be able to do so without appointing a local promoter. The local promoter must be either a bank or investment company licensed by the Central Bank or a company licensed for such purpose by the SCA. It is unclear at this stage if this latter category may leave room for DIFC entities, representative offices or other foreign entities to obtain a SCA license, but this is generally considered to be unlikely.

It is noted that representative offices, which have to date been able to market their own foreign fund products in the UAE, will only be able to promote foreign funds by private placement to institutions with a minimum investment of AED 10 million per subscriber. As many representative offices are of private banks, with private individual clients, meeting this requirement will be extremely difficult. We further note that DFSA regulated funds as well as funds from recognised regulated countries with sound regulation are not automatically exempted from the SCA approval process (as is the case in the DIFC).

Local promoters may also face difficulties in meeting requirements for foreign funds as they are required to continue to follow up in relation to the performance of the foreign fund following promotion to ensure protection of investor's monies. This requirement is very vague and may be difficult if the local promoter does not have an ongoing relationship with the fund manager. The local promoters are also required to distribute dividend and redemption proceeds to unitholders if not otherwise undertaken by an entity in the UAE. Given that most foreign funds will have off-shore administrators tasked with this role, this will be difficult for the local promoter to undertake practically and is not an ongoing role that many would want or be set up to perform.

Conclusion

As stated above, in our view, the Regulation will have a substantial impact on both the local fund industry as well as the marketing and promotion of foreign funds in the UAE.

Existing local funds will be required either to liquidate their assets and be wound within one year from the date the Regulation are gazetted or be amended to comply with the new requirements and obtain approval from the SCA under the Regulation. For local fund managers wishing to establish new funds there are a number of areas of uncertainty in relation to the form the local fund will be expected to take, the role and costs of the various service providers and the steps they will need to take to comply with the new Regulation.

In relation to the marketing and promotion of foreign funds, foreign fund managers and foreign fund distributors will need to reassess their business strategy and determine whether they will appoint local promoters or whether they will attempt to market and promote their foreign funds to investors in the UAE using electronic means rather than face to face visits.

We expect the new Regulation to be an area of major concern for fund managers and distributors looking to operate in the UAE.