CLIFFORD CHANCE

Client briefing
April 2011

ESCA Consultation on Investment Funds Regulations – Latest Developments

Please see the last section of this client briefing regarding clarifications provided by ESCA in a recent meeting with Clifford Chance LLP and certain industry members

In January 2011, the UAE Securities and Commodities Authority ("**ESCA**") published a Draft Decision on Investment Funds (the "**Investment Funds Regulation**") for consultation. If and when implemented, the Investment Funds Regulation will transfer regulatory responsibility for the licensing and marketing of investment funds and for a number of related activities from the UAE Central Bank (the "**Central Bank**") to ESCA. ESCA has confirmed that the UAE is considering implementing a "twin peaks" model of financial services regulation and supervision and the Investment Funds Regulation represents the first move in this direction. Under a twin peaks model, the Central Bank would be responsible for both systemic stability and prudential oversight, while ESCA would be responsible for conduct of business matters (including markets oversight and consumer protection).

Pursuant to the draft Investment Funds Regulation, all funds made available to investors in the UAE (irrespective of minimum investments, the size, number or sophistication of investors, and of whether contact results from reverse solicitation) would need to be approved by ESCA and offered through a locally licensed placement agent.

If implemented, this may cause problems for many firms established in the Dubai International Financial Centre ("**DIFC**") or elsewhere, who currently engage in a limited amount of cross-border business with non-retail investors in the UAE in a manner that was previously tolerated by the Central Bank. The proposed regime is more stringent than that applied by other regulators in the region (where there is often an informal "tolerated practice" for non-retail business) or in European jurisdictions (where there is generally an explicit exemption for private placements or exempt offers), and would be most comparable to the position in Saudi Arabia.

Latest developments

The period for consultation on the draft Investment Funds Regulation ended, after ESCA extended the original period, at the end of February 2011. It is understood that ESCA received an overwhelming number of responses to the initial consultation and, consequently, held two "lectures" (one in Abu Dhabi and the other in Dubai) to communicate its thoughts to interested parties on the draft Investment Funds Regulation and the consultation responses received.

Clifford Chance LLP was represented at both lectures and below we summarise our understanding of the key points discussed by Dr. Mounther Barakat of ESCA. We are aware that there were some differences in content between the Abu Dhabi presentation and the Dubai presentation (which could be as a consequence of the nature of the attendees at the different lectures; the lecture in Abu Dhabi was attended primarily by representatives of local banks whereas the lecture in Dubai was attended primarily by representatives of DIFC firms). Furthermore, in the absence of a revised draft of the Investment Funds Regulation or of any other written material provided by ESCA, it should be noted that the accuracy of the below cannot be guaranteed. Additionally, Dr. Barakat made it very clear that many of the issues set out below are still under discussion within ESCA itself, and that

Key Issues

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the position may well change further (perhaps significantly) by the time the revised Investment Funds Regulation is published. No further drafts of the Investment Funds Regulation are expected, and it was indicated that ESCA will implement a form of the regulation by the middle of May 2011.

The main issues discussed were:

Licensing

The draft Investment Funds Regulation listed the conditions that must be met prior to ESCA granting approval for the promotion of a foreign investment fund in the UAE. From the draft Investment Funds Regulation it appeared that both the approval of the Central Bank and the approval of ESCA would be required before units of a foreign fund could be marketed within the territory of the UAE and even then, this would need to be done through an authorised distributor in the UAE.

ESCA has now stated that local fund managers or distributors will need to be licensed by both ESCA and the Central Bank, but that foreign funds to be marketed in the UAE would need to be approved by ESCA only. Approval and licensing fees are still under discussion, but approval fees for individual funds are likely to be in the region of AED 1,000 for funds established in a "peer jurisdiction" and AED 2,000 for funds established in an "offshore jurisdiction", whereas blanket licences for fund platforms and licences for authorised distributors are likely to be more expensive (approximately AED 10,000 to AED 20,000). It is not currently clear whether a foreign fund that will be marketed by multiple local distributors (all of which are already licensed as authorised distributors) would need to be approved once only or if each distributor would need to apply for approval separately, and it was suggested that both options are being considered. There may also be some scope for established local distributors selling a significant number of funds to obtain a blanket approval (on the basis that the distributor would take responsibility for vetting individual funds), but it is not clear how this would operate in practice.

Treatment of the DIFC and DIFC firms under the Investment Funds Regulations

The draft Investment Funds Regulation is silent on how the DIFC would be treated going forward. However, there appear to be three different points of view within ESCA, namely: (1) treat the DIFC as an "offshore jurisdiction" and provide no special exemptions; (2) treat the Dubai Financial Services Authority (the "**DFSA**") as a "peer" regulator and provide a passporting or light-touch approval regime for funds marketed by DFSA-regulated firms from the DIFC; or (3) treat the DIFC as a "partner jurisdiction" and allow DIFC firms to market on a preferential or onshore basis. It appears that ESCA is aware of, and is seeking to accommodate, the views expressed by the DIFC Authority and the DFSA, but is unsure of how to achieve this without creating a conflict with UAE Federal Law restrictions on DIFC firms doing business "in the UAE". It was indicated that the DIFC/DFSA are currently involved in discussions with ESCA on this point. It remains to be seen how this issue will be resolved and, at this point, all that can be said is that ESCA is aware of the issue but has not yet decided upon a solution.

Private placement considerations

The draft Investment Funds Regulation does not provide for any form of private placement regime and, subject to any specific exemptions for DIFC firms, it appears that ESCA is not currently proposing to provide for a private placement exemption or other general exemption for non-retail business going forward. ESCA has discussed a quasi "private placement" regime for funds. This would not remove the need for the fund to be marketed through a local placement agent or the requirement for the fund to be approved by ESCA before it can be marketed in the UAE. However, we understand that such approval would most likely be very "light-touch" when compared to the approval process for retail funds. Additionally, whilst it currently appears that a requirement to translate prospectuses for retail funds into Arabic will be imposed, "private placement" funds could be marketed using an English-language prospectus together with an Arabic-language term-sheet.

The current proposed thresholds for the quasi "private placement" regime (which, we understand, are still very much under consideration) were:

- a minimum investment amount of AED 250,000 for funds established in the UAE (and for these domestic funds, some of the more onerous reporting and disclosure requirements would be relaxed and a number of diversification requirements and investment restrictions would be disapplied);
- a minimum investment amount of AED 500,000 for funds established in "peer jurisdictions" (such as the EU jurisdictions and the US);
- a minimum investment amount of AED 1,000,000 for funds established in "free zone" offshore jurisdictions (such as, e.g., the Cayman Islands or Mauritius); and
- where the fund is only marketed to institutional investors (the examples provided for in the lectures were sovereign wealth funds and other analogous state-owned entities) and meets certain additional minimum investment requirements (there were references to AED 5 million and USD 5 million, but we understand that the number is still under discussion), the requirement for the placement agent to be a locally licensed bank or

financial institution falls away. However, there would still be a requirement to offer the fund through a local placement agent, which could be an unlicensed local affiliate of the fund manager or an unlicensed third party.

It appears that there will be no form of suitability or client classification requirement as long as the minimum subscription amount is met (i.e. "private placement" classification will depend solely on the amount invested, and will not factor in investment experience, net worth, or other factors).

Funds may also be treated as being sold by way of "private placement" irrespective of the minimum investment amount when they are sold through accounts providing for regular investment (effectively, savings plans) operated by locally licensed banks.

Whilst, based on the above, it currently appears that there will be no full exemption (including an exemption from the approval requirements) for foreign non-retail funds marketed on a cross-border basis, Dr. Barakat, during the Q&A session in Dubai, suggested that there may be less interest in strictly enforcing the fund approval requirement in circumstances where non-retail funds are offered to a limited number of sophisticated investors on a reverse enquiry basis. There is, therefore, some possibility that a tolerated practice exemption (similar to the approach currently taken by the Central Bank) may develop, and it was indicated that reverse enquiries and a limited number of visits to the UAE may not be treated as breaching licensing or approval requirements. However, it is too early to say whether this will be the case or what the terms of any such tolerated practice would be, and it would clearly be preferable to have an explicit exemption in the Investment Funds Regulation, if possible.

Domestic fund diversification requirements

The draft Investment Funds Regulation contained detailed content requirements for the local investment fund's articles of association, investment policy and prospectus. For local funds, it would appear that many of the more controversial requirements, including the requirement for a fund manager to buy 10% of the units, are still under discussion, and it now appears that this particular requirement may be reduced and/or may be waived for established firms managing a large number of funds. Investment restrictions, including a prohibition on investing more than 10% of fund assets in non-local securities, which may not be entirely congruent with the also applicable requirement for diversification, may also be open to being disapplied in appropriate circumstances (e.g. a global markets fund), especially for non-retail products.

Separation of an investment fund's service providers

Requirements regarding the separation of service providers performing different functions for onshore funds (e.g. requirements for the custodian, manager and administrator to be separate persons) are also still being discussed, and it appears that it may ultimately be permissible for some of those functions to be performed by the same person, especially for non-retail funds (in particular, ESCA mentioned that there are not currently any licensed stand-alone fund administrators in the UAE outside the DIFC). ESCA's priority here is to keep administrators (who would, amongst other things, calculate asset values and returns) and managers separate in order to avoid conflicts of interest, and ESCA indicated that a matrix setting out which functions may be performed by the same person or persons in which circumstances will be published in due course. ESCA is open to receiving comments on the separation of functions and on which functions could be combined. Other requirements (such as the frequency of financial reporting and NAV publication) are also still under discussion, and may potentially be relaxed (for all funds) and/or disapplied (for non-retail funds).

Next Steps

It is understood that ESCA is currently planning to publish the final Investment Fund Regulation by mid-May, but, given the large number of issues under discussion and comments to be resolved, and the fact that the original implementation deadline of March 2011 has already been missed, it remains to be seen whether this goal will be attained.

Furthermore, whilst the Investment Funds Regulation still remain very much in draft form, it is understood that the UAE Central Bank has stopped licensing new funds for marketing "onshore", and that ESCA has started licensing a small number of funds for onshore distribution. A registration form and list of required documentation (in Arabic only) for the approval of foreign funds for marketing "onshore" has been published on the ESCA website.

Whilst the current position is far from satisfactory, it remains to be seen whether, and how, concerns will be addressed. Unfortunately, ESCA have indicated that the next published draft of the Investment Funds Regulations is likely to be final, limiting the scope for further formal consultation.

Further developments since this client briefing was published

Recently Clifford Chance LLP, accompanied by members of the industry, met with ESCA and the following issues have been clarified:

Treatment of the DIFC

ESCA considers the DIFC as a separate jurisdiction from the UAE onshore and there will be no passporting arrangement or other special treatment for DIFC funds or funds marketed by DIFC firms. ESCA have therefore determined to treat the DFSA as a "peer regulator" rather than a "free zone", which is relevant to the minimum investment amount required before the quasi-private placement regime can be triggered (i.e., the minimum investment threshold for the DIFC would be AED500,000 as opposed to the minimum investment threshold applied to "free zone" jurisdictions of AED100,000) and may also be relevant to the degree of scrutiny exercised in respect of other issues. Furthermore, ESCA welcomed the fact that the Investment Funds Regulation would potentially result in some DIFC firms opening an additional establishment onshore, which would be appropriately licensed by ESCA.

Indemnity to be Given by Distributor

With respect to local banks marketing investment funds, ESCA clarified that under the Investment Funds Regulation local banks would need to indemnify investors against any non-commercial losses suffered by the fund (i.e. "Madoff risk"). ESCA stated that banks are free to insure against this risk if possible, and ESCA suggested that discussions had been held with the Central Bank, so as to ensure less onerous regulatory capital treatment for any resulting contingent exposures. ESCA were clearly aware that this would lead to additional due diligence costs (which would be passed on to investors) and that this may lead to a competitive advantage for larger and better-known fund managers. However, ESCA were willing to accept these consequences on the basis that the risk of actually having to pay out under the indemnity would be very low if appropriate due diligence is performed.

As previously mentioned in the client briefing, the draft Investment Funds Regulation remain a work in progress, and it is difficult to provide more definitive information until the final Investment Funds Regulation have been published. However, ESCA's clarifications provide some indication of what industry participants can expect when the Investment Funds Regulation comes into force.