CONSULTATION PAPER NO. 69

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PROPOSED ENHANCEMENTS TO THE COLLECTIVE INVESTMENT FUNDS REGIME

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Why are we issuing this paper?

1. The DFSA proposes to make significant enhancements to the DIFC's Collective Investment Funds regime ("the Funds Regime") to better align it with international trends and practices, thereby making it more attractive to both fund managers and participants in the funds industry. The Funds Regime is mainly contained in the Collective Investment Law 2006 ("the CI Law") and the Collective Investment Rules (CIR) module of the DFSA Rulebook. Other modules of the DFSA Rulebook are also relevant, for example, the IFR module, which contains the Rules relating to Islamic Funds and the FER module, which contains Rules relating to fees applicable to Funds.

2. These proposals stem from a recent review of the Funds Regime by a Market Practitioner Panel ("the Panel") appointed by the DFSA, who recommended wide-ranging changes to the Funds Regime.

Who should read this paper?

3. The proposals in this paper would be of interest to:

   a. Authorised Firms currently operating Funds in the DIFC or marketing Units of Funds in or from the DIFC;

   b. Authorised Firms providing financial services to Funds (such as Fund Administrators, Eligible Custodians and Trustees);

   c. Persons who intend to set up Funds in the DIFC, provide services to Funds in the DIFC or elsewhere, or market Units of Funds in or from the DIFC; and

   d. Persons providing legal, accounting, audit, oversight or compliance services to Funds in the DIFC or who wish to provide such services.

How is this paper structured?

4. The proposals in this paper are set out mainly by reference to the Panel recommendations and are structured as follows:

   a. Background to the proposals – Paragraphs 10 – 13;

   b. Issues 1.1 & 1.2: Domicile of Funds and Fund Managers – Paragraphs 14 – 22;

   c. Issue 1.3: Investment Trusts and Trustee domicile - Paragraphs 23 – 27;

   d. Issue 1.4: Terminology – Paragraphs 28 – 33;

a. Issue 2: Distribution of Foreign Funds – Paragraphs 34 – 40;

b. Issue 3: Processes and costs – Paragraphs 41 – 45;

c. Issue 4: Protected Cell Companies and Umbrella Funds – Paragraphs 46 – 54;

d. Issue 5: Exempt Funds – Paragraphs 55 – 72;

e. Issue 6: Oversight Committee – Paragraphs 73 – 88;

f. Issue 7: Shari'a Compliance – Paragraphs 89 – 102;

g. Issue 9: Other Issues – Paragraphs 103 – 105; and

h. Other enhancements to the Funds Regime – Paragraphs 106 – 109.

5. The changes we propose require amendments to a range of DIFC legislation. These changes, and the Panel Report, are set out in the following Appendices:

a. the Collective Investment Law 2006 ("the CI Law") – Annex 1;

b. the Regulatory Law 2004 – Annex 2;

c. the Collective Investment Rules (CIR) module – Annex 3;

d. the Investment Trust Law 2006 – Annex 4;

e. the GEN (GEN) module – Annex 5;

f. the Islamic Finance Rules (IFR) module – Annex 6;

g. the Glossary (GLO) module – Annex 7;

h. the Fees (FER) module – Annex 8;

i. Companies Regulations – Annex 9; and

j. the Panel Report – Annex 10.

How to provide comments?

6. All comments should be forwarded to the person specified below. You may, if relevant, identify the organisation you represent when providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

7. This consultation paper also contains proposed amendments to chapters 12 &13 of the Companies Regulations (COR). These regulations are made under the Companies Law 2009 which is administered by DIFCA and the Registrar of Companies. These proposed amendments (set out in Appendix 9) are included in this DFSA consultation paper rather than in a separate DIFCA consultation paper for convenience. Accordingly, the proposals in Appendix 9 are being consulted upon jointly by the DFSA and DIFCA. The DIFCA and Companies Registrar will be consulted in regard to any comments received.

What happens next?

8. The deadline for providing comments on the proposals is 6 May 2010. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to put forward the changes to laws to the Ruler for enactment and to enact the changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the specified laws and the DFSA Rulebook modules are made. We will issue a notice on our website telling you when this happens.

Comments to be addressed to:

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Terminology in this paper

9. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in GLO or in the proposed amendments. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning. Please note that, while the term Operator is used in this paper when referring to the current requirements, the term Fund Manager is generally used when referring to the proposed future regime. This is because we intend to replace the term Operator with the term Fund Manager.

Background

10. In June 2009, the DFSA established the Panel, which comprised members with industry-wide expertise relating to the managed funds industry. The remit of the Panel was to review the DFSA's Funds Regime and present to the DFSA recommendations that would better promote the growth of the Funds industry in the DIFC, while remaining fully compliant with the relevant principles of the International Organisation of Securities Commissions (IOSCO).

11. The Panel presented its Report to the DFSA on 30 September 2009 (see Appendix 10 for the full Panel Report). It contains wide-ranging recommendations arranged under 10 issues. While the Panel found our Funds Regime fit for purpose, these recommendations suggest significant enhancements to that regime, to make it more usable by fund managers and industry practitioners.

12. The DFSA published the Panel Report on 19 October 2009, seeking public comments on the Panel recommendations. The period for public comment closed on 4 December and we received 4 sets of comments. While most of those comments were strongly supportive of the Panel recommendations, there were some differing views as to the nature of improvements that could be made to the Funds Regime. We have taken into account those comments in formulating the proposals in this paper.

13. The Panel Report contained recommendations under 10 discrete issues. While most of those issues dealt with the legislative framework of the DIFC's Funds Regime and therefore lie within the DFSA's powers, some of the recommendations went beyond those powers. The proposals in this paper focus on only those issues and recommendations in the Panel Report which require legislative changes to the Funds Regime, and are arranged under the same headings as in the Panel Report. In addition to the Panel recommendations, there are some additional issues, either arising from the public comments or identified by us, which are addressed in our proposals. These are set out under Issue 9 – Other Issues.

Issues 1.1 & 1.2: Domicile of Funds and Fund Managers

Analysis of the Panel recommendations

14. At present, the general prohibitions in Article 17(1) of the CI Law prevent a DFSA licensed Operator or Trustee from acting as an Operator or Trustee of a Foreign Fund and, similarly, prevent foreign fund managers or trustees from acting as Operators or Trustees of Domestic Funds, unless they establish a base in the DIFC. The Panel considered that these general prohibitions act as a barrier against the development of the DIFC as a truly international centre. In their view, such prohibitions are inconsistent with the objective of promoting the DIFC as an international hub for the funds industry and its participants (such as fund administrators, custodians and asset managers and valuers).

15. Accordingly, the Panel recommended that the DFSA removes these prohibitions, subject to adequate safeguards to ensure investor protection. As a result:

    a. DIFC based Fund Operators would have the flexibility to establish some of their Funds outside the DIFC; and

    b. adequately regulated foreign fund managers would have the flexibility to domicile Funds in the DIFC without having to establish a place of business in the DIFC.

    See the Key Recommendations under Issue 1, paragraph 27 of the Panel Report.

16. The Panel recommended the following measures to address any risks that would arise where the jurisdictional prohibitions are removed:

    a. in the case of a DIFC Fund Operator proposing to establish and manage a Fund in a jurisdiction outside the DIFC, to permit such activities only if the host jurisdiction of the Fund is not blacklisted or otherwise excluded by FATF, the UN, OECD, OFAC or other similar regulatory agency specified by the DFSA; and

    b. in the case of a foreign fund manager proposing to establish or manage a Domestic Fund from a place of business outside the DIFC, to permit such activities only if the jurisdiction in which the foreign fund manager is domiciled applies an equivalent level of regulation to the activities of that foreign fund manager. The Panel proposed that an expanded version of the Recognised Jurisdictions list should be used in this context to ascertain where a jurisdiction has an equivalent level of regulation.

17. We propose to adopt the Panel recommendations to remove the jurisdictional prohibitions, subject to a number of additional safeguards to augment investor protection and regulatory compliance. These are set out in detail under our proposed changes in paragraph 20 – 23 below.

18. We believe that this approach reduces the possibility that the DIFC may become, in the long run, simply a “parking lot” for Funds, rather than a hub where substantive fund management and related activities are undertaken.

Several off-shore fund regimes require at least some key service providers (such as asset managers, custodians or administrators) to a locally-registered Fund to be persons domiciled and regulated in their jurisdiction.

19. Public comments supported the Panel recommendation to remove the jurisdictional barriers. However, one commentator suggested that if DIFC Fund Operators are allowed to manage Funds established outside the DIFC, they should be subject to additional requirements to have "independent" custodians and independent valuers appointed to such Funds. We did not see the need to impose such requirements as the current requirements relating to Eligible Custodians of Funds are sufficiently stringent and any move to increase these requirements would lead to increased compliance costs without sufficient additional benefit.

Proposed changes

20. We propose, in-line with the Panel recommendations, to:

  a. permit a DFSA licensed Fund Operator to set up and manage a Fund in a jurisdiction outside the DIFC provided the host jurisdiction of the Fund is either included in the DFSA's Recognised Jurisdictions list or is otherwise acceptable to the DFSA. Such a Fund will be called an "External Domestic Fund" and be subject to the same requirements as those applying to a Domestic Fund, except where otherwise provided – see Article 14 of the CI Law and CIR Rule 6.2.2; and

  b. require the Fund Manager of an External Domestic Fund to:

    i. notify the DFSA of the jurisdiction outside the DIFC in which it proposes to establish the Fund – see CIR Rules10.2.1(3)(c), 11.1.1(d) and 12.1.2;

    ii. include, in its compliance procedures manual, provisions necessary to ensure compliance with the regulatory requirements applying in the host jurisdiction, including any measures required to address conflicting requirements applying in the host jurisdiction and the DIFC – see CIR Rule 6.2.2; and

    iii. include in the Fund's constituent and disclosure documents clear information as to where the Fund is located and whether the Fund is required to comply with any regulatory requirements applicable in its host jurisdiction – see CIR Rule A5.1.1(A)(8).

21. We also propose to permit a foreign fund manager to establish and manage a Domestic Fund in the DIFC without having to establish a place of business in the DIFC. To do so, such a person, who will be called an "External Fund Manager" (see Article 20(5) of the CI Law) must:

  a. be a body corporate which is regulated for the relevant activities by a Financial Services Regulator in a Recognised Jurisdiction or a jurisdiction otherwise acceptable to the DFSA (see Article 20(5)(a) and CIR Rule 6.1.2(a));

b. subject itself to the DIFC laws and the jurisdiction of the DIFC Courts (see CIR Rule 6.1.2(b));

c. appoint to the Fund a DFSA licensed Fund Administrator or Custody Provider (see CIR Rule 6.1.3(1)(a)); and

d. require the Fund Administrator or Custody Provider appointed to the Fund to both:

   i. act as its agent for service of process and dealings with the DFSA and Unitholders of the Fund (see CIR Rule 6.1.3(1)(b)); and

   ii. undertake specified tasks relating to the Fund, such as providing Unit pricing and access to Unit register and Fund disclosure in the DIFC (see CIR Rule 6.1.3(1)(c)).

22. The proposed Articles 41(9) and 42(3)(b) of the Regulatory Law (see Annex 2) provide an exemption from the Financial Services Prohibition to a person meeting the above requirements, so that such a person does not need to be licensed by the DFSA for the purposes of managing a Domestic Fund.

Issues for consideration

1. Should Authorised Firms be permitted to operate/manage Funds established in other jurisdictions?

2. If so, are the proposed circumstances under which they are to be allowed do so appropriate? If not, why?

3. Should foreign fund managers in reputable jurisdictions be allowed to manage Domestic Funds? If not, why?

4. If so, are the proposed circumstances under which foreign fund managers are to be allowed to manage Domestic Funds appropriate? If not, why?

Issue 1.3: Investment Trusts and Trustee domicile

Analysis of the Panel recommendations

23. A jurisdictional prohibition similar to that discussed above applies to a Domestic Fund structured as an Investment Trust. As a result, an Operator of such a Fund is currently prohibited from appointing to the Fund a Person who is not licensed as a Trustee by the DFSA. Similarly, a DFSA licensed Trustee cannot provide its trust services to foreign funds.

24. The Panel recommended that DIFC licensed Fund Managers should have the flexibility to use foreign trustees, provided the trustee is licensed and supervised with regard to its trust and custody services. Similarly DFSA

licensed Trustees should be permitted to provide their trust and custody services without any jurisdictional barriers.

25. The public comments supported the Panel recommendation to remove the jurisdictional barriers applying to Trustees.

Proposed changes

26. In-line with the Panel recommendations, we propose to permit a Domestic Fund structured as an Investment Trust to appoint as its trustee either a person licensed by the DFSA as a Trustee, or a foreign trustee where such a trustee is subject to regulation by a Financial Services Regulator in a Recognised Jurisdiction in respect of its custody services. This approach provides greater flexibility for Fund Managers to appoint trustees, taking account of factors such as the nature and location of the trust property/assets, particularly if such property is located outside the DIFC – see Article 21(1)(a) and (b) of the CI Law and Article 18(a) of the Investment Trust Law 2006.

27. Similarly we propose to allow DFSA licensed Trustees to provide their trust services to persons domiciled outside the DIFC. This approach is in line with the flexibility currently provided for Authorised Firms Providing Custody or Providing Trust Services, as they are not subject to any jurisdictional limitations in regard to the persons to whom they provide their trust/custody services.

Issues for consideration

5. Should domestic Investment Trusts be permitted to use adequately regulated foreign custody providers as their Trustees? If not, why?

6. Should DFSA licensed Trustees be permitted to provide their services to Foreign Funds? If not, why?

Issue 1.4: Terminology

Analysis of the Panel recommendations

28. The Panel identified that the term "Operator of a Fund" currently used to refer to the person legally accountable to investors for the establishment and management of a Fund is inconsistent with the international terminology. To remove any unnecessary confusion, the Panel recommended that terminology that focuses on the 'fund management' function should be used instead of the term "Operator". The Panel also noted the need to ensure better clarity between the functions of an Operator of a Fund and the activities undertaken by a person providing the Fund with the Financial Service of "Managing Assets".

29. The terminology used to refer to the person accountable to investors for collective management of the fund property varies from jurisdiction to jurisdiction. Commonly used terms in this context include Management Company, Fund Manager, Investment Manager and Responsible Entity.

30. The term Fund Manager is appropriate for our Funds Regime because it is the term more commonly used under the UK regime, on which our Funds Regime is primarily modelled, particularly in relation to regulated Authorised Unit Trusts and Open Ended Investment Companies.

31. We also acknowledge, as identified by the Panel, that there is a need for greater clarity relating to the distinction between "Managing Assets", i.e. the activity of asset or investment management, and the functions undertaken by the Fund Operator (the title of which we propose to change to Fund Manager under these proposals). This is particularly so as the asset management function is an activity which the Operator can either undertake under its own licence, or alternatively delegate to another entity under a permitted delegation arrangement.

32. The public comments supported the current distinction between Operating Funds and providing the Financial Service of managing assets/investments to a Fund and noted that this distinction should remain unchanged. This is because this distinction gives the Operator the necessary degree of flexibility either to carry on the function of Managing Assets under its own licence, or to delegate that function to a third party service provider. However, the need for greater clarity, as recommended by the Panel, was supported.

Proposed changes

33. In line with the Panel recommendations, we propose to:

    a. adopt the terminology of "Fund Manager" to replace the term "Operator of a Fund" – see Article 20(2) and (4) of the CI Law; and

    b. provide greater clarity between the role undertaken by such a Fund Manager and a person providing asset or investment management services to a Fund under a delegation arrangement – see proposed Guidance under GEN Rule 2.10.2.

Issues for consideration

7. Should we change the current terminology from Operator to Fund Manager? If not, why?

8. Are there any ambiguities or concerns relating to the respective roles of the Fund Managers vis-à-vis service providers to the Fund which are not adequately addressed by the proposed changes? If so, what are they, and how should they be resolved?

Issue 2: Distribution of Foreign Funds

Analysis of the Panel recommendations

34. The Panel considered the current limitations on the types of Foreign Funds that can be marketed or distributed by an Authorised Firm, to be overly restrictive, thereby inhibiting the DIFC's growth as a Funds hub.

35. Under the current CI Law (see Articles 18 and 19 of the CI Law and chapter 3 of the CIR module), Authorised Firms can only market Units of Foreign Funds that meet the prescribed qualification criteria. These encompass two main limbs, i.e. the Designated Foreign Funds test or the Non-Designated Foreign Funds test. Both these tests aim to ensure that those Foreign Funds which can be marketed by an Authorised Firm have the benefit of equivalent regulation or investment grade rating of the Fund.

36. The Panel recommended that rather than focussing mainly on the equivalence of regulation applying to a Foreign Fund, which is reflected in the current approach, due account should also be taken of other factors that provide adequate investor protection and thereby minimise any reputational risks to the DIFC. Accordingly, the Panel recommended that an Authorised Firm should be permitted to market Units of a Foreign Fund under one of the following four additional grounds.

    a. Where the marketing is to a new class of investors called "Qualified Investors", in reliance on such investors' having the necessary expertise and resources to assess the risks and benefits associated with such investments. In this context, the Panel proposed a test comprising a minimum asset test of US$1 million (which is higher than the current asset test for Professional Clients set at US$500,000), and an expertise test, as currently applied to Professional Clients.

    b. Where the Authorised Firm makes a personal recommendation of the suitability of the investment in the Unit of a Foreign Fund to a particular Client. In this context, the firm must undertake the suitability assessment required under the COB Rules before making a personal recommendation. The Panel considered that this would provide an adequate level of investor protection to the Client, while giving a commensurate benefit to both the Client and the firm, in terms of access to a wider range of foreign investments than is currently allowed.

    c. Where the Foreign Fund is one which, if it were established in the DIFC, would fall within the proposed definition of an Exempt Fund, i.e. a Fund open only to Qualified Investors, with a minimum initial subscription of at least US$50,000, and the restrictions relating to marketing (eg. by private placement) are met.

    d. Where the Authorised Firm is also the manager of the Foreign Fund, under the External Domestic Fund proposal.

37. While we agree with the Panel's overall rationale for widening the scope for Authorised Firms to market Units of Foreign Funds in or from the DIFC, we do not propose to adopt the Panel's recommendation for the introduction of a new classification of Clients called Qualified Investors. This is because it

would result in three types of Clients for marketing purposes, i.e. Retail, Professional and Qualified, which would unnecessarily complicate the current Funds Regime.

38. The public comments strongly supported the proposed expansion of the circumstances in which Units of Foreign Funds can be marketed by Authorised Firms.

Proposed changes

39. In line with the Panel recommendations, we propose to permit an Authorised Firm to market a Unit of a Foreign Fund where:

a. the Authorised Firm gives a personal recommendation that the investment in the Unit of the relevant Foreign Fund is suitable to the Client in light of that particular Client's investment needs, objectives and circumstances – see Article 54(1)(b) of the CI Law and CIR Rule 15.1.8; or

b. the Foreign Fund is one that would meet the Exempt Fund criteria proposed and the firm meets the parameters applying to the Offer of Units in such a Fund – see Article 54(1)(c)(i) and (ii) of the CI Law and CIR Rule 15.1.9; or

c. the Foreign Fund is an External Domestic Fund, in which case both the Fund Manager of that Fund and an Authorised Firm with an appropriate licence can market the Units of that Fund – see Article 14 and Article 50(1) of the CI Law.

40. In addition to the proposed expansions above, we would retain the current Designated and Non-designated routes. We also propose to extend the disclosure and warning requirements that currently apply to marketing of Units of Foreign Funds to the new categories proposed under paragraph 39 to promote adequate investor protection – see CIR Rule 15.1.2.

Issues for consideration

9. Do you consider the circumstances in which we propose to expand the criteria under which Authorised Firms could market Units of Foreign Funds in or from the DIFC to be appropriate? If not, why?

10. Do you consider any additional categories of Foreign Funds should be allowed to be marketed by Authorised Firms in or from the DIFC? If so, what are the types of Foreign Funds which should be included and, why should they be so included?

11. Given the proposals to expand the current categories of Foreign Funds that can be marketed in or from the DIFC by Authorised Firms, do you think it is appropriate for us to reduce some of the sub-categories that qualify under the criteria applicable to non-designated Foreign Funds? If so, which sub-categories should be removed?

Issue 3 – Processes and Cost

Analysis of the Panel recommendations

41. The Panel found that costs a Fund Operator has to incur in setting up and carrying on their fund management business in the DIFC to be higher than those which such managers have to incur to set up and carry on similar business in comparable jurisdictions. These higher costs include not only the DFSA's licensing fees but also other associated fees such as the Fund vehicle registration fees, which are charged by DIFCA. The Panel considered the current cost structure in the DIFC acted as a significant inhibitor in attracting fund management business to the DIFC, notwithstanding the significant tax and other advantages offered by the DIFC. It therefore recommended that the DFSA should better align its fees and charges with those applied in other comparable jurisdictions.

42. Our benchmarking supported the Panel's findings. In summary, our fees currently comprise:

    a. a licensing application fee for an Operator's licence of US$40,000 (with an additional fee component calculated based on the application fee pro-rated for the number of months remaining in the year from the grant of the licence);

    b. a periodic fee payable thereafter on an annual basis which is also set at US$40,000 (with an additional variable component based on annual expenditure); and

    c. an additional on-going periodic fee annually on each Domestic Fund which is 0.1% of the NAV subject to a minimum of US$10,000 and a maximum of US$50,000.

43. By contrast, the highest of the licensing fees paid in the jurisdictions we have considered appear to be no more than US$10,000.

44. The public comments supported the Panel recommendation to reduce costs. One commentator noted that not only are the fund set up fees in the DIFC currently greater than in comparable jurisdictions, non-DFSA costs such as rents and other service charges are also high.

Proposed changes

45. In line with the Panel recommendations, we propose to reduce the DFSA's licensing and on-going fees applicable to Operators of Funds and Funds (other than Umbrella Funds, the fees of which are addressed under Issue 4 below) as follows:

    a. a reduction of the application fee for Operating (Managing) a Fund from the current US$40,000 to US$10,000 (with the pro-rated additional component of the application fee also being reduced similarly – see FER Rule 2.1.1;

    b. a reduction of the periodic fees for Operating (Managing) a Fund from the current US$40,000 to US$10,000 (with the variable expenditure-based component of the periodic fees remaining unchanged) – see FER Rule 3.2.1;

c. a reduction of the cost of registering a Public Fund from $5,000 to $1,000 – see FER Rule 2.4.1;

d. the removal of the winding up of a Fund fee of US$10,000 (as there are no such fees charged by the regulator in other jurisdictions) – see FER Rule 2.5.1; and

e. a change to the periodic fee applicable to each Domestic Fund by reducing the minimum from the current US$10,000 to US$1,000 and increasing the maximum from the current US$50,000 to US$100,000. We consider the reduction in the minimum fee would provide adequate relief for start-up Funds where fee relief is most needed, while the increase in the maximum would bear only on Funds that had been successful in attracting substantial assets. See FER Rules 3.9.1 and 3.10.1.

Issues for consideration

12. Do you think that there are other areas in which fee reductions could be made? If so, what are they and what reductions should be made?

Issue 4 – Protected Cell Companies and Umbrella Funds

Analysis of the Panel recommendations

46. The Panel considered the advantages of allowing Umbrella Funds to use a Protected Cell Company (PCC) structure. Umbrella Funds are used by fund managers in other jurisdictions to have the flexibility to offer distinctly different investment strategies (such as conservative or speculative) to suit different investors while minimising infrastructure costs by centralising such costs within the Umbrella company. However, under our current requirements, while each Sub-Fund is notionally different from the other Sub-Funds operated under the same Umbrella, each Sub-Fund is not a separate legal entity. As a result, assets and liabilities in any one Sub-Fund are not insulated from those of any other Sub-Fund under the same Umbrella, nor are they insulated from any liabilities of the Umbrella itself. In contrast, the PCC structure, which involves cells operated by the core company, provides for legal segregation of the assets and liabilities of each separate cell.

47. While the DIFC has a PCC regime under the DIFC Companies Regulations (see COR chapter 12), the use of that structure is currently restricted to Insurers. The Panel identified that if the PCC structure were to be allowed to be used by Umbrella Funds, this would better promote legal certainty for investors investing in Sub-Funds. The Panel also noted that jurisdictions such as Ireland, Guernsey and Luxembourg allow the use of the PCC structure for Umbrella Funds, and the UK is currently proposing to do so.

48. Accordingly, the Panel recommended that the DFSA:

a. allow the protected cell or compartment structure to be used by Umbrella Funds (both Public and Private);

b. provide a more accessible arrangement of Umbrella Fund-related provisions under the CIR module;

c. remove unnecessary procedural impediments to setting-up Umbrella Funds by allowing individual Sub-Funds to be added without having to require any amendment to the Umbrella Fund's constituent documents; and

d. lower the current fees and minimum requirements for approval of the offering documents of Umbrella Funds, particularly if they are Private Funds or Funds that meet the proposed Exempt Fund criteria (see under Issue 5).

49. We agree with the Panel's view that the use of the PCC structure should be extended to Umbrella Funds as it provides a greater degree of legal certainty to investors in Sub-Funds, so that their assets will be insulated from risks associated with investment strategies adopted by other Sub-Funds in the Umbrella structure. While we believe that the PCC structure should be available to all Domestic Funds, we do not think that it is necessary to make it mandatory for all Umbrella Funds to use the PCC structure. This would give greater flexibility as some Umbrella Funds may prefer to adopt the more traditional route, with different share classes specific to individual Sub-Funds.

50. The Panel also recommended that we should remove the unnecessary procedural impediment arising from the fact that the Umbrella Fund Constitution has to contain detailed information relating to the types of investments which each Sub-Fund can make. This means that when a new Sub-Fund is added, changes must be made to the Umbrella Fund Constitution. This was not originally intended and hence we propose to address it by relocating those provisions more appropriately as Prospectus disclosure requirements relating to the relevant Sub-Fund.

51. The Panel found the fees associated with Umbrella Funds to be significantly higher than those charged in comparable jurisdictions. The current fees for Umbrella Funds and their Operators are the same as for other Funds, as described in paragraph 42 above.

52. We agree with the Panel's findings and propose to lower the Umbrella Fund fees as set out in paragraph 54. We propose to apply the proposed fee reductions to all Umbrella Funds, not merely to those using the PCC structure.

53. We have also considered whether the current PCC provisions contained in the Companies Regulations, which we propose to retain, are adequate to deal with Umbrella Fund specific requirements. We have identified that some enhancements to the PCC regulations would be needed to address a few gaps, such as the provisions relating to redemption of Units based on the net asset value (NAV) and the application of the prohibitions against cross-investments in sub-funds.

Proposed changes

54. We propose, as recommended by the Panel, to:

a. permit a Domestic Fund to use the PCC structure provided its Sub-Funds are open-ended – see Articles 26(2), 37(4), 59 of the CI Law which provide the overarching structure for the PCC related changes;

b. request DIFCA to make the necessary amendments to the existing COR provisions dealing with PCCs to:

   i. remove the current prohibition so that Umbrella Funds can use the PCC structure;

   ii. enhance the PCC provisions to address redemption of Units of open-ended Sub-Funds in accordance with NAV calculations as required under CIR; and

   iii. ensure that the CIR prohibitions relating to cross investments of one Sub-Fund's assets in other Sub-Funds in the same Umbrella Fund are applicable to Umbrella Funds using the PCC structure.

   As these regulations are made under the Companies Law 2009 which is administered by DIFCA and the Registrar of Companies, the proposed amendments to COR set out in Annex 9 are being consulted upon jointly by the DFSA and DIFCA.

c. arrange the Umbrella Fund provisions in CIR in a more cohesive and accessible manner as appropriate (see – Table in CIR Rule 13.7.2).

d. remove the current requirement in CIR to include in the Umbrella Fund constitution detailed information relating to investments in Sub-Funds; this information will instead be disclosed in the relevant Prospectus – see App 7 – CIR Rule A7.1.1(2)(h).

e. reduce fees applicable to Umbrella Funds (whether using the PCC structure or otherwise) as follows:

   i. For the Umbrella – a fee of US$8,000 per year (both in the initial and each subsequent year) + a sum prorated from US$8,000 to each month remaining in the initial year, and US$1000 for every US$1,000,000 of the aggregated total expenditure for each of the Sub-Fund under management in the subsequent years – see FER Rules 2.1.1 and 3.2.1.

   ii. For each Sub-Fund of an Umbrella – upon registration, a fee of US$1,000. See FER Rule 2.4.1.

   iii. Removal of the US$10,000 cost of winding up the Umbrella – see FER Rule 2.5.1.

   iv. Reduction of the periodic fee applicable to each Umbrella Fund by reducing the minimum from the current US$10,000 to US$1,000 and increasing the maximum from the current

US$50,000 to US$100,000 for the reasons given under Issue 3 above – see FER Rules 3.9.1 and 3.10.1.

Issues for consideration

13. Do you agree with the proposals to allow the use of the PCC structure for Umbrella Funds? If not, why?

14. Are there other issues which need to be addressed in allowing the use of the PCC structure for Umbrella Funds? If so, what are they and how should they be addressed?

Issue 5 – Exempt Funds

Analysis of the Panel recommendations

55. The Panel, after a review of the practices adopted in other jurisdictions, found creating an Exempt Funds regime would act as a key attraction for fund managers to establish and operate their funds in the DIFC. Such categories are available in many fund hubs. They noted that while there is no generally-used test for defining an Exempt Fund, commonly applied criteria included: in the case of individual investors, a high net worth test coupled with sophistication as evidenced by the size and frequency of transactions in their investment portfolio; in the case of institutional investors, tests based on assets under management or operational size of the entity; and a minimum level of investments in the Fund.

56. The Panel therefore recommended that the DFSA create an Exempt Fund regime, distinct from, and in addition to, the existing Public and Private Fund categories. The key features they proposed for such an Exempt Fund regime were:

    a. confinement of investments in an Exempt Fund to Qualified Investors, defined as persons with at least US$1 million net assets and, with the same level of sophistication as required under the current Professional Client test;

    b. distribution of Units in an Exempt Fund only by private placement and not by public offer (as in the case of distribution of Units of Private Funds);

    c. requirement for a minimum initial subscription of at least US$50,000 from each Qualified Investor; and

    d. the Operator of an Exempt Fund being a DFSA licensed Operator (Fund Manager).

57. The Panel proposed that where a Fund has the above features, it should attract a lighter regulatory regime than the regime currently applied to Public and Private Funds. The Panel considered that persons meeting the "Qualified

Investor" test should be regarded as having the necessary expertise and resources to be able to:

a. negotiate the terms of engagement of the Fund Manager, including required disclosure;

b. assess whether the Fund Manager's performance meets the agreed standards and delivers the expected outcomes; and

c. take appropriate action against the Fund Manager if required.

58. The Panel noted that the level of prescription currently applied to Private Funds is inappropriate for Exempt Funds, particularly in terms of Fund governance and disclosure relating to the Constitution, Prospectus, internal operations and administration and delegation and outsourcing. Instead, an Exempt Fund should only be subject to minimum regulation, in terms of having a registered auditor and its annual reports having to be filed with the regulator and made available to investors in the Fund.

59. The Panel also canvassed a fast-track process for obtaining a DFSA licence to operate Exempt Funds, where the activity to be undertaken is confined to managing Exempt Funds. Finally, the Panel recommended that the Exempt Fund structure be available to specialist types of Funds, such as Islamic, Hedge, Property and Private Equity.

<u>Do we need a third regime of Funds?</u>

60. When establishing the DFSA Funds Regime, the option of creating an Exempt Funds regime was considered. A decision against the creation of such a regime was made for two reasons: to retain the simplicity of the dual structure, and because the Private Funds were considered as providing an adequately light level of regulation.

61. We agree with the Panel that an overly prescriptive level of Fund governance and disclosure requirements is applied to Private Funds. As a result, our Private Fund requirements do not compare favourably with the lighter touch regimes provided in other jurisdictions.

62. We believe that having Private Funds alongside the Public and Exempt Funds may complicate the Funds Regime to no good purpose. Therefore, our proposal is to retain the simplicity of the dual structure, and, in the longer term, to have only Public and Exempt Funds.

63. However, there are already a number of Private Funds established and operated in the DIFC. Removing the Private Fund category without providing appropriate transitional arrangements may cause practical difficulties for the Operators of those Private Funds and affect their Unitholders. To address such practical difficulties, we propose to retain the Private Fund category within the current regulatory regime as a temporary measure, with the objective of phasing this category out, in consultation with the relevant stakeholders, as soon as possible.

What are the appropriate features for Exempt Funds?

64. Type of Clients: While the Panel recommended an increase in the net asset test from US$500,000 to US$1 million and a minimum subscription of US$50,000 for investors in Exempt Funds, we are reluctant to create a new category of Client, and consider that the minimum subscription of US$50,000 is in itself a significant element of the eligibility test. We therefore propose to retain the Professional Client criteria to determine whether a person is permitted to invest in an Exempt Fund, subject to the minimum US$50,000 subscription requirement.

65. Manner of distribution: We agree with the Panel recommendation that the appropriate manner of distribution of Units of Exempt Funds is by way of private placement. In addition, we propose that the number of investors that could invest in an Exempt Fund be limited to 50 or fewer. This is because in Funds with larger numbers of investors involved, particularly going beyond 50, it may generally not be as easy for Fund Managers to negotiate terms of placement with individual investors, and also, for investors in such Funds to arrange collective action against the Fund Manager. This number limitation is used in other jurisdictions to draw a distinction between private and public offerings and other arrangements.

66. Level of regulation: We also considered whether it is appropriate to adopt a lighter touch regulation for Exempt Funds as recommended by the Panel, particularly against the current regulatory environment. Under the Panel recommendations, the key controls against potential for abuse are the licensing (or equivalent regulation) of the Fund Manager of an Exempt Fund and the abilities of the type of investors allowed to invest in Exempt Funds to monitor and assess the performance of the Fund Manager.

67. We believe that these measures alone would not be adequate to mitigate the potential risks of abuse, particularly those risks that may arise in relation to valuations and unauthorised trading in the investment portfolio of Exempt Funds, which could go undetected by investors.

68. Risk mitigation measures: To address such risks, we propose, that in addition to the minimum level of regulation proposed by the Panel (encompassing only the audit by a Registered Auditor and the periodic reports), an Exempt Fund should be required to:

   a. have an Eligible Custodian or Trustee, in the same manner as Public and Private Funds; and

   b. be subject to a Fund valuation requirement at least every 6 months (with the report being available to investors), carried out by a DFSA licensed Fund Administrator or a person subject to an equivalent level of regulation (e.g. in a Recognised Jurisdiction), except where the Fund's investments are:

      i. financial instruments that are traded using a facility provided by a regulated exchange; or

      ii. financial instruments where the loss or gain of the investors in the financial instrument is determined by reference to a factor in relation to which there is a reliable and readily available public information (such as an index, interest or exchange rate or any combination of such factors).

69. Disclosure: We have also considered in the light of a public comment received whether the Offer documents of Exempt Funds should at a minimum be required to contain disclosure relating to the Fund's investment strategy, leverage limits, investment risks and expenses, including fees and charges. Given that one of the key premises of Exempt Funds is private placement and hence the scope and flexibility for individual investors to negotiate the terms of investment, we do not think any degree of prescription in this regard is necessary. However, we propose to extend to Exempt Funds the overarching disclosure obligation that the investors should be provided with an offer document that contains adequate information to enable them and their advisers to make well informed investment decisions regarding investment in the Exempt Fund.

70. Public comments strongly supported the Panel recommendation to create an Exempt Fund regime. One commentator noted that this proposal is the most interesting of the Panel recommendations and could have the potential for Fund Managers to attract far greater levels of investments to the DIFC. Another commentator suggested that there should be minimum disclosure covering investment strategy, leverage, investment risks and fees and expenses in the Exempt Fund offer documents. For the reasons highlighted above, we do not think such a specific requirement is needed.

Proposed changes

71. We propose to introduce an Exempt Funds regime substantially in line with the Panel recommendations but with some changes, incorporating the following features:

a. investors in an Exempt Fund being limited to 50 or fewer Professional Clients, each making an initial subscription of at least US$50,000 – see Article 16(4)(a), (c) and (d) of the CI Law;

b. Units in the Exempt Fund being offered by the Fund Manager or an Authorised Firm only by way of private placement – see Article 16(4)(b) of the CI Law;

c. an Exempt Fund being required to:

i. be audited by a Registered Auditor and prepare annual and interim reports as required by chapter 9 of the CIR module;

ii. have an Eligible Custodian or Trustee, except where the Exempt Fund is a Property Fund with special arrangements or a Private Equity Fund – see CIR Rules 8.2.2(2), 8.2.3, 13.4.2 and 13.3.1(1); and

iii. be subject to a fund valuation requirement at least every 6 months (with the report being available to investors and the regulator), carried out by a DFSA licensed Fund Administrator or a person subject to an equivalent level of regulation (e.g. in a Recognised Jurisdiction) except where the Fund's investments are financial instruments:

- that are traded using a facility provided by a regulated exchange; or

- where the loss or gain of the investors in the instrument is determined by reference to a factor in relation to which there is reliable and readily available public information (such as an index, interest or exchange rate or any combination of such factors) – see CIR Rule 8.4.1(1)(a)(ii); and

d. the Exempt Fund being required to have an offer document which contains any information investors, or their advisers, would reasonably require for the purposes of making an informed decision to make an investment in the Fund – see Article 52(2) of the CI Law.

72. We propose to undertake consultation with the Operators of Private Funds in the DIFC to ascertain what appropriate transitional arrangements would be needed by them for their Private Funds to be converted to either an Exempt a Public Fund. We also propose to establish a fast-track licensing/approval process for Persons who wish to operate/manage only Exempt Funds.

Issues for consideration

15. Do you agree with our proposals to establish Exempt Funds? If not, why?

16. Do you consider the proposed parameters for Exempt Funds to be appropriate? If not, why?

17. Do you have any concerns relating to the transitional arrangements for phasing out Private Funds? What are they, and how should they be addressed?

Issue 6 – Oversight Committee

Analysis of the Panel recommendations

73. All Domestic Funds which are Public Funds must have oversight arrangements that meet the criteria specified in CIR. The rationale for these oversight requirements is to ensure that significant parameters (such as investment guidelines and borrowing restrictions) within which an Operator must manage investors' funds are not exceeded or disregarded to the detriment of those investors, particularly where they include Retail Clients.

74. While the Panel conceded that having an independent oversight function relating to Public Funds that have Retail Clients is common in most jurisdictions, they were concerned that our requirements, are more prescriptive and restrictive than those applied in many other jurisdictions. They also noted that in a relatively new and small jurisdiction, it is difficult to find service providers with the necessary expertise and familiarity with the DIFC Funds Regime to be able to undertake the oversight function as currently prescribed.

75. The Panel also identified that, although Eligible Custodians are permitted to undertake the oversight function, in reality custodians did not wish to do so, given its currently onerous nature. They also noted that custodians may not have the required degree of independence from the Fund Operator to undertake the oversight function as they are appointed by the Operator. It was also thought that the procedural requirements, such as having to hold certain number of meetings in the DIFC at the same time as the meetings of the governing body of the Fund, are too onerous.

76. Accordingly, the Panel recommended that the DFSA:

   a. remove the requirement for an independent oversight function for Public Funds at least in certain cases, such as where more stringent and transparent investment guidelines are applied, for example in relation to funds investing in transferrable securities traded on recognised exchanges;

   b. in other cases, make the oversight function less prescriptive, so that more flexibility is available to Fund Managers to satisfy the oversight requirement; and

   c. consider removing the Eligible Custodian from the category of persons who could undertake the oversight function due to the possible conflicting nature of custody services and oversight functions.

77. Under the current requirements, the independent oversight function in every Public Fund must be carried out:

   a. if it is an Investment Company, by (i) a panel consisting of a majority of independent non-executive members of the Fund's board of Directors, (ii) a supervisory board comprising a majority of independent non-executive Directors of the Fund to supervise the Fund's board of Directors or (iii) an Eligible Custodian;

   b. if it is an Investment Partnership, by (i) a committee consisting of a majority of Limited Partners who are independent of the Operator or (ii) an Eligible Custodian; and

   c. if it is an Investment Trust, by (i) the Trustee of the Fund or (ii) by having a majority of independent directors on the Operator's Board.

78. The current obligations of the independent oversight provider include:

   a. monitoring whether the Operator complies with the Fund's Constitution and Prospectus and any obligation or requirement imposed on the

Fund under any legislation administered by the DFSA, including any requirements to establish and maintain proper systems and controls;

b. reporting to the Operator of any breaches of the requirements in the Prospectus, Fund Constitution, and any obligations or requirements imposed on the Fund, or any terms, conditions or restrictions of the Operator's Licence which it becomes aware of, or suspects;

c. taking reasonable steps to ensure that the Operator rectifies any non-compliance with the Rules as soon as reasonably practicable;

d. reporting to the DFSA if the Operator does not, or is not reasonably likely to, take any remedial actions of any breach reported to the Operator;

e. assessing at regular intervals whether the Fund's internal systems and controls are adequate, and reporting to the Operator on any improvements needed;

f. in addition, reporting at least quarterly to the Operator at its Board meetings on the effectiveness and appropriateness of the systems and controls that are in place for the proper discharge of oversight functions;

g. taking reasonable care to ensure on a continuing basis that the Operator is managing the Fund in accordance with the Rules in respect of single pricing and dealing, income, investment and borrowing and the periodic reporting obligations that apply in respect of the Fund;

h. taking reasonable steps and exercising due diligence to ensure on a continuing basis that the Operator:

   i. invests Fund Property in accordance with CIR Rules, and

   ii. takes necessary restorative measures to correct any identified non-compliance as soon as reasonably practicable;

i. holding in the DIFC at least two meetings in each annual accounting period, and in the case of Investment Companies or Investment Partnerships, holding those meetings at the same time as the meetings of the Fund's Governing Body; and

j. maintaining records relating to the discharge of oversight functions.

79. The current Funds Regime also imposes fairly extensive obligations on those performing the oversight functions, which apply in respect of every oversight function such individual undertakes. These are set out as high level principles, and cover overarching obligations to act with integrity, apply due care, skill, and diligence, observe standards of conduct in financial markets and open and cooperative dealings with the regulator. The Operator must also assess that every person who is appointed to undertake oversight functions is suitably qualified, fit and proper and meets the specified standards relating to independence from the Operator.

80. As the Panel identified, the compliance burden imposed on the oversight provider seems to be overly burdensome.

81. However, one public commentator on the Panel Report disagreed with the Panel's suggestion (not a Panel recommendation) that it may be appropriate to waive the requirement for third-party oversight in the case of large international organisations with layers of compliance throughout the group or with independent directors on the Board. This commentator was of the view that from a compliance perspective, having independent parties involved in the oversight would be useful, particularly as a protection against conflicts of interest that could cloud the decisions of interested parties.

82. In the light of the above considerations, we consider that a re-structuring of the current oversight arrangements is warranted. Some key issues that have arisen in determining appropriate oversight arrangements for Public Funds, and our proposals to address those issues are set out below.

   a. Flexibility for certain types of Public Funds: In the case of some types of Public Funds, particularly those involving passive management of Fund investments such as index tracking funds that do not require any active investment management as such, the Panel questioned whether the cost of having independent oversight arrangements is warranted. We are sympathetic to their views, provided the Operator's systems and controls adequately address proper monitoring of, and adherence to, the investment and borrowing limits applicable to the Fund, as set out in its Constitution and the most recent Prospectus; and

   b. The Eligible Custodian's role as the oversight service provider: The Panel was of the view that the Eligible Custodian of the Fund should not be permitted to undertake the independent oversight function, particularly due to their conflicting duties involved in the two roles. However, this concern seems to stem more from the nature of direct obligations imposed on the oversight provider relating to the Fund Property, as detailed in paragraphs 83 and 84 below, rather than any inherently conflicting nature of the two roles.

83. Under the current Funds Regime, independent oversight providers are subject to certain Fund Property specific obligations. In other regimes these are more typically the direct obligations of trustees and depositories of Funds, and not those of oversight providers. Particularly, where actual or potential breaches are identified, the oversight provider is required to ensure that the Operator takes necessary restorative steps to rectify such identified breaches.

84. Under our current Funds Regime, the Eligible Custodian of a Fund is not itself subject to those requirements in respect of its custody functions. Rather, it is only a delegate of the Operator, with the Operator remaining primarily and directly accountable to the investors for the safe custody of the Fund Property. As a result, where an Eligible Custodian of the Fund is appointed as the independent oversight provider, it attracts significantly more onerous requirements relating to Fund Property than it would otherwise. This appears to be the reason for custodians' reluctance to assume the oversight function.

85. Given that we are proposing to remove a number of Fund Property specific direct obligations from the responsibilities of the independent oversight

providers, Eligible Custodians are likely to find the task of assuming the role of independent oversight provider more acceptable under our proposals.

86. We also propose to make the permitted oversight arrangements less complex than the current arrangements, focussing on the suitability of the individuals appointed to the function. Accordingly, our proposals permit the oversight function to be undertaken by individuals provided they are independent of the Fund Manager and have the required degree of resources and competencies.

Proposed changes

87. In line with the Panel recommendations, we propose to restructure the independent oversight function relating to Public Funds as follows:

   a. To provide for the independent oversight function of a Public Fund to be undertaken by:

      i. an Oversight Committee comprising at least three individuals each of whom meets the suitability criteria specified (i.e. having necessary expertise, resources and independence) to carry out the oversight function – see CIR Rule 10.3.1(a); or

      ii. the Trustee or Eligible Custodian of the Fund – see CIR Rule 10.3.1(b).

   b. The obligations relating to the independent oversight function being recast so as to require the oversight provider to:

      i. monitor whether the Operator is managing the Fund in accordance with the parameters set by the Fund's Constitution and its most recent Prospectus, particularly those relating to investment and borrowings – see Article 40(1)(a) of the CI Law and CIR 10.3.4(a);

      ii. assess whether the Operator's systems and controls, including those relating to risk management and compliance, are properly implemented and operating as intended – see Article 40(1)(b) of the CI Law and CIR 10.3.4(b);

      iii. report to the board of the Operator immediately if there are any breaches or suspected breaches of the parameters referred to in (i) or any inadequacies or failures in relation to the Operator's systems and controls referred to in (ii) – see Article 40(1)(c) of the CI Law and CIR 10.3.4(c); and

      iv. report to the DFSA if any breaches or inadequacies referred to above are not resolved or rectified by the Operator within 30 days of being reported to the board of the Operator – see Article 40(1)(d) of the CI Law and CIR 10.3.4(d);

   c. Removing the prescriptive meeting related requirements of the independent oversight provider, instead giving the discretion to the oversight provider to determine when and how its meetings should take place, taking account of the nature of the activities of the particular Fund – see CIR 10.3.5;

d. To the extent some of the following resources, powers and privileges are not conferred on the independent oversight provider, incorporate those as relevant:

i. direct lines of dialogue with, and reporting to, the board of the Operator;

ii. direct access to, and reporting by, the persons providing Compliance and Risk Management functions;

iii. direct access to the persons providing custody and valuation functions;

iv. sufficient resources, including powers to obtain third party expertise where appropriate; and

v. whistle blower protection relating to their reporting of breaches/suspected breaches to the DFSA,

see Article 41(3) of the CI Law and CIR 10.3.11; and

e. Not requiring Public Funds which are passively managed to have independent oversight providers – see CIR Rule 10.1.1(2).

88. We propose to retain the current suitability criteria and the high level principles applying to individuals undertaking the oversight function, the latter with some refinements to reflect the changes resulting from the proposed approach.

Issues for consideration

18. Do you agree with our proposals to allow the oversight function to be undertaken by individuals who meet the prescribed suitability criteria (which includes a requirement for independence from the Fund Manager)? If not, why?

19. Do you have any concerns relating to our proposal to retain the Eligible Custodian of the Fund as a Person who is permitted to undertake the oversight function, provided the senior individuals who are primarily responsible within the Eligible Custodian for that function meet the prescribed suitability criteria? If so, what are those concerns and how should they be addressed?

20. Are there any other issues or concerns relating to the oversight function that the DFSA needs to address? If so, what are they and how should they be addressed?

Issue 7 – Shari'a Compliance

Analysis of the Panel recommendations

89. The Panel considered that the Islamic Fund regime in the DIFC, if enhanced in the manner proposed by the Panel, has the potential to become a key attraction for Fund Managers to locate their Islamic business in the DIFC.

90. The key issues which the Panel identified relating to Islamic Funds are:

    a. the possible overlap of the regulatory requirements relating to the appointment of Shari'a Supervisory Boards (SSB), which are currently required at the Fund Operator level and also at each of the Islamic Funds operated by the Operator;

    b. the need to have a three member SSB, given the limited number of Shari'a scholars available in the DIFC and associated costs and time taken to obtain their services; and

    c. the lack of sufficient flexibility for Fund Managers operating Islamic Funds through Islamic Windows, particularly as their conventional business attracts different accounting and audit standards, thereby increasing their costs.

91. In order to address the above issues, the Panel recommended that the DFSA adopts the following measures:

    a. consolidate the Shari'a compliance requirements that apply concurrently to the Operator and the Islamic Funds it operates, and in the process clarify any potential for overlap and unnecessary duplication of the relevant regulation;

    b. in consolidating the provisions as set out in (a), consider whether measures such as imposing an express statutory obligation on SSB members to place the interests of the Fund and its investors ahead of the interests of the Operator is necessary;

    c. reduce the requirement for a three member SSB for Operators of Private Funds. Instead have a minimum requirement for such Funds to have a single Shari'a adviser (or Shari'a services provider). Adopt a similar requirement as proposed for Private Funds for the proposed Exempt Funds;

    d. remove the need for a three member SSB for Public Funds where it relies on widely acceptable Shari'a screening processes such as investments in securities included in, or recognised by reference to, an Islamic index, sukuks or treasury instruments issued by a Shari'a compliant financial services provider regulated by a Financial Services Regulator;

    e. remove the requirements for Private Funds to adhere to AAOIFI standards when conducting their audits, and adopt a similar approach to the proposed Exempt Funds;

f. remove the current prescriptive Shari'a-related requirements applicable to Private Funds such as those set out in current CIR 13.1, and adopt a similar approach to the proposed Exempt Funds; and

g. provide a greater degree of flexibility for Operators when managing both Islamic and conventional Funds with a view to avoiding the unnecessary and dual layers of costs and regulation that generally occur under the current requirements for operating an Islamic Window from a conventional business platform.

92. These proposals are substantially in line with our internal thinking relating to regulation of Islamic financial activities in the DIFC, and in particular, the DFSA's objective of promoting the DIFC as a hub of Islamic financial activities. However, there were a number of issues we needed to consider in detail before developing our proposals in this context.

<u>Should Shari'a scholars appointed to Islamic Funds be subject to an express statutory obligation to place the interests of investors ahead of those of the Operator?</u>

93. Generally, if a Shari'a scholar is appointed by the Operator and is required to act both for the Fund and the Operator, conflicts of interests may arise in this context. However, unlike any other functionary appointed to the Fund, Shari'a scholars are subject to the paramount Shari'a principles, which dictate high standards of ethical behaviour. Perhaps more importantly, the SSB itself does not bear any direct accountability to investors; this rests with the Operator and it is there that the fiduciary responsibility should be, and is, located. Therefore, we do not consider it necessary to impose such an explicit requirement.

<u>Should Private Funds be subject to less stringent Shari'a requirements than currently applied?</u>

94. The Panel recommended that at the Private Fund level (and also at the proposed Exempt Fund level), most of the prescriptive requirements that currently apply under CIR 13.1 (which are now in IFR chapter 6) should be removed. These requirements include systems and controls to ensure Shari'a compliance, an Islamic Financial Business policy and procedures manual, the appointment of a three member SSB, Shari'a review by the SSB resulting in annual and interim reports complying with AAOIFI standards and an internal Shari'a review in accordance with the applicable AAOIFI standards. Instead of these prescriptive requirements, the Panel recommended that the DFSA requirements be confined to:

a. the Private Fund's disclosure documents to investors (e.g. the Short Form Prospectus) containing provisions describing the Shari'a compliant nature of the Fund, the process for achieving such compliance, including the names of the Shari'a advisers appointed to the Fund; and

b. those encompassing:

   i. the operations and investments of the Fund being subject to compliance monitoring and reporting by its Shari'a advisers;

   ii. requiring the provision of semi-annual and annual reports to investors and the DFSA explaining the work undertaken by the Shari'a advisers during the relevant period to verify compliance by the Fund with the Shari'a guidelines and restrictions set out in its disclosure documents; and

   iii. requiring confirmation from Shari'a advisers of the extent of the Fund's Shari'a compliance status during the period concerned.

95. While we agree that a less prescriptive approach to Private Funds and Exempt Funds is warranted, we do not think it is appropriate to remove at the Private Fund level the current requirement to have a three member SSB, which is in line with the international standards. Therefore, we propose to retain the three member SSB requirement for Public and Private Funds.

96. However, in order to provide greater flexibility and remove some of the overly onerous aspects of the Shari'a compliance requirements, we propose to:

   a. not impose on Exempt Funds an obligation to have an SSB at the Fund level, so that such Funds may use a single Shari'a scholar who is a member of the Firm's SSB for signing off on Shari'a compliance aspects of the Fund operations. Where it does so, the Exempt Fund's disclosure documents must contain information about the Shari'a compliance sign-off process that is applied;

   b. remove the requirements for an Islamic Financial Business policy and procedures manual at the Fund level. The Fund Operator's systems and controls should, however, adequately address how Shari'a compliance is achieved at the Fund level; and

   c. not require Funds to have an SSB at Fund level where they rely on widely accepted Shari'a screening methodologies (such as securities included in an Islamic index).

97. Further, where the proposed Exempt Fund category is concerned, the DFSA also proposes not to apply most of the prescriptive requirements currently applied to Private Funds which are contained in IFR chapter 6.

98. Another option is to relieve the Fund Manager from the Shari'a supervisory requirements altogether at the firm level, in reliance on the full application of the SSB and other Shari'a governance requirements at the Fund level. To minimise the need for deviation from the existing conceptual framework of the Shari'a governance requirements, we have not adopted this option.

Should the removal of the SSB requirement for Funds using acceptable Shari'a screening methods be confined to Public Funds?

99. The Panel's recommendation to remove the SSB requirement for certain types of Islamic Funds using acceptable Shari'a screening methodologies is confined to Public Funds. However, Exempt and Private Funds using similar acceptable Shari'a screening methodologies should equally be exempt from the otherwise applicable Shari'a advisory requirements (i.e. the minimum Shari'a scholar requirement) as they, too, have the benefit of the relevant screening. Therefore the DFSA proposes to extend the benefit of this proposal in similar circumstances to Private and Exempt Funds. The overarching disclosure obligations applicable to Private and Exempt Funds would require the Operators of such Funds to include in their disclosure documents which Shari'a screening methodology is being used by the Fund, and also the information relating to the SSB that has approved it.

100. The public comments supported the overall thrust of the Panel proposals to clarify and, where necessary, reduce the current prescriptive requirements relating to Shari'a compliance. However, one commentator did not support the reduction of the three member SSB requirement for Private or proposed Exempt Funds at the firm level, especially where the firm undertakes Islamic financial activities that are not confined to the operation of Islamic Funds. They also did not support the greater degree of flexibility proposed by the Panel with regard to firms operating Islamic funds through an Islamic Window, nor the proposal to remove the requirement to apply AAOIFI standards relating to the audits of Islamic Private/Exempt Funds, as they feared that these proposals, if implemented, would lead to the level and quality of Shari'a review process being compromised.

101. We have, in designing our proposals, not gone as far as the Panel recommended, particularly in regard to the Panel recommendation to remove the 3 member SSB requirement at the firm level for Private and Exempt Funds, partly due to these concerns raised.

Proposed changes

102. We propose, substantially in line with the Panel recommendations, to:

a. consolidate the Shari'a compliance requirements that apply concurrently to the Operator and the Islamic Funds it operates, so that the Shari'a compliance requirements need not be duplicated at both the Fund level and the Operator level. In doing so, we propose to provide clarification to remove any potential for overlap and unnecessary duplication of the relevant requirements – see IFR Rules 6.1.2(2), 6.1.4 and 6.2.1(2);

b. reduce the compliance burden on Exempt Funds – see IFR Rules 6.1.3, 6.2.1(1) and Guidance under IFR Rules 6.3.2 and 6.4.1;

c. permit the use of a single Shari'a scholar for Shari'a compliance purposes of the Fund, instead of the 3 member SSB, for Exempt Funds – see Guidance note 3 under IFR Rule 6.2.1; and

d. remove completely the need for an SSB and Shari’a scholars for an Islamic Fund where reliance is made on widely accepted Shari'a screening processes such as investments in securities included in, or recognised by reference to, an Islamic index, sukuks, or treasury instruments issued by a Shari'a compliant financial services provider regulated by a Financial Services Regulator – see IFR Rule 6.2.1(3).

Issues for consideration

21. Do you agree with our proposed approach relating to Shari’a compliance requirements? If not why? In particular, do you have any views on the option noted in paragraph 98? If so, what are they?

22. Are there any additional issues or concerns that need to be addressed relating to the Shari’a compliance requirements applying to Islamic Funds and their Fund Managers? If so, what are they and how should they be addressed?

Issue 9 – Other Issues

Removing the unintended application of provisions designed for open-ended Funds to closed-ended Funds

103. The Panel noted that a number of provisions in our Funds Regime, particularly those relating to Fund valuation and pricing requirements associated with redemptions, are inappropriate for closed-ended Funds. For example, Article 21(3) of the CI Law provides that "Every Domestic Fund shall employ single pricing in relation to the price of Units and Unitholders shall be entitled to have their Units redeemed by the Operator of the Fund at a price related to the net asset value of the property to which the Units relate calculated in accordance with the Rules made under this Law." See also the associated requirements in CIR Rules 6.7.1(1) – (5), which provide for redemption of Units based on NAV.

104. The Panel noted that if a Fund is a closed-ended vehicle, e.g., an Investment Company, there will be no arrangements for redemption of Units, i.e. shares in this case, of the Fund, particularly as share buy-backs are not generally considered as redemptions for the purposes of these provisions and are subject to stringent regulation under the Company Law. Therefore, the Panel recommended that this anomaly be resolved to provide greater certainty for closed-ended Funds which are not subject to an obligation to provide continuous redemptions based on NAV.

Proposed changes

105. We propose to remove the unintended application of the redemption provisions to closed-ended Funds. See – Article 27(1)(f) of the CI Law and CIR Rule 8.6.1.

Other enhancements to the Funds Regime

106. The Panel also indicated that it would be desirable if we could make our rules, particularly those in the CIR module, more accessible and user friendly.

107. We have taken the opportunity to restructure the CIR module, both to bring about a closer alignment with the arrangement of the provisions in the CI Law and also to enhance clarity and accessibility of the CIR provisions while incorporating the proposed changes to it set out above. We have also removed some inconsistencies and anomalies in this process. Some of the changes proposed to the CIR module in this context include:

    a. the removal from the GLO module of some of the definitional provisions that apply to Funds, such as the definitions of specialist classes of Funds and fund functionaries such as Eligible Custodians and placing them in the CIR module (see Part 2 of the CIR module);

    b. the inclusion in the definitional provisions of the concept of "Excluded Offers" (see chapter 4 of the CIR module), so that certain types of Transactions and marketing activities which are not treated under the current CIR module as regulated offers are more prominently identified as unregulated offers;

    c. the exclusion of secondary sales of Units which are "personal offers" from being treated as regulated Offers (see CIR Rule 4.1.2). This proposal would alleviate the Prospectus disclosure burden for private individuals selling their own personal holdings in limited circumstances. Individuals using this route would still need to go through the Fund Manager or other Authorised Firm to effect the transaction, at which point the Client classification requirements would apply; and

    d. a more cohesive thematic grouping of related requirements. Examples are the "Accounting, audit and periodic reporting of a Fund" in chapter 9 of the CIR module and bringing together under "Marketing of Domestic Funds and Prospectus Disclosure" in chapter 14 of the CIR module all the provisions associated with the marketing of Units of Domestic Funds, including Prospectus disclosure and liability provisions.

108. We also propose to make some changes to the requirements that apply to the valuation function of a Property Fund, taking account of practical difficulties arising due to limited resources available in this regard to Fund Managers in the DIFC. While retaining the current requirement for a valuer of a Property Fund to be independent of the Fund Manager, we have given more flexibility to Fund Managers by removing prescription and providing Guidance on factors that should be taken into account by a Fund Manager in assessing the competency and objectivity of valuers (see CIR Rule 13.4.19).

109. We also propose to make a number of consequential changes to other modules of the DFSA Rulebook to implement the proposals set out in this paper, such as those resulting from the terminology changes referred to under Issue 1.4 (e.g. the change of the term Operator to Fund Manager). In addition, we will be liaising with DIFCA to ensure necessary changes to the Companies Regulations to give effect to the PCC-related changes referred to under Issue 4.

Issues for consideration

23. Do you have any concerns or issues relating to the proposed changes to the valuation function relating to Property Funds? If so, what are they and how should they be addressed?

24. Do you have any concerns or issues relating to the Funds Regime, including any which have not been addressed by, or arising out of, the proposed changes? If so, what are they and how should they be addressed?