

ESCA publishes draft regulations concerning investment funds and investment management activity

Proposed changes for the investment funds sector in the UAE

The UAE Securities and Commodities Authority ("ESCA") has published a Draft Decision on Investment Funds (the "**Investment Funds Regulation**") and a Draft Decision on Regulating Investment Management Activity (the "**Investment Management Activity Regulation**") for consultation (the "**Consultation**"). The Consultation comes at a time of considerable development in the regulation of the asset management sector in the Middle East; both the Dubai International Financial Centre ("**DIFC**") and the Qatar Financial Centre ("**QFC**") have revamped their investment fund regulatory regimes in the past year.

Investment Funds Regulation

Scope and licensing requirements

The Investment Funds Regulation applies to all matters relating to local investment funds and to the promotion of foreign funds in the United Arab Emirates ("**UAE**"). For the purposes of the Investment Funds Regulation, a local investment fund is an investment fund established in the UAE and licensed by ESCA. Funds established in any of the UAE free zones, such as the DIFC, are considered to be foreign funds. The shift in the regulatory oversight from the UAE Central Bank to ESCA is reminiscent of a "twin peaks" model of financial services regulation. Under such a model, ESCA would be responsible for conduct of business requirements (both in respect of market oversight and consumer protections) for licensed entities and therefore freeing up the resources of the UAE Central Bank to focus on systemic stability and prudential oversight.

The Investment Funds Regulation prohibits an entity from establishing a local investment fund without first obtaining a licence from ESCA. Companies wishing to establish a local investment fund are required to be established as a joint stock company, have their permanent headquarters in the UAE, and have a paid-up capital of no less than 10 million Dirhams. The Company is required to invest a minimum of 10% of the capital for each local investment fund established. However, the company (alongside its affiliates) is not permitted to invest in excess of 49% of the capital in a fund, unless the fund is a close-ended fund that does not permit public trading of its units.

Entities licensed by the UAE Central Bank will be exempted from the capital requirements but will be required to furnish ESCA with an unconditional bank guarantee from a UAE bank for the same amount.

Local investment funds

Detailed content requirements for the local investment fund's articles of association, investment policy and prospectus are provided for in the Investment Funds Regulation.

The investment policy of the fund is required to correspond to the nature, type, duration and purpose of the fund. The Investment Funds Regulation sets forth certain investment restrictions, including a prohibition on investing in any legal entity with unlimited shareholders' liability. Where a local investment fund's investment policy aims at investing in traded securities, it is proposed that the

Key Issues

Proposed changes for the investment funds sector in the UAE

Investment Funds Regulation

- Scope and licensing requirements
- Local investment funds
- Investment fund's service providers
- Promotion of foreign investment funds in the UAE
- Transitional provisions

Investment Management Activity Regulation

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following investment restrictions will apply:

- The fund may invest no more than 15% of its total money in securities of a single issuer and no more than 20% of its total money in securities issued by an associated group. In all cases, the fund cannot invest more than 10% of its money in any individual security type (i.e., shares or debt instruments) or invest in 15% or more of all the securities issued by an issuer.
- The fund may not invest in other funds managed by the same investment manager. However, it may invest up to 20% of its money in other equivalent funds, so long as no investment in a single fund is in excess of 10% of the fund's money. Furthermore, the fund's investment in a single fund should not represent more than 15% of that fund's total money.
- The fund's investment in foreign markets is limited to 10% of its total money (unless the prior written consent of ESCA is obtained). The Investment Funds Regulation provides that the fund is responsible for preparing and submitting monthly reports to ESCA detailing the size of its foreign investments and the financial situation of the fund. It is unclear whether these reporting requirements apply to any fund investing in foreign securities or only to those who have obtained ESCA's approval to exceed the 10% threshold.

The investment manager of the fund is required to consider its investment policy and maintain a level of liquidity commensurate with the risks associated with the fund's investments. Liquidity can either be maintained by holding cash or by holding low-risk investment instruments which are convertible into cash on demand.

The prospectus will need to be prepared in a form set by ESCA and is required to be in the Arabic language. The prospectus may also be prepared in English or another language, but, in the case of discrepancy, it is the Arabic version that shall prevail.

The mechanical matters relating to local investment funds covered by the Investment Funds Regulation include subscription, issuance, listing and trading, and distribution and redemption of a local investment fund's units.

The subscription of units in a local investment fund must be conducted in accordance with the process detailed in the relevant fund's articles of association and the fund has 15 days from the date the fund closes for subscriptions to issue the units with a nominal value of not less than AED10 and not more than AED500,000.

Where so provided by the fund's articles of association and investment policy, the units of a local investment fund may be listed and traded on one of the UAE securities markets; either the Abu Dhabi Securities Exchange ("**ADX**") or the Dubai Financial Market ("**DFM**"). The Investment Funds Regulation makes clear that closed-ended investment fund's units made available for public subscription should be listed, whereas those not available for public subscription can be traded in accordance with the mechanics stipulated in the fund's articles of association. Unlisted open-ended investment funds must only be sold and redeemed through banks, brokerage companies and/or agents authorised by ESCA to conduct such activities.

Redemptions must also be conducted in accordance with the process detailed in the relevant fund's articles of association. However, under the Investment Funds Regulation the fund may temporarily suspend redemptions for a period of no more than ten days. However, where the flow of redemption requests is such that the investment manager is having difficulty in meeting them, or the investment manager is experiencing liquidity issues for reasons beyond its control, or there is price volatility in respect of the fund's assets then the period of suspension may be extended beyond ten days with the approval and supervision of ESCA. There is a provision, however, which allows the fund to access the loan market to obtain funds to meet redemption requests.

Investment fund's service providers

Part three of the Investment Funds Regulation sets out the obligations and roles of a fund's service providers and includes a summary of the main tasks of the investment fund's investment manager, management services company and custodian.

Each of the fund's service providers must enter into an agreement with the fund, detailing the rights and obligations of each of the service provider and the fund. The agreement is required to cover the fees of the service provider and the basis for calculating such fees. Furthermore, the agreement must cover the instances in which the agreement may be rescinded or terminated and the steps to be taken to transfer operations to a new service provider so that the process causes minimal disruption to the business continuity of the fund.

The Investment Funds Regulation imposes certain obligations on service providers to (i) make every effort to cooperate and coordinate with the fund, its board of directors and the fund's other service providers; and (ii) make all necessary reports and statements to ESCA. Service providers have an obligation to also acting in a cooperative manner with ESCA which involves both disclosing any irregularities in the fund management of which it is aware and not withholding any relevant information.

Promotion of foreign investment funds in the UAE

The Investment Funds Regulation also lists the conditions that must be met prior to ESCA granting approval for the promotion of a foreign investment fund in the UAE. The conditions are (i) the foreign investment fund must be established and licensed in a State subject to the supervision of an authority that is the equivalent of ESCA or in a UAE free zone; (ii) the related parties of the foreign investment fund are licensed to perform their respective activities in a State subject to the supervision of an authority that is the equivalent of ESCA; (iii) the foreign investment fund will contract with ESCA licensed local service providers (i.e., the authorised promoter and distributor of the foreign investment fund which will conduct marketing and underwriting activities in respect of subscriptions); and (iv) the fund has obtained the approval of the UAE Central Bank to promote its units within the UAE.

It would appear therefore, that both the approval of the UAE Central Bank and the approval of ESCA is required before the units of a foreign fund can be marketed within the territory of the UAE and even then, this must be done through an authorised distributor in the UAE.

Furthermore, it is currently unclear as to how the approval requirements in the Investment Funds Regulation will apply to limited cross-border business with sophisticated or high-net worth investors. The Investment Funds Regulation does not provide for any form of private placement regime.

Transitional provisions

Entities conducting investment fund activities prior to the implementation of the Investment Funds Regulation will have a period of one year to achieve compliance.

Investment Management Activity Regulation

ESCA has also published the Investment Management Activity Regulation which prohibits a person from undertaking investment management activity in respect of securities in the UAE without first obtaining a licence from ESCA. Investment management comprises management of securities portfolios for others or the management of investment funds in accordance with defined objectives and policy.

Entities undertaking such activities within the UAE are currently regulated by the UAE Central Bank as financial investment companies and are licensed accordingly. To date the UAE Central Bank has operated in accordance with a tolerated practice which permits limited unlicensed cross-border provision of investment management services in respect of foreign securities where certain conditions (including conditions in respect of the number and status of UAE customers and the manner in which services are promoted to such customers) are met. ESCA has not adopted a tolerated practice akin to that of the UAE Central Bank and therefore, the draft Regulations appear to signify a shift in regulatory attitude to the conduct of unlicensed cross-border business into the UAE.

The Investment Management Activity Regulation also contains transitional provisions; although the transitional period is yet to be determined. Furthermore, it is unclear as to whether firms currently acting on an unlicensed cross-border basis would be able to continue to operate in accordance with the UAE Central Bank's tolerated practice during this transitional period.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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