

**REPORT BY THE MARKET PRACTITIONER PANEL**

**REVIEW**

**OF THE DIFC'S COLLECTIVE INVESTMENT FUNDS REGIME**

**"DIFC FUNDS – THE WAY FORWARD"**

**30 SEPTEMBER 2009**

## CONTENTS

<b>Section</b>	<b>Page</b>
Members of the Market Practitioner Panel.....	1
1. Introduction .....	2
2. Definitions .....	5
3. Overview .....	10
4. Issues .....	13
Issue 1 – Domicile of Funds.....	14
Issue 2 – Distribution of Foreign Funds.....	21
Issue 3 – Process and Cost Issues.....	27
Issue 4 – Protected Cell Companies and Umbrella Funds.....	29
Issue 5 – Exempt Funds Regime .....	33
Issue 6 – Oversight Committee .....	38
Issue 7 – Shari'a Compliance.....	41
Issue 8 – Taxation and Foreign Investment Issues .....	47
Issue 9 – Other Broad Issues and Recommendations .....	54
Issue 10 – Panel Conclusions: General Strategy and Positioning for the DIFC Funds Regime.....	59
 <b>Appendix</b>	
1. Outline of the DIFC's Collective Investment Funds Regime .....	64

## **MEMBERS OF THE MARKET PRACTITIONER PANEL**

**Mr Nick Smith**, Partner, Allen & Overy LLP – Chair of the Panel

**Ms Lynette Brown**, Partner, Al Tamimi & Company – Deputy Chair of the Panel

**Mr Kevin Birkett**, Executive Director, Asset Management Division, DIFCA

**Ms Farah Foustok**, CEO, ING Investment Management (Dubai) Ltd

**Ms Lanae Holbrook**, Senior Vice President, General Counsel & Head of Market Regulation, NASDAQ Dubai Limited

**Dr Ryan Lemand**, Head of Risk Management – Economic Advisor, Emirates Securities and Commodities Authority (ESCA)

**Mr Craig Roberts**, Chief Executive Officer, Apex Fund Services (Dubai) Ltd.

**Mr Nick Savastano**, Senior Executive Officer, Invesco

**Mr David Smith**, Partner, PwC

**Mr Tom Speechley**, Executive Director, Abraaj Capital

**Mr Jacques Visser**, Managing Director, Legal and Compliance, Algebra Capital Limited

**Ms Dhammika Amukotuwa**, Associate Director – Policy & Legal Services of the DFSA, has acted as the Secretary to the Panel.

## **1. INTRODUCTION**

### **1.1 Panel's mission**

The DFSA established the Panel in July 2009 to provide a report to the DFSA by 30 September 2009 setting out its recommendations as to how the DFSA may support the growth of the funds industry in the DIFC by:

- (a) encouraging the establishment of DIFC Funds; and
- (b) promoting the management of funds (both domestic and foreign) from the DIFC,

in a manner that is consistent with international best practice, particularly IOSCO principles relating to regulation of collective investment schemes.

(For IOSCO Objectives and Principles of Securities Regulation for Collective Investment Schemes, see chapter 11 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>).

### **1.2 Context – current level of DIFC Fund activity and the DIFC's Collective Investment Funds regime**

The DIFC's Collective Investment Funds regime came into force in 2006. The DFSA has advised the Panel that as at the date of this Report the level of DIFC Fund activity is low with only: (i) nine Fund Operators; (ii) four Private Funds; and (iii) one Public Fund. In addition, the DIFC has 87 Asset Managers and 24 Fund Administrators. The number of Authorised Firms distributing Units of Foreign Funds in or from the DIFC stands at 47, with the number of Foreign Funds distributed by them as of 31 December 2008 standing at 1,643.

For ease of reference and context, Appendix 1 to this Report provides a brief outline of the DIFC's Collective Investment Funds regime as at the date of this Report.

### **1.3 Panel's process**

Given the short time within which the Panel was asked to produce this Report, it has had to rely upon the expertise of the Panel members and the resources available within their own organisations.

Within the time available, the Panel has nevertheless undertaken limited consultation with external parties to ascertain further information and their views.

As a general comment, while the Panel has tried to identify regulatory risks and how best the DFSA may address them when implementing the Key Recommendations in this Report, the resource and time constraints within which the Panel has had to operate have not permitted as detailed a study of these risks as the Panel would have liked. Accordingly, the Panel believes that the DFSA will need to undertake more detailed analysis and benchmarking to the extent appropriate in respect of the areas covered by the Key Recommendations in its implementation process. Where possible, this Report refers to some of those areas which may need further analysis by the DFSA.

### **1.4 Panel's approach**

This Report contains recommendations relating to 10 key Issues as identified by the Panel. The Panel has adopted a pragmatic approach in selecting these Issues. They address areas which the

Panel views as being particularly important in making the DIFC Funds regime more accessible and attractive to both investors and the funds industry (fund managers and their service providers such as fund administrators and custodians).

While most of the Key Recommendations are within the powers of the DFSA to implement, in limited areas the Panel recognises that the ability to implement the Key Recommendation may lie outside the powers of the DFSA. For example, the Panel proposes that significant changes be made to both the level and structure of the fees applicable to Fund managers. Not all of these are DFSA fees, however. Rather, some are levied by DIFCA as the corporate regulator and owner of the DIFC office premises. By making these wider reaching proposals the Panel aims to draw attention to areas which it believes warrant a more consolidated and co-operative action by all powers and authorities involved. It hopes that this will go at least some way towards encouraging the relevant authorities to co-ordinate their efforts to bring about changes which the Panel believes would make a significant difference in helping the funds industry to grow in the DIFC.

## **1.5 Basis of this Report**

The views reflected in this Report are those of the individual Panel members. They do not represent the views of the organisations for which they work, or those of the DFSA which commissioned this Report. Some of the recommendations reflect interpretation of the applicable laws and regulations. They are purely the personal views of the Panel members and should not be construed or acted upon as legal opinions or legal, tax or other advice, or DFSA proposals. This Report is provided for use by the DFSA in its efforts to promote the development of the DIFC Funds industry.

## **1.6 Acknowledgments**

The Panel acknowledges the contributions made in preparing this Report by Christopher Thornes, Partner, Amar Meher, Senior Associate, and Asal Mottaghi, Personal Assistant, all of Allen & Overy LLP, and by Sarah Florer, Associate, of Al Tamimi & Company.

## **1.7 Structure of this Report**

The following parts of this Report are structured as follows:

- Definitions
- Overview
- Issues:
  - Issue 1 – Domicile of Funds
  - Issue 2 – Distribution of Foreign Funds
  - Issue 3 – Process and Cost Issues
  - Issue 4 – Protected Cell Companies and Umbrella Funds
  - Issue 5 – Exempt Funds Regime
  - Issue 6 – Oversight Committee
  - Issue 7 – Shari'a Compliance
  - Issue 8 – Taxation and Foreign Investment Issues

- Issue 9 – Other Broad Issues and Recommendations
- Issue 10 – Panel Conclusions: General Strategy and Positioning for the DIFC Funds Regime
- Appendix 1 – Outline of the DIFC's Collective Investment Funds Regime

The Overview highlights the key messages, recommendations and rationale of the Panel.

## **1.8 Implementation of the Key Recommendations**

In going forward, the Panel is happy to provide any further clarifications or information as requested by the DFSA in order to assist the DFSA in implementing the Key Recommendations set out in this Report as the DFSA believes appropriate.

**The Market Practitioner Panel**

**30 September 2009**

## 2. DEFINITIONS

2.1 In this Report the following words and phrases shall have the following meanings:

**AAOIFI** means the Accounting and Auditing Organization for Islamic Financial Institutions.

**Asset Manager** means a Person who holds a Licence to carry out the Financial Services activity of Managing Assets as defined in the [Glossary Module](#) of the DFSA Rulebook.

**Authorised Firm** means a Person who holds a Licence to carry on one or more Financial Services prescribed pursuant to Article 42(1) of the Regulatory Law 2004, as an Authorised Firm.

**CI Law** means the Collective Investment Law DIFC Law No. 1 of 2006, as amended.

**CIR** or **CIR Rules** means the Collective Investment Rules contained in the CIR module of the DFSA Rulebook.

**Client** means a Retail Client, Professional Client or Market Counterparty as defined in the COB, chapter 2.

**COB** or **COB Rules** means the rules contained in the Conduct of Business (COB) module of the DFSA Rulebook.

**Collective Investment Fund** or **Fund** means an arrangement that falls within the definition of Article 15 of the CI Law which provides as follows:

*"(1) A Collective Investment Fund ("Fund") is, subject to Article 16, any arrangements with respect to property of any description, including money, where:*

*(a) the purpose or effect of the arrangements are to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income;*

*(b) the arrangements must be such that the persons who are to participate ("Unitholders") in the arrangements do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions; and*

*(c) the arrangements have either or both of the following characteristics:*

*(i) the contributions of the Unitholders and the profits or income out of which payments are to be made to them are pooled; or*

*(ii) the property is managed as a whole by or on behalf of the Operator of the Fund.*

*(2) If the arrangements provide for such pooling as is mentioned in Article 15(1)(c)(i) in relation to separate parts of the property, the arrangement is not to be regarded as*

*constituting a single Fund unless the Unitholders are entitled to exchange rights in one part for rights in another."*

There are certain exclusions from this definition provided for in the CIR, chapter 2.

**Designated Fund** means a Foreign Fund which has been designated by the DFSA under Article 20 of the CI Law.

**DFSA** means the Dubai Financial Services Authority.

**DFSA Rulebook** means the modules of rules made and issued by the DFSA.

**DIFC** means the Dubai International Financial Centre.

**DIFC Fund** means a Fund established or domiciled in the DIFC.

**DIFC Islamic Law** means the Law Regulating Islamic Financial Business, DIFC Law No. 13 of 2004.

**DIFCA** means the DIFC Authority.

**DIFCI** means DIFC Investments.

**Domestic Fund** means a Fund established or domiciled in the DIFC.

**DTA** means a double tax agreement or treaty.

**Exempt Fund** means a Fund investment in which is restricted to high-net-worth Clients making an initial subscription of at least USD50,000, as proposed under the Key Recommendations at Issue 5.

**Feeder Fund** has the meaning given to that term in the [Glossary Module](#) of the DFSA Rulebook.

**Financial Services Regulator** means a regulator of financial services in a jurisdiction outside the DIFC.

**Firm** or **firm** means an Authorised Firm, and includes a Person who is regulated by a Financial Services Regulator outside the DIFC, as the context requires.

**Foreign Fund** means a Fund established or domiciled in a jurisdiction other than the DIFC.

**FSA** means the United Kingdom Financial Services Authority.

**Fund** see Collective Investment Fund above.

**Fund Administrator** means a Person who holds a Licence to carry out the Financial Services activity of Providing Fund Administration as defined in the [Glossary Module](#) of the DFSA Rulebook.

**Fund manager** means a Person undertaking the responsibility for the operation of a fund and is used to refer to the Operator, unless the context requires otherwise.

**Fund of Funds** has the meaning given to that term in the [Glossary Module](#) of the DFSA Rulebook.

**Fund Property** means the property held for or within a Fund.

**GCC** means the Gulf Cooperation Council, consisting of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE.

**Hedge Fund** has the meaning given to that term in the [Glossary Module](#) of the DFSA Rulebook.

**Investment Company** means a company registered under the DIFC Companies Regulations, chapter 13.

**Investment Partnership** means a limited partnership established under the DIFC Limited Partnership Law 2006.

**Investment Trust** means a Fund structured as an Investment Trust pursuant to the Investment Trust Law of 2006.

**Investment Trust Law of 2006** means the Investment Trust Law DIFC Law No. 5 of 2006, as amended.

**IOSCO** means the International Organization of Securities Commissions.

**Islamic Fund** means a Fund whose entire Fund operations are, or are intended to be, conducted in accordance with Shari'a.

**Islamic Window** means that part of an Authorised Firm's business which is conducted as Shari'a compliant, and is distinct from that Authorised Firm's conventional business.

**Issue** means a key issue as identified by the Panel and set out at Section 4 of this Report.

**Key Recommendations** means the key recommendations of the Panel to the DFSA set out in this Report.

**Licence** means a licence granted by the DFSA under chapter 2 of part 3 of the Regulatory Law 2004.

**Market Counterparty** means a Client specified under COB Rule 2.3.4.

**Non-Designated Fund** means a Foreign Fund which has been designated by the DFSA under Article 20 of the CI Law.

**Operator** means the Person described under Article 17(3) of the CI Law who is responsible for the management of the property held for or within a Fund and who otherwise operates the Fund and, in relation to a Domestic Fund, is authorised under a Licence to operate the Fund.

**Panel** means the Market Practitioner Panel established by the DFSA in July 2009 in order to provide this Report to the DFSA, the members of which are set out at Section I of this Report.

**Person** means a natural or legal person.

**Private Equity Fund** has the meaning given to that term in the [Glossary Module](#) of the DFSA Rulebook.

**Private Fund** means a Fund that meets the criteria for a Private Fund in CIR Rule 18.3.1 and which is not a Public Fund.

**Professional Client** means a Client specified under COB Rule 2.3.2, including a Market Counterparty.

**Property Fund** has the meaning given to that term in the [Glossary Module](#) of the DFSA Rulebook.

**Prospectus** means a document containing the information prescribed under the CI Law and CIR Rules, including a Short Form Prospectus and a Supplementary Prospectus.

**Protected Cell Company** or **PCC** means such a company as defined for the purposes of the DIFC Company Regulations (for these regulations see [http://difc.complinet.com/en/display/display\\_main.html?rbid=2618&element\\_id=5884](http://difc.complinet.com/en/display/display_main.html?rbid=2618&element_id=5884)).

**Public Fund** means a Fund that meets the criteria in Article 46 of the CI Law.

**Qualified Investor** has the meaning given to such term in Issue 5, paragraph 18.1.

**Recognised Jurisdiction** means a jurisdiction which has been recognised by the DFSA under Article 20 of the CI Law.

**Regulatory Law 2004** means Regulatory Law DIFC Law No. 1 of 2004, as amended.

**Report** means this report.

**Retail Client** means a Client specified under COB Rule 2.3.5.

**Short Form Prospectus** means a Prospectus containing all the information required under the CI Law and the CIR Rules for a Domestic Fund which is a Private Fund.

**Specialist Fund** has the meaning given to that term in the [Glossary Module](#) of the DFSA Rulebook.

**SPV** means a special purpose vehicle.

**SSB** means a Shari'a Supervisory Board.

**Supplementary Prospectus** has the meaning given to that term in the [Glossary Module](#) of the DFSA Rulebook.

**Trustee** means a Person described under Article 18 of the Investment Trust Law 2006 who is appointed as the Trustee of an Investment Trust.

**UAE** means the United Arab Emirates.

**Unit** means a unit or share or partnership interest representing the rights or interests of Unitholders in a Fund.

**Unitholder** means in relation to a Fund any holder of a Unit in the Fund or of any right or interest in such a Unit, otherwise known as a "participant".

2.2 Other capitalised words and phrases used in this Report shall have the meanings given to them in the Glossary Module (GLO) of the DFSA Rulebook, unless the context requires otherwise.

### **3. OVERVIEW**

#### **3.1 Overall theme of the Panel's Key Recommendations**

The Panel recommends that the DFSA takes a fresh approach in revitalising the DIFC Funds regime. The Panel believes that the starting point for such an approach is for the DFSA to have a well defined and clearly articulated long-term strategy. That strategy should align the DFSA's regulatory framework with the interests of the regulated and the investor communities, being the funds industry participants and their clients in this case. The strategy may encompass a multifaceted approach, including:

- (a) making the regulatory framework the "right fit" for the DIFC Funds industry;
- (b) embracing regulatory proactivity; and
- (c) having a highly visible and viable "angle" to promote the DIFC Funds industry,

each of which is discussed in greater detail below.

#### **3.2 Making the regulatory framework the "right fit" for the DIFC Funds industry**

To make the DIFC regulatory framework the "right fit" for the DIFC Funds industry, it requires not an overhaul but rather some fairly significant fine-tuning. The Panel is of the view that this fine-tuning process should include the following measures:

- (a) removing the overly burdensome aspects of the current requirements, while retaining their beneficial aspects. Good examples that would benefit from some fine-tuning are the current requirements relating to Shari'a compliance and to Independent Oversight of Public Funds. The Panel recommends retaining these requirements, but in a less prescriptive fashion, thereby providing an appropriate level of flexibility for DIFC Fund managers to apply those requirements in a sensible and effective way to deliver their intended benefits. See the Key Recommendations at Issues 6 and 7;
- (b) reducing the current regulatory costs relating to the establishment in the DIFC of a funds business, including those relating to initial and on-going licensing, compliance and documentation costs. Across all the jurisdictions which the Panel has looked at, the DIFC and DFSA costs are the highest. The Panel recommends that the DFSA reduces its fees and charges to bring them in line with those applied in comparable jurisdictions. It also recommends that the DFSA works with other regulatory authorities, particularly DIFCA, in order to explore ways as appropriate and feasible to bring down their costs (such as office rents in the DIFC and incorporation costs of companies), so that the overall costs of the funds business in the DIFC are set at a sustainable and competitive level. See the Key Recommendations at Issue 3;
- (c) removing the "DIFC only" exclusivity of the DIFC Funds business, resulting from the current restrictions that do not allow DIFC Fund managers to locate Funds outside the DIFC and Fund managers located outside the DIFC to set up Funds within the DIFC. Such exclusivity is not consistent with the international stance which the DIFC is intended to have. Moreover, the Panel believes that these restrictions can be removed without leading to undue investor detriment or exposing the DIFC to undue reputational risks by ensuring only

reputable jurisdictions are acceptable for the purposes of allowing such fund activities either to be based or carried out. See the Key Recommendations at Issue 1; and

- (d) liberalising what the Panel believes to be the unnecessarily restrictive approach reflected in the current list of Foreign Funds, the Units of which are allowed to be distributed by Authorised Firms in or from the DIFC. The Panel believes that these firms should be allowed to distribute a wider range of Foreign Funds, subject to alternative safeguards, such as a suitability assessment or the sophisticated nature of the clients involved, which would allow both investors wider access to Foreign Funds distributed in or from the DIFC and Authorised Firms wider scope of business. See the Key Recommendations at Issue 2.

### **3.3 Embracing regulatory proactivity**

In the Panel's view, achieving the right regulatory fit is not enough in itself, however. There is a need for the DFSA to be closely in touch with the needs of the regulated community and its clients. This enables the DFSA to pre-empt and put into place regulatory requirements to meet the needs and objectives of the funds industry and its investors, hence "proactivity" in making those changes.

Dubai already has many of the facilities offered by other important fund jurisdictions, in terms of excellent infrastructure, tax benefits, a central location and a prudent and sound regulator with international expertise. Building on these foundations, what remains to be done is a revitalised approach by the DFSA and also by DIFCA in promoting greater awareness of these beneficial attributes of the DIFC among the international funds community, helping the industry participants rapidly to develop their expertise in the DIFC Funds regime, and exploring how further incentives can be created to attract a flow of assets into the DIFC, and in their wake the fund managers and associated service providers. See the Key Recommendations at Issues 9 and 10.

### **3.4 Having a highly visible and viable "angle" to promote the DIFC Funds industry**

The Panel is of the view that having a highly visible and viable "angle" to promote the DIFC Funds industry will give the industry additional projection to help it evolve from its current position. In fact, not one, but two such angles exist:

- (a) firstly, creating a pre-eminent Shari'a funds platform is both achievable and desirable as a cornerstone for promoting the DIFC. The implementation of the Panel's Key Recommendations at Issue 7 could go a significant way in paving the path for the DFSA to achieve this goal. The Panel believes that Dubai has the combination of ideal factors that could allow it to gain ground in this area, if a concerted effort is now made on this front; and
- (b) secondly, creating an Exempt Funds regime accessible to high-net-worth Persons with at least USD1 million net assets and appropriate levels of sophistication, as proposed by the Panel, is another highly visible and viable "angle", thereby giving DIFC Fund managers potential access to investable capital that could flow with less costs and regulatory requirements, and at the same time giving those investors the right level of protection and costs (see the Key Recommendations at Issue 5).

### **3.5 Conclusion**

In the Panel's view, the timing is right for the revitalising of the DIFC Funds industry as the DFSA is currently faced with a unique opportunity to attract fund management business given the dislocation going on in the funds industry, and with the likelihood of further regulation emerging in response to

the recent market crisis contributed to by a relatively few industry participants, the consequences of which, however, have to be borne by many.

The Panel recommends the DFSA adopts a strategy that embraces the above three elements, thereby going forward boldly. With the concerted efforts of the funds industry participants and the regulator working together, through measures embodied in the Key Recommendations, there is great potential for a vibrant and significant international DIFC Funds industry. The Panel therefore believes it is in the interests of the DIFC, the funds industry participants and the investors, as a whole, that the DFSA swiftly implements the Key Recommendations in this Report, together with any other complementary or consequential measures as deemed appropriate by the DFSA, together with further engagement with the funds industry as required.

#### **4. ISSUES**

Issue 1 – Domicile of Funds

Issue 2 – Distribution of Foreign Funds

Issue 3 – Process and Cost Issues

Issue 4 – Protected Cell Companies and Umbrella Funds

Issue 5 – Exempt Funds Regime

Issue 6 – Oversight Committee

Issue 7 – Shari'a Compliance

Issue 8 – Taxation and Foreign Investment Issues

Issue 9 – Other Broad Issues and Recommendations

Issue 10 – Panel Conclusions: General Strategy and Positioning for the DIFC Funds Regime

## Issue 1 – Domicile of Funds

### 1.1 Should DIFC firms be permitted to operate/manage Foreign Funds established in other jurisdictions?

### 1.2 Should there be a prohibition on operating/managing Domestic Funds from outside the DIFC?

#### Background

1. There is a general prohibition in Article 17(1) of the CI Law which prohibits (i) the operation of Foreign Funds from within the DIFC, and (ii) the operation of Domestic Funds from outside the DIFC. This Article provides that:  
  
*"A person shall not:*
  - (a) *operate or act as trustee of a Foreign Fund from the DIFC; or*
  - (b) *operate or act as a trustee of a Domestic Fund from outside the DIFC."*
2. A decision relating to the location of a fund management business is driven by a variety of considerations. These include economies of scale, the geographical investment mandate of the funds managed, accessibility of resources including appropriately qualified investment professionals to work for the fund manager as well as support services (such as fund administration, custody and trust service providers) at competitive costs in or from that location, the ease with which the relevant business activities can be conducted in that location (which would depend on the user friendliness of and the familiarity with the relevant regulatory regime), the political and environmental stability that prevails in the location, and, of course, the tax or other monetary consequences of the setting up in that particular location. The *perception* of the quality and maturity of the location is also not to be underestimated.
3. International fund managers (particularly those that have investment strategies that cover more than one single country; which represents the vast majority of fund managers already present in the Middle East as well as those fund managers likely to consider the region as a location), as well as the service industry that supports fund management, develop their business models based on these types of considerations, although the relevance of some may weigh more heavily than others in their decision-making process.
4. Any new fund jurisdiction, not just the DIFC, will inevitably start with some apparent disadvantages. For example, very few fund managers and their advisers will have the necessary familiarity with or the expertise relating to the relevant regulatory regime. There will be new establishment costs in terms of premises, licences and other relevant authorisations required to operate in the new location, as well as human resources that may have to be migrated to the relevant jurisdiction or accessed otherwise. In order to off-set these initial disadvantages and to encourage fund managers to actively choose the DIFC over other jurisdictions, there should be factors that more than counterbalance these

disadvantages. The recommendations relating to this issue, as well as a number of other recommendations in this Report, are designed to create such counterbalancing factors.

5. In a number of ways, the general prohibition in Article 17(1) of the CI Law acts as a barrier both to the establishment of Domestic Funds in, and the migration of fund managers to, the DIFC. These barriers include, for example, fund managers not being able to generate economies of scale because they can only operate Domestic Funds if they are to set up in the DIFC. Similarly, they will not be able to "test the water", and in the process develop familiarity and expertise relating to the DIFC Funds regime, by being able to operate a Domestic Fund from a location outside the DIFC, notwithstanding they are adequately regulated in their current location.
6. It is the Panel's view that for an international financial centre to be regarded as such, regulated fund managers must be provided with the choice of engaging with other jurisdictions. In some situations they will simply not be able to adopt a domestic-only approach to their business because, by definition, their business is international in scope.
7. Practical reasons may also heavily bear upon the choice of location. For example, a core group of investors from whom a fund manager raises money may not be willing to accept the DIFC as the jurisdiction of a particular new fund, instead insisting on another jurisdiction due to its familiarity with the relevant jurisdiction or lower costs. As a result, even with a "level playing field" (similar regulations, equal familiarity with the regime, similar costs etc.), there will nevertheless be situations where a fund manager will need to have a fund established in a jurisdiction other than the DIFC. In such instances, the Panel does not believe that a fund manager should be legally constrained such that it either has to create a separate legal entity in the other jurisdiction to manage the new fund or not set up in the DIFC at all. Such an approach is unlikely to result in a net inflow of international or regional investors or fund managers to the DIFC. This in part touches upon the issue of whether the DIFC views itself as a purely local/domestic jurisdiction or as a truly international financial centre for the funds industry – the Panel would encourage the DFSA to take the latter view.
8. As the CI Law stands, an international or even a regional fund manager (especially one that has existing funds under management) has significant disincentives or technical or practical impediments to selecting the DIFC as a location for its business, including those mentioned above. In other words, with the CI Law as it stands, it is unlikely that there will ever be a marked inflow of fund management business into the DIFC. In short, it is therefore the Panel's view that the general prohibition in Article 17(1) of the CI Law be removed.

#### **What are the risks to the DFSA/DIFC in removing these prohibitions?**

9. The Panel has considered whether there are any regulatory risks in allowing DIFC Fund managers to operate Foreign Funds from within the DIFC, or, conversely, in allowing Domestic Funds to be operated from outside the DIFC.
10. It is possible that if fund managers from jurisdictions with "lax" regulation are allowed to operate Domestic Funds from outside the DIFC, they may apply standards that are unacceptable to the DFSA, leading to possible investor detriment and resulting reputational risk to the DIFC. Similarly, although well regulated in the DIFC, DIFC Fund managers setting up Foreign Funds in not so well regulated jurisdictions may not have a strong incentive to abide by DIFC standards, leading to unacceptable conduct that may have the potential to tarnish the DIFC's reputation by the DIFC Fund managers' association with the DIFC arising from their location in the DIFC.

11. The Panel is of the view that these are not insurmountable issues or risks, however, and that such risks can be mitigated and in any event are far outweighed by the benefits of allowing access to DIFC Funds and Fund managers of business and services located elsewhere.
12. The Panel believes, however, that, in addressing this issue by way of any changes to the CI Law, a distinction needs to be drawn between (i) DIFC Fund managers (i.e. managers located in the DIFC and regulated by the DFSA) managing funds located outside the DIFC, and (ii) Domestic Funds being managed by fund managers located outside the DIFC.

*DIFC Fund managers managing funds located outside the DIFC*

13. To address any reputational issues to the DIFC, the DFSA may wish to confine the jurisdictions in which DIFC Fund managers can locate their funds (or the jurisdictions under which laws their funds are governed) outside the DIFC to those which are not blacklisted by say the Financial Action Task Force (the **FATF**), the United Nations (the **UN**), the Office of Foreign Assets Control (the **OFAC**) or the Organisation for Economic Co-operation and Development (the **OECD**) (which typically blacklists jurisdictions for tax reasons), or any other regulatory or international agency deemed appropriate by the DFSA. The Panel acknowledges that notwithstanding regulating this area "in the negative", by adopting this approach there will need to be certainty for both DIFC Fund managers and the DFSA as to which jurisdictions are blacklisted in this way at any time. Further, the Panel acknowledges that the DFSA should always ultimately retain the ability to act in accordance with its own determinations with regard to any black list.
14. In relation to funds established by DIFC Fund managers in jurisdictions not appearing on any relevant black list at the time of their establishment but which subsequently become blacklisted, the Panel suggests that the DFSA considers this be dealt with by say a reasonable grace period for either (i) the blacklisted jurisdiction to become compliant, or (ii) the DIFC Fund manager to move the fund to a non-blacklisted jurisdiction. In this regard, the Panel acknowledges that the DFSA will take into account the impact on the investors in the fund, the DIFC Fund manager, the regulator of the jurisdiction of the fund, and the wider market in taking any appropriate action.

*Domestic Funds being managed by fund managers located outside the DIFC*

15. On the other hand, fund managers located outside the DIFC seeking to manage DIFC Funds would in any case have to abide by certain legal requirements that apply in the DIFC, as their activities would amount to carrying on a Financial Service in or from the DIFC (note a Person is prohibited from carrying on Financial Services in or from the DIFC unless licensed by the DFSA). Therefore, the DFSA may wish to consider equivalence of regulation of the foreign fund managers in their home jurisdictions with that of the DIFC in order to grant them a form of recognition for licensing purposes. The Panel notes that there is a precedent for this approach in relation to Recognised Members who are allowed to trade on DIFC Exchanges.
16. The DFSA may consider allowing only those fund managers that are located in jurisdictions which the DFSA considers as having an appropriate or equivalent regulatory regime to operate Domestic Funds from outside the DIFC, which need not go to full reciprocity, but recognition by the DFSA of the relevant regime. It should be a sufficiently broad list of jurisdictions to include the existing main international fund regimes in order to achieve the general aim of ensuring that the DIFC is accepted as an international funds jurisdiction, at the same time as not risking association with unacceptable practice. The list of recognised regimes may be linked to the "Recognised Jurisdiction" regime currently in place under Article 20 of the CI Law, albeit extended in terms of its scope and jurisdictions. In any event, the list should be reviewed frequently and updated as appropriate.

17. The Panel does not consider that the approaches suggested above for DIFC Fund managers managing funds under different jurisdictions or for foreign fund managers managing Domestic Funds would be inconsistent with the DFSA's current regulatory approach. For instance, the DFSA's approach to allowing Foreign Funds to be marketed from the DIFC already reflects the recognition of regulatory equivalence. The Panel also sees other distinct benefits in the suggested approaches. For example, DIFC Fund managers operating funds in other reputable jurisdictions will have to comply with the requirements in those jurisdictions and hence the benefit of that regulation will flow to investors. Similarly, the benefit of regulation in another jurisdiction would flow to investors in Domestic Funds operated by foreign fund managers located in reputable jurisdictions. Of course there is a risk of dual regulation or additional costs due to inconsistent regulation applying in different jurisdictions. The Panel is of the view that the DFSA is accustomed to dealing with these issues through measures available to it, such as better alignment of its regulatory requirements with international standards and waivers and modifications of its rules where appropriate.

### **Some related issues**

18. There are three related issues that the Panel has considered in this context:
  - 18.1 whether the general prohibition in Article 17(1) of the CI Law so far as it relates to Trustees of Investment Trusts is justified;
  - 18.2 whether the terminology of "Operating a Fund" is the most appropriate terminology by which the Fund management function should be identified and regulated; and
  - 18.3 the ability for DIFC Fund managers to distribute in or from the DIFC Units of funds managed by them in locations outside the DIFC.

### *Trustees of Investment Trusts*

19. Considerations that underpin the case for removing the general prohibition in Article 17(1) of the CI Law for Operators apply equally to Trustees. The current requirements that prohibit a Domestic Fund to have a foreign trustee or a Domestic Firm authorised to act as a Trustee of a Fund to be able to act as a trustee of a Foreign Fund are inconsistent with the flexibility proposed for Fund managers so that they can manage Funds in the DIFC while being located elsewhere and conversely, act as Fund managers to funds located elsewhere. This is particularly the case if DIFC Fund managers are to be allowed to manage funds located elsewhere, as often the legal title to the assets under management may likely require them to be held by an entity in the location of the fund assets, rather than by a trustee in a different location (although the appointment of sub-custodians could address this issue). Therefore, these restrictions should be removed to provide greater flexibility to fund managers in choosing trustees for funds they manage. Again, to the extent relevant, the appropriateness or equivalence in terms of the applicable requirements to trustees in the relevant jurisdiction should underpin the DFSA's decision in allowing fund managers to choose trustees in other jurisdictions. This seems to be consistent with the approach the DFSA already uses in relation to custodians.

### *Terminology*

20. The current terminology of the Financial Service constituting the operation/management of Funds is "Operating a Fund". This is not the terminology which the funds industry is generally accustomed to, however, as in most jurisdictions the terms used to refer to the fund manager are "investment manager" or "management company" and rather than "operating a fund" the commonly used term is

"managing a fund". Familiarity with concepts has a natural attraction. Therefore, rather than use different terminology, it would provide greater clarity as well as comfort to Fund managers to be able to use terms to which they are accustomed, especially where they are to be given the flexibility to operate/manage Foreign Funds while being based in and regulated by the DIFC regime.

21. Central to this issue is the somewhat artificial distinction which the DFSA seems to have drawn between "operating a Fund" and "managing a Fund". Article 17(3) of the CI Law states that, for the purposes of the CI Law, a Person "operates" a Fund if he:

*"(a) is responsible for the management of the property held for or within a Fund under the Fund's Constitution whether or not, [sic] he delegates any activity which is prescribed in rules made for the purposes of Article 41(2) of the Regulatory Law 2004 as a Financial Service in respect of such property; and*

*(b) establishes, operates or winds up the Fund."*

Further, guidance is given in Articles 17(4) of the CI Law which gives some clarity on what activities amount to "Operating a Fund". Under that Article a Person is not taken to operate a Fund merely because, inter alia:

*"(b) he is appointed under a written agreement by an Operator to provide investment management and other Financial Services for the Fund;"*

22. The Panel believes that this perceived distinction has resulted in a general lack of clarity as to the terms "operate" and "manage". Further, as the DFSA is aware, this has led to a "tolerated practice" whereby Foreign Funds are already in effect "managed" by Fund managers from within the DIFC, pursuant to Article 17(4)(b). (Equally, it should be noted that Article 17(4)(b) would therefore permit the "management" of Domestic Funds from outside the DIFC provided the management activities fit within the definition of the Financial Service of "Managing Assets"). It is therefore the Panel's view that the unhelpful distinction between "operating" and "managing" a Fund should be removed by the DFSA and the current "tolerated practice" be formally acknowledged and expressly permitted. In this regard the DFSA should also consider the issue of "grandfathering" existing practices in respect of amendments to the legislation and regulations.
23. Further, no additional authorisations should be required for Authorised Firms to establish, manage or wind up Funds beyond a standard licence for "Managing Assets" or "Investment Management".
24. An additional benefit of this approach is the removal of the other somewhat artificial distinction that seems to have been drawn by the DFSA between "Managing Assets" and "Operating a Fund". Discretionary asset management for individual clients (whether corporate or natural person clients) where no pooling of different clients' assets occurs seems to be the subject of regulation under the category of activities called "Managing Assets" so far as Investments are concerned. However, in both cases, i.e. "Managing Assets" and "Operating a Fund", the relevant activity is the management of assets and the entity undertaking this activity remains legally accountable to the clients for the management of assets on a discretionary basis as per the investment charter/mandate and any other applicable legal and regulatory requirements. Therefore, to remove any uncertainties and to reflect consistency with the international practice relating to terminology, the Panel believes the DFSA should move towards using "investment management" terminology in referring to the fund manager function that involves management of collective investments. Discretionary portfolio services should attract a more appropriate term to that activity, given that they are not Collective Investment

Funds due to the absence of pooling and that activity is best suited to being regulated by COB requirements that apply to the firms offering such services.

*Distribution of Units in or from the DIFC of funds located outside the DIFC managed by DIFC Fund managers*

25. The Panel notes that to the extent that the DFSA permits DIFC Fund managers to manage funds located outside the DIFC as recommended by the Panel, the DFSA should not restrict the distribution of Units of those funds in or from the DIFC by the DIFC Fund managers. The Panel notes, however, that in so doing DIFC Fund managers will nevertheless remain subject to the regulatory requirements of the relevant jurisdictions.

**International trends**

26. The Panel notes that the current international trend is to promote a more open rather than a purely domestic or regional approach to regulation, as evidenced by the Committee of European Securities Regulators' (the **CESR's**) recent call for evidence on mutual recognition with non-EU jurisdictions in June 2009. This EU initiative is directed at gathering evidence from the industry to ascertain impediments to mutual recognition of financial products and services from non-EU jurisdictions to identify means by which greater integration of cross-border flow of financial products and services could be achieved, not only among EU members but including non-EU jurisdictions, thereby delivering cost efficiencies, adequate investor protection and market integrity without inhibiting market innovation and healthy competition. At the same time, the Panel acknowledges that there is a proposed new directive in Europe that is attracting a lot of debate and that could have the effect of closing barriers in Europe rather than opening them, although there is likely to be a good deal more debate before any such directive is finalised.

**Key Recommendations**

27. The Panel recommends to the DFSA that:
- 27.1 the DFSA removes the current general prohibition in Article 17(1) of the CI Law so that (i) DIFC Fund managers can operate Foreign Funds from within the DIFC, and (ii) fund managers based outside of the DIFC can operate Domestic Funds from outside the DIFC;
- 27.2 in removing the general prohibition in Article 17(1) of the CI Law, the DFSA:
- (a) limits the jurisdictions outside the DIFC in which DIFC Fund managers can operate/manage Foreign Funds to those which are not blacklisted by say the FATF, the UN, the OFAC, the OECD or any other regulatory or international agency deemed appropriate by the DFSA; and
  - (b) creates a recognised status under which fund managers located in jurisdictions outside the DIFC can manage Domestic Funds where the DFSA considers such jurisdictions to provide an appropriate or equivalent regime of regulation to that of the DIFC regime. A broader list than the current "Recognised Jurisdiction" list should be adopted, which includes the existing main international funds regimes. In other words, while the Panel does not think that it is appropriate to deviate from the equivalence of regulation basis, a more inclusive approach to recognition of jurisdictions should be adopted;

- 27.3 the DFSA should also remove the general prohibition in Article 17(1) so far as it relates to Trustees of Investment Trusts, for similar considerations as those set out for removing the restriction for Fund managers and also in the same manner as suggested for the removal of the restrictions for Fund managers;
- 27.4 the DFSA should use the terminology "investment management", "fund manager" and "managing a Fund" (and other relevant derivations) instead of fund "Operator" and "Operating a Fund" when regulating the conduct of Fund managers, as this is the normally accepted and internationally recognised terminology. In addition, managing discretionary portfolio services, which is covered under Managing Assets, should be given a more appropriate term to distinguish it from "investment management", given that it is not a collective investment fund due to the absence of pooling; and
- 27.5 the DFSA should remove the distinction between "managing a Fund" and "operating a Fund". Further, no additional permission should be required for Authorised Firms to establish, manage or wind up Funds beyond a standard endorsement for "Managing Assets" or "Investment Management".

## Issue 2 – Distribution of Foreign Funds

### Should DIFC firms be allowed to distribute a wider variety of Foreign Funds?

#### Background

##### *Applicable legal requirements*

1. Articles 18 and 20 of the CI Law set out the main parameters within which the marketing of Units in Foreign Funds in or from the DIFC can be undertaken. Article 18 of the CI Law contains two types of restriction which apply to the marketing of Units in Foreign Funds:
  - 1.1 the first relates to the type of Persons who can undertake such marketing activities. Only an Authorised Firm with relevant authorisations on its Licence can undertake such marketing; and
  - 1.2 the second relates to the type of Foreign Funds which can be marketed in or from the DIFC, being those which:
    - (a) are Designated Funds in Recognised Jurisdictions;
    - (b) have an investment manager and eligible custodian subject to regulation and supervision in a Recognised Jurisdiction; or
    - (c) meet one of the Non-Designated Funds criteria in the CIR.
2. Article 20 of the CI Law sets out grounds upon which the DFSA may recognise a jurisdiction or designate funds in a jurisdiction as meeting its Recognised Jurisdiction/Designated Fund criteria. For the DFSA to recognise a jurisdiction and designate funds in that jurisdiction, it must be satisfied with the equivalence of regulation between the key elements of the DFSA Funds regime and the regulatory regime applying in that other jurisdiction. In addition, there must also be mutual arrangements for co-operation between the DFSA and that other regulator.
3. Articles 18 and 19 of the CI Law include the parameters within which the DFSA may make Rules setting out new, or modifying the existing, eligibility criteria for Foreign Funds, and also any additional requirements including as to disclosure which apply to marketing of Units in qualifying Foreign Funds. These additional requirements are set out in chapter 3 of the CIR and encompass the following:
  - 3.1 when a Foreign Fund qualifies as a Designated Foreign Fund – i.e. when such a Fund is included in the DFSA's Recognised Jurisdictions and Designated Funds Notice, and if it is also a Property Fund meets the additional criteria relating to Property Funds such as its closed-ended structure and being included in an official list of a Recognised or Authorised exchange;
  - 3.2 if a Foreign Fund is not a Designated Fund, how it can qualify as a Non-Designated Foreign Fund – there are three discrete tests to qualify under this heading. Primarily, two of these

tests focus on an appropriate and equivalent level of regulation as provided under the DFSA regime applying directly or indirectly to the investment manager and custodian of the Fund, with some variations as to how that level of regulation is derived. The other test relies on the Foreign Fund being rated "investment grade" by a recognised rating agency;

- 3.3 additional requirements that apply to the marketing of Foreign Funds which qualify under 3.1 or 3.2 – these requirements are primarily about access and availability of Prospectuses relating to such Foreign Funds being in the English language to investors to whom the Units are marketed, warnings that the DFSA does not regulate the Foreign Funds and the restriction that only Foreign Funds that can be offered to retail investors in the home jurisdiction can be offered to Retail Clients in or from the DIFC; and
- 3.4 certain exemptions from the requirements relating to the marketing of Units of Foreign Funds – these exemptions apply to execution-only Transactions undertaken by an Authorised Firm (i.e. execution of Client initiated buy or sell orders), offers of Units of a Foreign Fund to a Market Counterparty and redemption related Transactions.

#### **Should the DFSA continue to be highly restrictive in its approach to the marketing of Foreign Funds?**

4. Considerations relating to the activities of an Authorised Firm which sets up in the DIFC for marketing purposes are not that dissimilar to those which relate to an Authorised Firm establishing in the DIFC to operate Funds. They both, for example, look to economies of scale, ease of access to as large a base of potential investors as possible, competitive costs at which they can set up and operate their business, as well as familiarity and ease with which they can comply with the relevant regulatory requirements.
5. Equivalence of regulation appears to have been a major factor in influencing the DFSA's current restrictive approach in allowing Foreign Funds to be marketed in or from the DIFC. A consideration which may have supported this approach is likely to have been the possible reputational risks for the DFSA/DIFC arising from any major mis-selling scandal surrounding Foreign Funds which are marketed by managers located in jurisdictions with "lax" regulation. Recent financial market crisis may also give some credence to the need to address the latter risk.
6. The Panel is aware that in the aftermath of the financial market crisis, regulators are generally more reticent about becoming deregulatory, particularly relating to the use of their territory as a base for channelling investment funds to investment vehicles in unregulated or poorly regulated jurisdictions, as they have no control over the operations which occur outside of their territory.
7. These considerations must, however, be weighed against the desire to position the DIFC as a well regulated, yet competitive, international player in the funds arena. The Panel believes that the right balance between these competing considerations can be struck through a regulatory approach which moves its focus wider than the current product (i.e. the Fund) specific "equivalence of regulation" focus. Through a wider approach, better alignment between the regulatory requirements that apply to Authorised Firms and their marketing activities can be made. It also allows the DFSA to tailor better the regulatory protection accorded to certain types of investors taking account of the level of sophistication and net worth they possess. These measures would provide greater flexibility for Authorised Firms in marketing Units of Foreign Funds without exposing the DFSA/DIFC to unwarranted reputational and other regulatory risks.

8. Accordingly, the Panel believes that Authorised Firms should be allowed to market Units of Foreign Funds under any of the following three circumstances:
  - 8.1 where the investors targeted are sophisticated and high-net-worth individuals (in addition to Market Counterparties who can under the current regime be offered Units of Foreign Funds without invoking the current restrictions), subject to appropriate safeguards;
  - 8.2 where the Authorised Firm makes a recommendation as to the suitability of the investment in the Foreign Fund for the particular Client, in terms of that Client's individual investment objectives, financial circumstances and risk tolerance; or
  - 8.3 under the current Foreign Fund qualification criteria.

*Marketing to sophisticated and high-net-worth individuals*

9. This test relies on the investors possessing an adequate level of sophistication to understand the risk-benefits associated with investing in Foreign Funds and also having adequate resources to absorb potential losses that may result from such investments where such an eventuality occurs. The Panel notes that under the current regime an Authorised Firm can offer Units of a Foreign Fund to a Market Counterparty without being restricted by the qualifying criteria for Foreign Funds and the additional requirements referred to in paragraph 3 above. Market Counterparties are by definition institutional investors. High-net-worth Persons with a sufficient degree of sophistication in investment activities should also be included in the category of Persons to whom an Authorised Firm could market Units of Foreign Funds in reliance on their expertise and resources.
10. An issue, however, which the DFSA will need to consider in more detail in this context is whether the current test for "Professional Client" (premised on net assets of at least USD500,000 and a sufficient understanding of relevant financial instruments and markets) alone would be a sufficient proxy for adequate net worth and sophistication when investing in Foreign Funds. To ensure that suitable Persons are allowed to invest in Units of Foreign Funds on the basis of their high-net-worth, the bar may need to be set at a higher level than the current Professional Client test in terms of net assets.
11. The Panel believes that the DFSA should consider this category in the context of an Exempt Funds regime, if adopted by the DFSA. In this regard refer to Issue 5.

*Personal recommendation based marketing*

12. This test relies on the benefit of alternative regulation resulting from a suitability assessment undertaken by an Authorised Firm. Therefore, an Authorised Firm should be permitted to undertake marketing of Units of Foreign Funds where it makes a recommendation relating to the suitability of the investment in the Foreign Fund for the particular Client, in light of that Client's investment needs, circumstances and risk tolerance. This would require the Authorised Firm to undertake a proper needs analysis and product research relating to the Foreign Fund before it reaches a conclusion as to the suitability of the investment for the particular Client and making a recommendation to the Client to that effect. Already the standards in the COB module contain these provisions.
13. Under the current regime, however, an Authorised Firm cannot escape the qualifying criteria applying to Foreign Funds even in a recommendation situation (although where an Authorised Firm undertakes discretionary portfolio management, the Foreign Fund qualification criteria may not

apply to the firm). The Panel believes the benefit of the suitability assessment process, and the ultimate accountability of the Authorised Firm for the recommendation it makes to the Client, provide adequate safeguards to remove the need for the Foreign Fund qualification criteria that currently apply. Moreover, this provides a more tailored level of protection while giving Authorised Firms the flexibility to recommend a wider range of Foreign Funds provided they are satisfied with the suitability of the investment for the particular Client. Investors would benefit by way of access to a wider range of investments subject to adequate alternative safeguards in terms of the suitability assessment by the Authorised Firm.

14. From a regulatory perspective, this approach shifts the burden of doing due diligence to the Authorised Firm, instead of the DFSA having to undertake an equivalence of regulation analysis on new jurisdictions which are not included in the list (although the DFSA should continue to expand its list of Recognised Jurisdictions).

#### *Retaining the current criteria*

15. The Panel believes there is scope for retaining the current eligibility criteria for Foreign Funds, so that it can be used by Authorised Firms to market Units of Foreign Funds in circumstances where the tests in either 3.1 or 3.2 cannot be met. The Panel is aware that the current requirements may well serve the needs of some Authorised Firms which have already developed their marketing models based on the Designated Funds in Recognised Jurisdictions, or the alternative Non-Designated Funds criteria, and they may choose to use this approach to gain a marketing advantage. While the proposed expansion may undoubtedly lead to competitive pressures, the benefit of the expanded criteria may nevertheless flow to those firms using the existing criteria.

#### *Other complementary initiatives*

16. In addition to the proposals to expand the current criteria for marketing of Units of Foreign Funds, the Panel notes that if the Authorised Firms were to market Units of Foreign Funds to investors located outside the DIFC, they would in any event encounter the need to comply with the regulatory requirements applicable in the host jurisdictions. While this is a common requirement in most jurisdictions, the DFSA should explore avenues for entering into mutual recognition treaties with other jurisdictions, particularly in the MENA region, possibly with a greater emphasis on GCC jurisdictions, as this will go a long way in promoting the marketing of Foreign Funds in or from the DIFC.
17. In this context, the Panel also notes that the DFSA may have the opportunity to make submissions to appropriate governmental agencies in the UAE to promote a passporting of regional investment vehicles through a harmonisation and standardisation process of the applicable regulatory requirements in the regional jurisdictions in a move similar to the EU approach to UCITS. While such an initiative would be highly beneficial, to what extent there is an appetite for such a move remains to be seen.
18. While the DIFC based exchanges are operated on international standards, the Panel notes that the listing of Foreign Funds and Exchange Traded Funds on the DIFC based exchanges has not taken-off well. This is another area that would benefit from further exploration with a view to enhancing the marketing and distribution of Foreign Funds by Authorised Firms. Some of the factors which may be contributing to the slow growth in listed Funds include:
  - 18.1 the lack of familiarity with the listing and other associated requirements that apply to DIFC based exchanges;

- 18.2 uncertainties relating to ownership and other laws that may apply to Foreign Property Funds seeking to invest in assets located in the GCC;
- 18.3 practical difficulties for Foreign Funds seeking dual listings if the DIFC based exchanges have listing requirements that are not similar to other exchanges on which such Funds have their primary listings; and
- 18.4 possible process and cost issues associated with listing on DIFC based exchanges.

Although the Panel has had limited time to explore these issues in any degree of detail, it is of the view that the DFSA should, in conjunction with the DIFC based exchanges, undertake a more detailed analysis to identify issues that hinder Foreign Funds and Exchange Traded Funds in seeking listings on DIFC based exchanges and remove those barriers to promote greater growth in this area.

### **Key Recommendations**

19. The Panel recommends to the DFSA that:

- 19.1 the DFSA adopts a more flexible approach to allowing Authorised Firms to undertake the marketing of Units of Foreign Funds by expanding the current requirements with the inclusion of four additional grounds:
  - (a) the first is based on the high-net-worth and sophisticated nature of the individual Clients involved, so that they have the ability to assess the risk-benefits of the investments in Foreign Funds themselves. However, the DFSA should consider setting a test for such Clients at a level higher than currently envisaged for Professional Clients as an additional safeguard. For this purpose, the Panel recommends a net asset test of USD1 million combined with appropriate expertise as currently required for Professional Clients, be used, and such investors be called "Qualified Investors". (The same "Qualified Investor" definition is to be used for the Exempt Fund proposal in Issue 5);
  - (b) the second is based on recommendation-based marketing, so that reliance is placed on the benefit of regulation flowing from the suitability assessment undertaken by the Authorised Firm. This ground will give more flexibility to the repertoire of investments accessible by an Authorised Firm for its Clients taking account of the Authorised Firm's accountability to the Client when making such recommendations;
  - (c) the third is the distribution of Units of Foreign Funds which fall within the proposed definition of an Exempt Fund (see Issue 5). Authorised Firms should be permitted to distribute Units of such Funds in or from the DIFC provided the restrictions relating to the nature of investors, i.e. the Qualified Investor test, and the minimum initial subscription level of at least USD50,000 are met; and
  - (d) where the Authorised Firm is the manager of Foreign Funds, allowing that Authorised Firm to distribute in or from the DIFC the Units of these Foreign Funds;
- 19.2 the DFSA should also explore complementary measures such as mutual recognition treaties which would not only better facilitate the marketing activities of Authorised Firms, thereby attracting firms to be based in the DIFC, but also increase the profile of the DIFC in the region as a promoter of international best practice; and

19.3 in conjunction with the DIFC based exchanges, undertakes a more detailed analysis to identify issues that hinder Foreign Funds and Exchange Traded Funds in seeking listings on DIFC based exchanges and removes those barriers to promote greater growth in this area.

## Issue 3 – Process and Cost Issues

### 3.1 Are establishment and on-going compliance costs in the DIFC comparable with other similar jurisdictions?

### 3.2 Are there concerns about the time taken for the establishment/authorisation in the DIFC?

#### Background

1. Rules 3.2.1(3), 3.9.1 and 3.10.1 of the Fees (FER) module set out the DFSA fees and charges relating to DIFC Funds and Operators.
2. It is generally understood that the costs of setting up an Operator and establishing Public and Private Funds in the DIFC are higher than in other on-shore and off-shore jurisdictions. The application and ongoing annual fees for a fund Operator are USD40,000 plus a further annual fee of USD40,000 pro-rated to the number of months left of the year in the first year of operations. From the second year, they are annually USD40,000 plus USD1,000 for each complete USD1 million of expenditure (in addition to the capital requirements for a Category 3 entity which are a minimum of USD500,000).
3. The fees to register a Public Fund comprise an application fee of USD5,000 plus, where the Public Fund is an Umbrella Fund, USD2,500 for each sub-fund up to a maximum of USD20,000. No fees are payable for notification to the DFSA of a Private Fund.
4. In addition, the initial annual fee for a Domestic Fund (payable on registration for a Public Fund and on notification to the DFSA for a Private Fund) is an amount equal to the net asset value of the Fund (or sub-funds) multiplied by 0.001 subject to a minimum fee of USD10,000 and a maximum fee of USD50,000 (pro-rated if the initial period is less than one year). For subsequent periods, the fees are calculated in the same manner on the net asset value of the Fund or sub-funds as at 10 November of each year (or if registered or notified after 10 November in that year, on the date of registration or notification).
5. The Operator and the Fund vehicle will also need to be registered separately from the Fund and fees will be payable for registration and to maintain the registration annually. The fees for this are USD2,000 per entity.
6. In addition to the fees and capital requirements, potential DIFC Fund Operators cite other issues, such as office rents which are generally higher than in similar quality buildings in other parts of Dubai and higher costs generally for services in the DIFC, as making the DIFC less attractive commercially than other financial centres in the region and internationally.
7. There are other regulatory requirements relating to DIFC Funds which contribute to added costs over and above those found in other financial centres, these include:
  - 7.1 oversight requirements for Public Funds;
  - 7.2 Shari'a compliance costs;

- 7.3 general compliance costs; and
  - 7.4 documentation costs, including the need to repeat all of the specific Fund information usually only contained in the offering document in the constitutional documents of the Fund entity. This is particularly onerous in relation to an Umbrella Fund structure.
8. In relation to the current time to establish and have Funds approved/registered following submission of all the relevant documentation, while this is not considered always to be a major issue, where, for example, there is the need to have a Category 3 licence for an Operator, the time to obtain such a licence (approximately 3 to 6 months) is a factor discouraging potential Operators to set up and operate Funds in the DIFC.
9. In short, the Panel believes the treatment by the DFSA of the issue of process and cost to be of particular importance to the future growth of the funds industry in the DIFC. It is the Panel's view with regard to costs that the DFSA's focus should be a long-term strategic one, which is in the best interests of the DIFC as an international financial services centre, rather than a short term one (see further at Issue 10).

### **Benchmarking**

10. In some important fund jurisdictions the fees for incorporation and registration of relevant entities and funds are generally less than USD10,000 in total, and sometimes less than this.
11. In addition, given the costs of compliance in the DIFC, the level of office rents and other costs within the DIFC, and the capital requirements for an Operator, the cumulative costs of operating a Fund in the DIFC are higher than in other jurisdictions considered by the Panel.

### **Key Recommendations**

12. The Panel recommends that the DFSA:
- 12.1 undertakes, in conjunction with DIFCA, a comprehensive review of their respective fees and charges with a view to aligning better their charges to those applied in other comparable jurisdictions;
  - 12.2 when undertaking such a review the DFSA, in conjunction with DIFCA, also takes into consideration the layering of costs when additional costs such as office rents, charges for services, compliance etc. are taken into account;
  - 12.3 reviews the requirements for oversight, Shari'a compliance, repetitive documentation etc. in an effort to reduce time and costs for Operators of DIFC Funds;
  - 12.4 in terms of timing issues, looks at ways to reduce, for example, the time it takes to obtain a Category 3 licence for an Operator of a Fund; and
  - 12.5 in addition explores avenues through which DIFC Funds can gain "added value" by way of additional benefits over other regional and international financial centres, such as easy marketability in other GCC countries and improved access to investments in GCC countries.

## **Issue 4 – Protected Cell Companies and Umbrella Funds**

### **4.1 Should a Protected Cell Company structure be used for Umbrella Funds?**

### **4.2 Clarification of Umbrella Fund provisions, including cross liability issues and requirements in relation to constitutional documents.**

#### **Background**

1. Umbrella Funds form a significant segment of the funds industry as they provide fund managers with the flexibility to offer different investment strategies (such as conservative or speculative) to suit different types of investor-needs and circumstances, while minimising costs associated with the infrastructure for implementing those discrete investment strategies by centralising those costs within the Umbrella company (the **Umbrella**). However, while each sub-fund is notionally different to the other sub-funds operated under the same Umbrella, with each having its own dedicated investment strategy, under the current DIFC Funds regime these sub-funds are not separate legal entities. Consequently, assets in one sub-fund are not insulated from any liabilities arising in the other sub-funds in the Umbrella, or the Umbrella itself.
2. In this context the Panel has turned its focus to the Protected Cell Company (**PCC**) structure available under the DIFC Companies Regulations which is designed to provide captive insurers with the flexibility to provide a "rent a captive" service so that different clients with different insurance needs can be catered to, using the infrastructure provided by the core of a PCC. In this sense, functionally, the PCC structure is very similar to the Umbrella structure, in that each cell is similar to a sub-fund and the Umbrella is similar to the core. Although functionally similar, PCCs differ from Umbrella Funds in a significant respect because the PCC structure, unlike the Umbrella structure, provides for legal certainty so that each cell and its assets are protected and insulated from any liabilities arising in other cells managed by the core and the core itself. The Panel considers this analogy to be particularly important as other jurisdictions are, or are quickly moving towards, providing Umbrella Funds with the legal structure to insulate each sub-fund from liabilities arising in other sub-funds within the Umbrella as provided in a PCC structure (see below under Benchmarking).
3. It is against this backdrop that the Panel has explored issues that deter the growth of Umbrella Funds in the DIFC. These are considered under two categories:
  - 3.1 issues relating to legal and functional segregation of sub-funds; and
  - 3.2 procedural impediments that invoke administrative inefficiencies and resultant costs.

#### **Issues relating to legal and functional segregation of sub-funds**

4. It is generally considered to be an advantage for a funds regime to offer a segregated sub-fund structure much like that available under the PCC structure to streamline the setting-up and operation of Umbrella Funds, so that each sub-fund is ring-fenced in terms of its assets and liabilities from other sub-funds under the Umbrella. This simplifies the setting-up of a number of different sub-

funds with similar management and operational features thereby allowing those funds to use the same infrastructure provided by the Umbrella, such as the management expertise and systems and controls. Naturally, this promotes cost and time efficiencies from both a fund management and regulatory perspective.

5. Fund managers of large investment firms generally operate a small number of Umbrella companies with a large number of sub-funds within each Umbrella, which allows them to establish and operate a range of funds with discrete investment strategies more efficiently. However, while notionally discrete, if there is no legal segregation of liabilities between different sub-funds, investors in these different sub-funds are exposed to the risk of cross-contagion. For example, if an Umbrella Fund has one sub-fund with a cautious A-rated fixed income strategy, and another with a high-risk leverage equity investment strategy, the former is exposed to a higher risk of collapse, in the event of which the creditors of the latter are able to reach the assets of the former, thereby exposing investors in the cautious fund to risks which the investors in the riskier fund took, without being able to participate in any profits or benefits of the riskier fund, had that fund been in profit.
6. Providing a legal framework that provides segregation of assets and liabilities of sub-funds as in a protected cell regime will provide greater investor protection. Recent global events highlighted the importance of not exposing investors in a low-risk fund to the risks in a separate sub-fund holding riskier assets. Furthermore, investors have become more risk-averse and see any possible risk of contagion as a reason not to invest, or to invest elsewhere.
7. While the central feature of such a legal framework is to provide for a clear segregation of each sub-fund's assets and liabilities from those of the other sub-funds operated by the Umbrella, and the Umbrella itself, such a framework also needs to address associated issues, such as those relating to the apportionment of management costs between sub-funds in a manner commensurate with the activities undertaken by each sub-fund and a fair allocation among sub-funds of any surpluses which are not clearly attributable to a specific sub-fund, particularly in the event of a winding-up or liquidation. The Panel believes that the existing over-arching CI Law obligations of a DIFC Fund manager such as those relating to the fair treatment of investors as between themselves and between classes of investors and avoiding conflicts of interest provide the foundation principles to develop such rules.
8. Further, the PCC company structure is already available in the DIFC, although the use of that structure is currently available for insurance businesses such as those of captive insurers and for securitisation purposes, and not for DIFC Funds. However, while these regulations themselves can be enhanced for use in the context of DIFC Funds, to the extent there are any gaps that need to be addressed, the DFSA may look to other jurisdictions which use segregated cell or compartment structures for Umbrella Funds, such as Luxembourg, and also the UK under its new proposal to allow Open Ended Investment Companies (**OEICs**) to use a PCC company structure.
9. The Panel is aware that the DFSA and DIFCA are currently undertaking efforts to reduce costs associated with setting-up PCC companies in line with other jurisdictions that allow the use of protected cell structures. Such a move would undoubtedly act as a further incentive for the use of protected cell structures for Umbrella Funds.
10. Finally, the Panel is also aware that the concept of protected cells or compartments within a legal entity that legally and functionally behave like legal entities themselves is a comparatively novel legal construct. It is not fully legally tested and therefore is open to legal challenge, particularly by creditors of insolvent cells which would have an interest in piercing the mini corporate veil provided to other cells which are not insolvent. However, other jurisdictions have gone ahead in using this

structure and, such legal uncertainties are, as is the practice in those jurisdictions, clearly matters that should be included in disclosure and other offer documents (such as prospectuses) provided to investors investing in Umbrella cells.

### **Procedural impediments**

11. Umbrella Fund related requirements are found in Rules 8.2.1(3), 9.2.2.(6), 9.2.3, 9.4.1, 9.4.2, 9.5.1(g), 13.1.1(1), 13.1.14, 13.2.2, 19.4.1, 20.5.2, 18.5.1, App 4(E) and App 6, item 17 of the CIR.
12. The rules relating to Umbrella Funds provide that reports must be separately prepared for each sub-fund. The prospectus and the constitution for an Umbrella Fund must contain all required information (including types of investments permitted and any restrictions) for each sub-fund and any costs or restrictions relating to switching between sub-funds. There is also a restriction on one sub-fund of an Umbrella Fund investing in another sub-fund of that Umbrella Fund.
13. Under the present Umbrella Fund regime it is necessary for the terms and conditions of each sub-fund to be repeated in the constitutional documents for the fund vehicle (as well as in the offering document itself). This leads to a good deal of additional work and therefore cost. It is also necessary to amend the constitutional documents for the fund entity every time a new sub-fund is formed or the terms of a sub-fund are amended, which also has time and cost implications.
14. Further, having Umbrella Fund related provisions scattered over the CIR module does not lend itself to easy accessibility for the user. Therefore, a more cohesive re-arrangement of these provisions, along with the removal of unnecessary procedural requirements such as the inclusion of sub-fund specific information in the constitution of the Umbrella, would promote better use of this structure by DIFC Fund managers.

### **Benchmarking**

15. PCC regimes or separate legal status and liability for different sub-classes of funds are now accepted practice in many well-known fund jurisdictions.

### **Key Recommendations**

16. The Panel recommends that the DFSA:
  - 16.1 allows the protected cell or compartment structure to be used by Umbrella Funds (both Public and Private). For this purpose, the DFSA may either enhance the current PCC company structure available under the Company Regulations with the assistance of DIFCA, or develop separate regulatory requirements built into the CI Law regime, to allow the creation of segregation of assets and liabilities of sub-funds. However, given that DIFC Funds which use the company structure are governed under the DIFC Company Law regime, enhancements as appropriate to the PCC Regulations that are also within the DIFC Company Law regime appear to be the more appropriate route for establishing a segregated cell structure to be used by Umbrella Funds;
  - 16.2 provides a more accessible arrangement of Umbrella Fund-related provisions under the CIR module;

- 16.3 removes 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
- 16.4 lowers the current fees and minimum requirements for approval of the offering documents particularly for Exempt Funds or Private Funds (see the Key Recommendations at Issue 3).

## Issue 5 – Exempt Funds Regime

### Should there be an Exempt Funds regime?

#### Background

##### *Current categories of Funds*

1. The CI Law currently distinguishes between Public and Private Domestic Funds. A Domestic Fund is a Public Fund if it has or is intended to have more than 100 Unitholders or its Units are or are to be offered by the Operator of the Fund by means of public offering to potential participants (Article 46 of the CI Law). A Domestic Fund will be a Private Fund if it is not categorised as a Public Fund under Article 46 (Article 54 of the CI Law).
2. The CIR further provide that the Units in a Private Fund may only be offered for sale or issue by means of a private placement with Professional Clients and in a manner which does not result in the Fund having more than 100 Unitholders (CIR 18.3.1).
3. "Professional Client" is defined in COB as a Person who has net assets of at least USD500,000, is an employee of the Authorised Firm in question or an employee in a professional position in another Authorised Firm. Such a Person must appear on reasonable grounds to the Authorised Firm in question to have sufficient experience and understanding of relevant financial markets, products or transactions and any associated risks and must not have elected to be treated as a Retail Client.

##### *Current Private Fund regime*

4. The requirements to establish a Private Fund and the restrictions on the operation of a Private Fund are set out in the CI Law and the CIR. This regime represents lighter touch regulation than the full regime applying to Public Funds.
5. Key differences between the DIFC regimes for Public Funds and Private Funds include the following:
  - 5.1 a Public Fund requires an application for registration with the DFSA; a Private Fund, conversely, only requires notification to the DFSA;
  - 5.2 a Public Fund must publish a Prospectus, whereas a Private Fund needs only to publish a "Short Form Prospectus". The content requirements for the Short Form Prospectus are significantly less than those for a full Prospectus;
  - 5.3 Public Funds are subject to broad provisions regarding spread of risk, investments in other funds, transactions in derivatives, stock lending and borrowing. These restrictions do not apply on the whole to Private Funds, although there are exceptions to this rule; and
  - 5.4 there is a general requirement for a Public Fund to have independent oversight arrangements (for example, a panel of non-executives or a supervisory board). This does not apply to a Private Fund.

6. Despite the Private Fund regime being significantly less onerous than the Public Fund regime, there remains a large volume of rules that apply to both Private and Public Funds, both in the CI Law and in the CIR. While the CIR includes sections that apply solely to Private Funds and Public Funds respectively, the majority of the rules cover both Public and Private Funds.
7. Some key features of the current Private Fund regime include the following:
  - 7.1 the Fund must have an Operator that is authorised by the DFSA to carry on the financial service of Operating a Collective Investment Fund (CIR 18.3.1);
  - 7.2 the Fund Operator in certain fund structures (investment company and investment partnership structures) must delegate the financial services activity of providing custody to an Eligible Custodian (CIR 7.3.1). The rules prescribe the form of written delegation agreement (CIR 7.4.2 and App 1);
  - 7.3 the Fund must publish a "Short Form Prospectus" with prescribed contents (CIR 19.4). A number of persons will have statutory responsibility for the Prospectus, including the Operator (CIR11.2);
  - 7.4 the rules prescribe the contents of the constitution of the Fund (CIR 5.2.1 and App 4);
  - 7.5 the rules require that the financial accounts and statements of the Fund are either produced in accordance with USGAAP or IFRS as supplemented by the Statement of Recommended Practice issued from time to time by the United Kingdom's Investment Managers Association (CIR 8.2.1);
  - 7.6 the rules provide a process and mechanics for valuation of Units in a Fund (CIR 6.5) and the Operator has a duty to ensure that the Units in the Fund are correctly priced to ascertain an accurate single price for a Unit (CIR 6.6);
  - 7.7 the rules are prescriptive regarding meetings of the "governing body" of the Fund and meetings of Unitholders in the Fund (CIR 6.9.1);
  - 7.8 certain fundamental alterations to the Fund, its Constitution or the Prospectus can only be made with the sanction of a "Special Resolution" (i.e. a 75% vote of Unitholders at a general meeting of Unitholders); proposed alterations are also subject to DFSA approval (Articles 58 and 59 of the CI Law, and CIR 6.10, App 2);
  - 7.9 Article 58(1) of the CI Law provides, amongst other things, that the Operator may be replaced if an appropriate special resolution is passed by the Unitholders; and
  - 7.10 the rules are prescriptive as to the form of any outsourcing of any function by an Operator or Trustee and the form of on-going review of outsourced functions (CIR 7.5, 7.7, App 1).
8. Private Funds that also qualify as Specialist Funds (Islamic Funds, Fund of Funds, Feeder Funds, Private Equity Funds, Property Funds and Hedge Funds) are subject to additional provisions and restrictions set out in CIR 13.
9. The Panel believes that these key features and additional provisions and restrictions are in many cases more onerous than in exempt regimes in other jurisdictions and functionally closer to the level of regulation conventionally applied at the retail level than to that applied at the sophisticated professional investor level.

### *Possible Exempt Fund regime*

10. A number of other jurisdictions have adopted regimes under which a lower regulatory burden is placed on funds whose investors are limited to sophisticated or high net-worth persons. These regimes are particularly suited to private funds that are not intended for listing on public securities exchanges (although a number of these regimes permit such listing). They are therefore well suited to funds in the alternative funds industry, in particular hedge funds, property funds and private equity funds.
11. The rationale for the lower regulatory oversight in respect of these regimes is that funds targeting sophisticated investors tend to be self-regulating. Documentation tends to be standardised in respect of each market. This includes elements such as managers' fees, ability to remove service providers, information provision to investors, investment restrictions and other common areas. Investors will routinely conduct due diligence both on a fund manager's track record and the fund documentation prior to investing and will invariably engage professional advisers, including lawyers, to advise on fund documentation. Professional investors rely to a large extent on their contractual protections as set out in the fund documents and the legal system in the jurisdiction in which the fund is domiciled to enforce those contractual rights. The dual effect of market-standard documentation and the need of fund managers to get repeat investors makes these regimes largely self-policing in the absence of fraud.
12. The Panel has considered whether the DIFC should adopt a fund regime to cater for more sophisticated investors, while bearing in mind the regulatory protection available in the DIFC.

### **Options/Suggestions**

13. The current Private Fund regime already incorporates a net worth and sophistication test, in that only Professional Clients are permitted to invest in Private Funds. In these circumstances, the possible options considered by the Panel were:
  - 13.1 retaining the Private Fund regime in largely the current format;
  - 13.2 revising the Professional Client "hurdle" for the current Private Fund regime and considering excluding Private Funds from certain of the current regulatory provisions and restrictions; and
  - 13.3 adopting a new "Exempt Fund" regime while retaining the existing Public Fund and Private Fund regimes.
14. Most leading fund jurisdictions have adopted a form of exempt fund regime and these have become an accepted feature of the international funds landscape. Many of these regimes have been successful at attracting a flow of funds to such exempt arrangements. Given the self-policing nature of these types of funds and the general acceptance of equivalent regimes elsewhere in the world, the Panel believes that the reputational risks to the DFSA and DIFC of adopting such a regime would be low. The Panel also believes that, having looked at the options set out in paragraph 13 above, the establishment of a new Exempt Funds regime would be well received by the fund management industry (and, in particular, fund managers seeking to establish alternative funds) and would bring the DIFC in line with international regulatory practice.

## **Benchmarking**

15. The regimes that the Panel have examined for the purpose of this Issue for the most part contain exemption criteria to determine which investors are permitted to invest. There appears to be no international standardisation with respect to exemption criteria, however elements common to a number of regimes include:
  - 15.1 a net-worth test for individuals, often including the net worth of any spouse and often excluding the principal residence;
  - 15.2 a net asset test for companies, partnerships and trusts;
  - 15.3 an experience test, often by way of certification by an authorised firm;
  - 15.4 a commitment to invest a minimum amount (sometimes in place of the experience test);
  - 15.5 categories to include institutional and other professional investors; and
  - 15.6 categories to include employees of promoters/investment managers and carry/co-invest vehicles.
16. The degree of regulatory oversight in respect of these regimes varies considerably between jurisdictions. Some notable features are:
  - 16.1 a number require that the investment manager is regulated either in the jurisdiction of the fund or by an equivalent regulatory authority;
  - 16.2 requirements to appoint other service providers, including fund administrators and custodians, vary widely;
  - 16.3 mostly these regimes contain no, or very limited, restrictions on the investments that the fund can make or the level of the fund's borrowings;
  - 16.4 offer documents are invariably required, but contents requirements are minimal and there is generally no requirement for any review by the regulator; and
  - 16.5 the regulatory process for approval/registration tends to be light and very quick. In a number of these regimes the turn-around time promised by regulators is a number of days rather than weeks.

## **Key Recommendations**

17. The Panel recommends to the DFSA that the DFSA adopts a separate Exempt Funds regime with the features set out below, while retaining the current Public and Private Funds regimes:
  - 17.1 Exempt Funds only be open for investment by Qualified Investors, defined as Persons (both natural and legal) with at least USD1 million net assets, with the same level of sophistication required as under the current Professional Client test, and the distribution of Units in such Exempt Funds being confined to private placement;
  - 17.2 Exempt Fund participation not be limited to any particular number of Qualified Investors, however a minimum initial subscription threshold be established at no less than USD50,000

to help distinguish and warrant the lighter regulatory regime applied to such Funds when compared to Private Funds;

- 17.3 the Exempt Fund regime be significantly lighter than the current Private Fund regime in that no prescriptive requirements relating to the constitution, prospectus disclosure, operation and internal administration of the Fund, delegation and outsourcing and periodic reporting be applied, except with regard to an annual audit conducted by a registered auditor and annual reports, which should be filed with the regulator and made available to investors in the Exempt Fund;
- 17.4 the key regulatory control to be applied by the DFSA in relation to Exempt Funds will be the application of the licensing requirement to the managers of Exempt Funds, with the possibility of obtaining a licence allowing a fund manager to manage/sell only Exempt Funds;
- 17.5 the DFSA should implement a fast track process for DIFC Fund managers to obtain a licence limited to managing/selling Exempt Funds;
- 17.6 the Exempt Fund rules should be set out separately from the Public/Private Fund rules to provide a single set of exhaustive rules for Exempt Funds;
- 17.7 the Exempt Fund regime be extended to include Islamic Funds, Hedge Funds, Property Funds and Private Equity Funds provided the Qualified Investor and other requirements noted above are met;
- 17.8 Authorised Firms should be permitted to distribute the Units of Exempt Funds in or from the DIFC, subject to the Qualified Investor and minimum subscription levels noted above are met (see also the Key Recommendations at Issue 2);
- 17.9 DIFC Fund managers authorised to manage Exempt Funds should be permitted to set up an Exempt Fund in any other jurisdiction provided that jurisdiction is not blacklisted (see the Key Recommendations at Issue 1); and
- 17.10 Fund managers located outside the DIFC should be allowed to set up an Exempt Fund in the DIFC, provided such managers meet the recognition criteria set out in Issue 1.

## Issue 6 – Oversight Committee

### 6.1 Are the oversight obligations too onerous?

### 6.2 If so what are the options?

#### Background

1. The requirements in chapter 17, section 9.7 and Appendix 5 and Rules 4.5.2, 6.6.2, 8.3.2, 9.1.1, 9.3.1, 9.4.1, 9.4.3, 10.2.3, 10.3.1 and 10.5.1 of the CIR are relevant to this issue.
2. The above provisions require Public Funds to have certain prescribed oversight arrangements. While the oversight arrangements vary somewhat depending on whether the Public Fund is an Investment Company, Investment Partnership or Investment Trust, generally, such oversight arrangements must comprise:
  - 2.1 a panel consisting of the independent non-executive members of the Fund's board of Directors;
  - 2.2 a supervisory board consisting of the independent non-executive Directors who supervise the activities of the Fund's board of Directors;
  - 2.3 an Eligible Custodian;
  - 2.4 in the case of an Investment Trust, the Trustee; or
  - 2.5 in the case of an Investment Partnership, a committee consisting of at least two Limited Partners who are independent of the Operator.

If 2.1 or 2.2 is selected, then the number of independent non-executive board members must form a simple majority on the board or on the supervisory board, respectively.
3. In appointing persons to perform oversight functions, the Operator must ensure that any individual it appoints to oversee the operation of the Fund is, and continues to be:
  - (a) suitably qualified;
  - (b) fit and proper; and
  - (c) independent.

4. The oversight functions include taking reasonable steps and exercising due diligence to ensure on a continuing basis that:
  - 4.1 the Fund Property is being used or invested by the Operator in accordance with the investment and borrowing restrictions that apply to the Fund as set out in CIR or the Fund's Prospectus; and
  - 4.2 the Operator takes the steps necessary to ensure a restoration of compliance with the relevant requirements as soon as reasonably practicable having regard to the interests of Unitholders.
5. The Persons providing oversight functions must hold in the DIFC at least two meetings during every annual accounting period. If the Fund is an Investment Company or an Investment Partnership, at least two of these meetings must be held in the DIFC at the same time as the Fund's Governing Body meets.
6. The Persons providing oversight functions must keep:
  - (a) minutes of their meetings; and
  - (b) records of their reports and recommendations.
7. Custodians are often unwilling to accept this additional responsibility for the oversight function and would also find the procedural meeting requirements difficult to comply with. There is also the further issue whether an Eligible Custodian appointed by the Operator is truly independent of the Operator. This is because an Eligible Custodian's obligations are to provide safe custody for the Fund assets in accordance with the instructions and any investment mandate implemented by or on behalf of the Operator, rather than keeping vigil over the overall operations of the Fund to ensure due compliance with the relevant requirements, as envisaged under the independent oversight function. Individuals with the required experience may also fail on the independence test due to the relatively few parties with the relevant expertise and familiarity with DIFC Funds to date. This leads to delays, additional costs and increased risk of regulatory non-compliance.

## **Benchmarking**

8. Although other jurisdictions considered by the Panel provide for a level of oversight, the DIFC appears to be at the higher end of the scale in this regard, particularly relating to the independence requirements.
9. Where other jurisdictions do apply some additional oversight requirements to certain classifications of funds, these tend to be directed at the fund manager/operator level and then extended to the specific funds.
10. This is reasonably consistent with IOSCO's recent Hedge Fund Oversight Report (June 2009), where it seeks to require that hedge fund managers/operators should be subject to registration and then subject to ongoing regulatory requirements relating to organisational and operational standards, conflicts of interest and conduct of business rules, disclosure to investors and prudential regulation, in respect of which there are applicable IOSCO standards. IOSCO considers that fund managers/operators of hedge funds should put in place appropriate risk management and independent compliance functions, and this, combined with the regulatory supervision of the fund manager/operator and its service providers such as prime brokers, provides a satisfactory platform for supervision.

## Options/Suggestions

11. While not all the current requirements for Public Funds are designed for Specialist Funds, with Hedge Funds being just one sub-set of Specialist Funds that may be set up as a Public Fund (although most Hedge Funds are set up as Private Funds), the DFSA should take comfort in the fact that current industry thought is leading towards a greater degree of supervision of hedge funds. While some of the current proposals suggested by the European Commission and the US Treasury Department do not appear to be universally accepted, there does seem consensus in that regulation should be directed towards the fund manager/operator in the case of hedge funds. There is no move, even in regard to hedge funds, towards an independent oversight body as prescribed by the DFSA, however. Instead, the focus of the IOSCO framework is for the regulatory system to provide for, among other things, rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
12. As DIFC Public Funds are required to register with the DFSA and are already subject to fairly stringent operational standards, and also the Operator has to be licensed by the DFSA, the basis of IOSCO requirements including the proposals relating to hedge funds have been met under the DIFC regime.
13. The DFSA should continue to ensure that service providers to the Operator are independent and suitably qualified. This should form a significant part of the DFSA's risk assessment of the Operator.
14. The Panel is of the view that the oversight requirements need to be changed to offer more flexibility with the focus being on the fund manager/Operator of the Fund rather than a strict requirement to have independent third parties providing oversight in all cases. For example, where an Operator is part of a large international group with layers of compliance throughout the group or with independent directors at board level, it may be appropriate to waive the requirements for third-party independent oversight.
15. The Panel is also of the view that certain types of Public Funds, for example Funds investing in listed securities, may be exempt from additional independent oversight requirements, as the internal compliance and risk control functions should be able to monitor adequately on-going due compliance with the applicable requirements including adherence to applicable borrowing and investment restrictions.

## Key Recommendations

16. The Panel recommends to the DFSA that:
  - 16.1 the requirement for an independent oversight function should be removed for Public Funds 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;
  - 16.2 in other cases, the oversight function should be made less prescriptive and greater options and DFSA guidance should be provided to fund Operators to satisfy the oversight requirement; and
  - 16.3 the Eligible Custodian's role with regard to the oversight function be reconsidered on account of possible conflicts of interest.

## Issue 7 – Shari'a Compliance

### 7.1 Is the Shari'a compliance standard too high?

### 7.2 Is there scope for streamlining this process?

#### Background

##### *Applicable legal requirements*

1. The key requirements relating to Islamic Funds are found in the provisions in the DIFC Islamic Law, the CI Law (Article 30(2)) and the CIR module (sections 13.1, 15.5 and 19.5 of the CIR).
2. The combined effect of these provisions on a Fund that is established or held out as being Shari'a compliant is that Shari'a related regulation remains more prescriptive and onerous than other fund jurisdictions that have specific provisions for Shari'a compliant funds.

##### *Operator-specific Shari'a compliance requirements*

3. A Person intending to operate an Islamic Fund or Islamic sub-Fund must obtain a licence with an endorsement either as an Islamic Financial Business or to operate an Islamic Window. Both types of activities are referred to as "Islamic Financial Business". An Operator conducting Islamic Financial Business must:
  - 3.1 have an SSB comprising three Shari'a scholars with appropriate skills and competencies to carry out their functions, as well as a sufficient degree of independence from the firm by not being a director or controller of the firm;
  - 3.2 require its SSB to undertake a Shari'a review of the Operator's activities in accordance with AAOIFI GSIFI No.2 and prepare an annual report in accordance with AAOIFI GSIFI No.1, which must be provided to the DFSA within 14 days of receiving it;
  - 3.3 have systems and controls to ensure that its Islamic Financial Business is conducted in accordance with Shari'a;
  - 3.4 have an Islamic Financial Business policy and procedures manual which addresses matters such as:
    - (a) how the compliance function relating to Shari'a is undertaken;
    - (b) the manner in which its SSB will oversee and advise on Shari'a compliance in respect of the Islamic Financial Business conducted by the Operator, including how the SSB's fatwas, rulings and guidelines will be recorded, disseminated and implemented by the Operator and how the internal Shari'a review of the firm is undertaken;

- (c) the manner in which disputes between the SSB and the firm in respect of Shari'a compliance will be addressed;
- (d) the manner in which conflicts of interest between the SSB and the Operator (or in the case of an Investment Trust, the Trustee) will be identified and resolved;
- (e) in the case of an Operator using an Islamic Window to operate a Fund or sub-Fund, the systems and controls in place to ensure the appropriate separation of the Islamic Financial Business from its conventional business; and
- (f) disclose to its Clients at the outset of the relationship the details about its SSB and, upon request, additional information such as the frequency of its Shari'a reviews.

*Islamic Fund-specific Shari'a compliance requirements*

4. An Islamic Fund attracts a range of Shari'a specific requirements in addition to those that apply to a conventional Fund (with the exception of where Islamic specific requirements are specified as replacing the requirements applying to a conventional Fund, such as accounting requirements). Although imposed at the Fund level, the Operator, and in the case of an Islamic Fund structured as an Investment Trust the Trustee, of the Fund is responsible for ensuring compliance with these requirements.
5. As such, an Operator (and where relevant the Trustee) of an Islamic Fund must:
  - 5.1 have systems and controls to ensure that its management of the Fund and the Fund Property is Shari'a compliant;
  - 5.2 appoint an SSB to the Fund, which has at least three Shari'a scholars as members who are approved by the Governing Board of the Fund and are independent of the Operator by not being a director or controller of the Operator (any change in the membership of the SSB is to be notified promptly to the DFSA and markets/Unitholders);
  - 5.3 ensure that the Fund's Constitution and Prospectus are, and remain on an on-going basis, approved by the Fund's SSB;
  - 5.4 implement and maintain an Islamic Financial Business policy and procedures manual for the Fund which addresses matters such as those which the Operator's Islamic Financial Business policy and procedures manual must address (see paragraph 3 above);
  - 5.5 require the Fund's SSB to undertake a Shari'a review of the Fund in accordance with AAOIFI GSIFI No.2 and prepare an interim and annual report in accordance with AAOIFI GSIFI No.1, and provide copies of these to Unitholders of the Fund and the DFSA within prescribed periods;
  - 5.6 ensure that certain prescribed additional disclosure relating to Shari'a compliance is included in the Prospectus of the Islamic Fund, depending on whether it is a Public or Private Fund, with the latter attracting less onerous disclosure than the first in this regard;
  - 5.7 ensure that the Fund's underlying investments are Shari'a compliant, and any restrictions relating to the type of Funds that can be invested in are met;

- 5.8 prepare and maintain all financial accounts and statements relating to the Fund in accordance with AAOIFI FAS 14, and also prescribed periodic reports which must be prepared and filed; and
- 5.9 ensure the audit function of the Fund is carried out in accordance with the relevant AAOIFI standards.

*The issues identified*

6. At present, there are only a small number of Islamic Funds established in the DIFC, which raises the question whether the current regime in this regard is conducive to the growth of the Islamic funds business in the DIFC. The Panel has identified three areas of primary concern relating to the current regulatory regime applying to Islamic Funds, which it believes are impeding the growth of the Islamic funds industry in the DIFC. These are:
  - 6.1 the requirement to have a separate SSB appointed for each Islamic Fund managed by an Operator (in addition to having its own SSB at the fund operator level), which leads to:
    - (a) an unnecessary cost burden on Operators of DIFC Funds in appointing an SSB at two levels (i.e. at the Operator level and the Fund level itself); and
    - (b) potential duplication of Shari'a compliance obligations (such as in relation to supervision and audits) between the Operator and similar duties that it has for separate Funds;
  - 6.2 the prescriptive nature of the DFSA's Shari'a compliance related requirements in relation to matters such as:
    - (a) the minimum number of Shari'a scholars required on the SSB; and
    - (b) the exact nature of compliance, audits and financial accounting to be adhered to; and
  - 6.3 the overly burdensome way in which the current Shari'a compliance requirements apply to Fund managers operating both conventional and Islamic Funds (through an Islamic Window).

**Benchmarking**

7. None of the jurisdictions considered by the Panel that make provision for Shari'a compliant funds appear to have the level of regulatory controls or prescriptive regulations in respect of Shari'a compliant funds that one currently finds in the DIFC Funds regime.
8. Also, importantly, none of those jurisdictions seems to require, as the DIFC Funds regime does, for Shari'a compliance standards that require SSBs to be duplicated, i.e. one at the fund manager level and the other at the fund level.

**Other considerations**

9. What should also be considered in the context of regulating Shari'a compliance with funds is the amount of self-regulation that goes on within this industry, especially concerning institutional or sophisticated Islamic investors. More often than not, the Shari'a boards of investing institutions will have their own requirements relating to Shari'a compliance of a fund they are interested in investing

in, and, therefore, the regulatory requirements of a specific fund regime are not their primary consideration when they determine what is required in this regard. As a result, an investment manager would often rather establish the fund in a jurisdiction where the regulatory requirements in terms of Shari'a compliance are not overly prescriptive, focusing on the practical guidelines, restrictions, auditing and reporting requirements suggested by the Shari'a boards of significant investors or seed capital providers into their funds.

10. Another key consideration is the way in which the current DFSA Shari'a compliance requirements apply to Operators operating both conventional and Islamic Funds. For example, if an Operator conducting conventional business wishes to establish an Islamic Fund, it must establish an Islamic Window. Even if the Islamic Fund is only a small component of the Operator's business, the Operator must comply with a whole plethora of requirements, such as having (a) to appoint SSBs both at the Islamic Fund and the Operator level, (b) an Islamic Financial Business policy and procedures manual and, systems and controls to ensure separation of conventional and Islamic business and (c) to ensure audit and reporting requirements are carried out in accordance with AAOIFI standards for Islamic Funds while complying with the other applicable accounting standards for its conventional business. This detailed level of prescription and duplication makes it generally impractical and too costly for Operators to manage both conventional and Islamic Funds concurrently in the DIFC.

### **Options/Suggestions**

11. The Panel is mindful of the fact that the intentions of the DFSA, as reflected in the regulations, were commendable in the above regard as the DFSA used AAOIFI standards and guidelines as its principal template in drafting the current regulations, with which the Panel agrees in principle. Nevertheless, as noted above, the Panel could not find the degree of prescription as found in the current DFSA regime in any other fund jurisdiction it considered.
12. The Panel also observes that AAOIFI standards on which the DFSA requirements are modelled appear to be designed with a primary focus on Islamic banks, and not Islamic funds. The Panel, therefore, considers it appropriate that the DFSA adopts a more pragmatic and eclectic approach when applying AAOIFI based requirements to Islamic Funds.
13. Further, the Panel believes that a less prescriptive approach, particularly relating to Private Funds, as well as proposed Exempt Funds (discussed at Issue 5), is warranted because of the amount of self-regulation that applies in the Islamic funds industry, as noted in paragraph 9 above.
14. The Panel also believes that the current requirements that apply to Operators managing Islamic Funds through an Islamic Window should be modified to provide a greater degree of flexibility to Operators who manage both conventional and Islamic Funds.

### **Key Recommendations**

15. The Panel recommends that the DFSA:
  - 15.1 clarifies the potential for overlap and unnecessary duplication of regulation by consolidating the Shari'a compliance requirements that apply concurrently to the Operator and the Islamic Funds it operates, such as the requirement for separate SSBs for the Fund and the Operator, without minimising investor protection. However, to ensure that in the process of streamlining and rationalising the current dual requirements investor protection is not compromised, the DFSA should consider measures such as including an express statutory

- obligation when an SSB is required to act for both the Public Fund and the Operator to place the interests of the Fund and its investors ahead of the interests of the Operator;
- 15.2 allows certain types of Public Funds to reduce the number of Shari'a scholars on its SSB where it relies on Shari'a screening processes that are widely accepted in the Islamic finance industry such as where an Islamic Fund invests only in one or more of the following:
- (a) securities included in a recognised Islamic index;
  - (b) securities identified through the screening methodology of a recognised Islamic index;
  - (c) sukuks; or
  - (d) treasury instruments issued by a Shari'a compliant financial services provider regulated by a Financial Services Regulator;
- 15.3 reduces the requirement for a three member SSB for Operators of Private Funds and proposed Exempt Funds by instead having a requirement for a Shari'a adviser (or Shari'a services provider) for such Funds, so that the Operator has the flexibility to appoint one or more Shari'a scholars as it considered appropriate;
- 15.4 removes the requirements for Private Funds and proposed Exempt Funds to adhere to AAOIFI standards when conducting their audits;
- 15.5 removes the current detailed Shari'a related requirements applicable to Private Funds and proposed Exempt Funds (such as those set out in CIR 13.1), where the Operator:
- (a) ensures that the Fund's disclosure documents to investors (e.g. the Short Form Prospectus) contain provisions describing the Shari'a compliant nature of the Fund, the process for achieving such compliance, the reports to be rendered to the investors and the names of the Shari'a advisers appointed to the Fund; and
  - (b) ensures that the operations and investments of the Fund are subject to compliance monitoring and reporting by its Shari'a advisers and provide 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 to confirm the extent of the Fund's Shari'a compliance status during the period concerned;
- 15.6 in line with the Key Recommendations at Issue 1, removes the general prohibition in Article 17(1) of the CI Law, so that (i) DIFC based Fund managers can operate Foreign Funds from within the DIFC, and (ii) fund managers based outside of the DIFC can operate Domestic Funds from outside the DIFC, in respect of Islamic Funds; and
- 15.7 provides 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 regime for operating an Islamic Window from a conventional business platform. This will better promote the viability of such businesses while still adhering to applicable Shari'a standards. By way of illustration, greater flexibility should be given to Operators engaging in both conventional and Islamic

Funds business to adopt the requisite SSB or Shari'a advisers either at the Operator level or at the Islamic Fund level.

## **Issue 8 – Taxation and Foreign Investment Issues**

### **8.1 Are there any taxation issues that need to be addressed or clarified?**

### **8.2 Are there ownership of real estate/equity issues that need to be clarified?**

#### **8.1 Are there any taxation issues that need to be addressed or clarified?**

##### **Background**

1. Although taxation matters have been considered by the Panel, the enactment or amendment of taxation laws is beyond the powers of the DFSA. The Panel has, however, undertaken the task of identifying some taxation and related issues to promote a better understanding of these issues and their impact on the DIFC Funds regime, so that efforts to address those issues can be initiated or encouraged as appropriate by the DFSA and other relevant authorities.
2. Taxation is an important consideration in the funds industry. At the most basic level, participants strive to ensure no tax is incurred at the fund level, but instead that the income and gains of the fund are taxed only at the investor level according to the legislative framework and rate applicable to each particular investor. This ensures that, inter alia, an investor which is generally tax exempt in its country of residence or domicile (e.g. a pension fund, a sovereign entity, etc.) will not have its returns eroded by tax at the fund level, and that a taxable investor will avoid problems with excess tax credits in circumstances where it has an effective tax rate lower than that suffered by the fund.
3. Avoiding tax at the fund level is typically achieved in a number of ways, or indeed by a combination of ways. In particular:
  - 3.1 funds are often established in a jurisdiction which does not impose income or capital gains taxes. Examples of such jurisdictions include the Cayman Islands, Bermuda, the British Virgin Islands, etc.;
  - 3.2 similarly, funds may be established in a jurisdiction which generally imposes tax but which offers a zero tax regime for funds (e.g. Luxembourg, Ireland, etc.); and
  - 3.3 although less common, there are examples of funds being established in taxable jurisdictions, but as fiscally transparent vehicles. (For completeness, it should be noted that funds are also commonly established as fiscally transparent vehicles in non-taxing jurisdictions or in taxable jurisdictions which have special tax regimes for funds). This means that tax is imposed only on an investor in respect of the investor's share of the underlying income and gains. However, investors may not be taxable in the jurisdiction of domicile of the fund where the income and gains arise outside such jurisdiction and/or the investors are not resident in such jurisdiction.
4. But the taxation position in the jurisdiction of domicile of a fund is only part of the story. Because funds are often, at least to some extent, managed in one or more jurisdictions other than that of the fund domicile, risks exist that the fund may be subject to tax in one or more of such jurisdictions.

Such risks arise as a consequence of the domestic laws of each jurisdiction, but essentially revolve around the existence of a "permanent establishment" or similar concept under domestic law whereby the management of a non-resident, or the undertaking of certain activities on behalf of a non-resident, will bring that non-resident into the charge to tax in the jurisdiction in respect of some or all of its income and gains.

5. Funds attempt to mitigate such risks by carefully selecting where management takes place, by restricting the authority of personnel in certain jurisdictions and making them sub-advisers rather than fund managers, or by relying on the "safe harbour" rules enacted by a number of jurisdictions.
6. Although the above risks prima facie apply irrespective of where a fund is established or domiciled, in some cases limited protection from such risks is available under an applicable DTA as these typically set a threshold of activity before a jurisdiction obtains taxing rights. Accordingly, where the level of activity in the foreign jurisdiction can be kept below the appropriate threshold, that jurisdiction will have no right to tax the fund. Not all jurisdictions, however, enter into DTAs.
7. DTAs may also offer advantages to funds by reducing withholding taxes on income or gains derived by a fund from the treaty jurisdiction. In the absence of a DTA between the fund jurisdiction and the jurisdiction of the source of the income, reduced rates of withholding tax may still be available through the interposition of additional layers of entities, although such planning adds costs to the fund and is increasingly coming under scrutiny from revenue authorities in the source jurisdiction.
8. Apart from the fund and investors, however, taxation is also a relevant consideration for management companies and executives thereof. With regard to the latter, a significant amount of planning has traditionally been undertaken around the derivation of "carried interest" (typically from private equity and hedge funds), the aim being for the executives ultimately to derive this in the form of a dividend, capital gain or some other form of income which attracts concessional tax treatment. Such arrangements are, however, increasingly being challenged in a number of sophisticated jurisdictions.

## **Benchmarking**

9. In terms of protection of a fund from taxation, on the face of it the DIFC compares favourably with other jurisdictions the Panel considered. In particular, Article 14 of Dubai Law No. 9 of 2004, being the law establishing the DIFC, effectively provides a zero rate of tax for 50 years to DIFC entities, as well as their employees, and also guarantees tax free repatriation of profits for the same period.
10. Moreover, the UAE has entered into a significant number of DTAs which, as noted above, potentially provide a degree of protection against a DIFC Fund becoming taxable in another jurisdiction where some part of its management may be considered to take place, and may also provide for reduced rates of withholding tax on certain types of income and gains derived by a fund.
11. As noted, however, the broad tax exemptions applicable in the DIFC encompass all entities and individuals, not just funds. This allows the DIFC to differentiate itself from some competitor jurisdictions which, although offering some concessions for the funds themselves, still typically tax the profits and income of a fund management company and its employees. The lack of all forms of income tax in the DIFC, combined with the excellent infrastructure, its geographic location and legal framework render the DIFC a potentially attractive location for the establishment of fund management businesses.

12. The lack of taxation is potentially particularly attractive for those managers/executives deriving remuneration from carried interest arrangements as such amounts are simply exempt and do not require the planning adopted, and are not subject to the challenges increasingly faced, in other jurisdictions. Of course, whether the absence of UAE taxation is an advantage depends on whether the relevant executives can avoid tax in their home jurisdiction and this will depend on the residence rules in such jurisdictions. In particular, the otherwise favourable tax regime in the DIFC will largely be neutral for US citizens who are subject to tax on their worldwide income with credits being granted for foreign tax suffered.

## Issues

13. Although on the face of it the taxation regime in the DIFC appears to be extremely favourable for the development of a fund management industry, there are some areas of uncertainty. Clarifying such matters would further strengthen the appeal of the DIFC from a tax perspective. The main areas of uncertainty are as follows:
  - 13.1 to give greater levels of comfort that a tax exemption will be maintained, in some cases the relevant governments have provided express undertakings that tax will not be imposed for a defined period. No such undertaking has been given in respect of the DIFC, particularly at the federal level;
  - 13.2 as noted, the existence of DTAs provides some protection for funds from being taxed in another jurisdiction. However, there are some uncertainties about the applicability of some of the UAE's DTAs. In particular, DTAs typically provide benefits to a "resident" of the relevant jurisdiction. Some of the UAE's DTAs, particularly older ones, define a resident as a person subject to tax in the UAE by virtue of its residence, domicile, place of incorporation or similar criteria. Since most UAE entities are not subject to UAE tax, there is a possible risk that those DTAs will have limited application and that few businesses will be entitled to the protection and benefits otherwise afforded by the DTA. In the context of the DIFC, the analysis is potentially slightly different because of the application of a zero rate of tax, but the ultimate conclusion could arguably be the same;
  - 13.3 moreover, there is a risk that some DTAs, particularly those entered into prior to the establishment of the DIFC will not apply to DIFC entities. This is because Article 3(2) of UAE Federal Law No. 8 of 2004, being the law regarding financial free zones, excludes, inter alia, the application of UAE commercial laws in the DIFC and a DTA is likely to be considered a UAE commercial law. It is possible that under a correct interpretation of UAE law, DTAs entered into after the establishment of the DIFC would, however, still have potential application because their later enactment means that they take precedence over UAE Federal Law No. 8 of 2004; and
  - 13.4 another DTA related issue again concerns the definition of "resident". Even those DTAs which do not employ a "subject to tax test" often refer to companies established under UAE law. As there is no definition of "UAE law", there is a question whether a company established not under the Commercial Companies Law (a UAE federal law), but under DIFC law, a free zone law or an Emiri decree, could be considered to be established under UAE law. Whilst it is easy to postulate that "UAE law" should be considered a collective term which encompasses all such legislation, it is important to remember that the term will essentially be interpreted by treaty partners rather than the UAE Ministries or courts and they may find it convenient to apply a narrower definition. Also, it is noteworthy that in some places in DTAs, references to the UAE are defined as extending to local governments, local

authorities and government institutions, but this is not explicitly stated when considering which companies are considered residents of the UAE.

14. Although the above areas of uncertainty are issues of some concern and potentially negatively impact the attractiveness of the DIFC as a location for funds and fund management businesses, care should be exercised to ensure that the significance of these issues is not overstated. In particular:
  - 14.1 the potential for a DTA to apply to prevent a jurisdiction in which a fund is partly managed from taxing that fund is probably limited in practice as the threshold below which no taxing rights arise is relatively low and may not be significantly lower than that set by the domestic law of that jurisdiction. That is, most jurisdictions do not attempt to tax an activity below a defined level and that benchmark is often not significantly different to the level set in a DTA. This is one reason why the funds industry now typically looks more to the safe harbour provisions in various jurisdictions' domestic legislation to avoid a liability to tax than to the provisions of a DTA;
  - 14.2 the withholding tax reductions offered by DTAs are typically available even to a fund established in a jurisdiction which does not have any DTAs, by simply interposing one or more companies between the fund and the investment which gives rise to the relevant income or gain. Although such arrangements are increasingly scrutinised, they are still commonly effective. Without such planning options, the funds industry would not have flourished as it has in certain jurisdictions which do not have a network of DTAs. Accordingly, to the extent that a fund manager has concern over the applicability of one of the UAE's DTAs, other options exist to deal with such risk; and
  - 14.3 many funds are set up as partnerships, which are permitted in the DIFC, and these are commonly considered as transparent for tax purposes in many jurisdictions. One consequence of treating partnerships as "fiscally transparent" is that DTAs entered into by the jurisdiction in which the partnership is established are not considered relevant. Rather, it is any DTA between the jurisdiction of residence of each partner and the jurisdiction of source of the relevant income which is usually considered relevant. Accordingly, where a DIFC Fund is established as a partnership, any uncertainties surrounding the interpretation or application of a DTA entered into by the UAE will usually be of little concern in practice.

## **Key Recommendations**

15. The tax regime in the DIFC is essentially favourable to the development of the DIFC as a centre for both the domicile of funds and the development of fund management and administration activities. Nonetheless, there are areas of uncertainty which could be clarified in order to make the DIFC's value proposition from a tax perspective more robust. These changes, however, are beyond the powers of the DIFC bodies. Nonetheless, a wish list of Key Recommendations would include:
  - 15.1 having the zero rate of tax in the DIFC guaranteed under a federal law and extended to any future indirect taxes, i.e. amending UAE Federal Law No. 8 of 2004 to enshrine tax exemptions;
  - 15.2 amending old DTAs which adopt a "subject to tax" test in relation to the definition of "resident" by way of a protocol to make it clear that all UAE incorporated or domiciled entities qualify for DTA benefits;

- 15.3 amending UAE Federal Law No. 8 of 2004 to make it clear that the exclusion of commercial laws does not extend to any DTA; and
- 15.4 ensuring that in those DTAs which deem a resident to include a company incorporated under UAE law, the term "UAE law" is defined to include any entity established under a law of an individual emirate.

## **8.2 Are there ownership of real estate/equity issues that need to be clarified?**

### **Background**

1. One of the key advantages that some fund managers/operators are looking for when considering setting up a Fund in the DIFC is access to investments in the UAE and other jurisdictions in the region, particularly real estate and equity investments. Such access, however, is not in fact readily available to DIFC Funds, so in part limiting their appeal.
2. Due to foreign ownership restrictions relating to both real estate and certain securities in the UAE, a Fund set up in the DIFC may be at a disadvantage to one set up elsewhere in the GCC or under the UAE Central Bank regulations as it may in practice be treated as a "foreign entity" for the purposes of the relevant authorities (which are generally at the emirate level). There are general restrictions on foreign ownership of real property in the UAE outside of certain special zones. The ownership of shares in UAE incorporated companies is also restricted with foreign individuals and companies restricted to holding a maximum of 49% of shares in UAE incorporated entities. This may be a lower percentage for companies undertaking certain types of activities. A fund regulated by the UAE Central Bank is not a separate legal entity (investors only have a contractual right to returns based on the value of the assets of the fund rather than an ownership right to the underlying fund assets) and will take on the 'nationality' of the fund manager for the purposes of satisfying any requirements for foreign ownership.
3. One exception to this restriction on foreign ownership arises from a memorandum of understanding which the Panel understands has been entered into between the Dubai Economic Department and the DIFC whereby public listed companies incorporated in the DIFC are able to apply for consent to hold shares in local Dubai incorporated companies (which have restrictions on foreign ownership) in circumstances where the shareholding of the DIFC entity is held by a minimum of 51% of shareholders with UAE nationality (i.e. the DIFC company has an ownership structure which is the same as permitted for a UAE company). There have also been indications from the UAE government that changes are now proposed to the UAE Commercial Companies Law to reduce the level of national ownership required for UAE companies involved in certain trade or industry sectors. It would be advantageous for DIFC Fund entities if they were accorded the same rights to own shares as a DIFC company, particularly if the UAE government is amending the laws to allow for greater levels of foreign ownership of companies generally.
4. There has been no similar arrangement with the Dubai Lands Department to treat DIFC companies (even those with 100% UAE national ownership) as UAE companies for the purposes of real estate ownership in Dubai (although UAE Federal Law No. 8 of 2004 establishing Financial Free Zones permits DIFC companies complying with the UAE laws to be treated as UAE national companies).
5. It is usual for a fund in other jurisdictions to utilise "holding companies" and special purpose vehicles (SPVs) to hold particular assets for the fund as this, inter alia, assists in ring-fencing any

liabilities relating to a particular asset and can also assist in the eventual sale of the asset. The concept of "holding companies", i.e. companies which do not carry on any activities except the holding of assets, is not, however, one which is generally recognised in the DIFC (although there are special provisions for SPVs for facilitating both Islamic and conventional transactions, as well as for holding real property for a Property Fund; with regard to these real property holding SPVs the Panel understands that none has been established to date) and there are requirements for all DIFC incorporated entities to lease office space and employ a certain number of persons. Furthermore, the minimum capitalisation of a DIFC incorporated entity is currently USD50,000 and, in addition to this, the process for incorporating a DIFC entity is likely to take several months and involve the incurrence of considerable expenditure. Moreover, in order to incorporate a DIFC entity it is necessary to enter into discussions with DIFCA to obtain their consent for such incorporation. Finally, it is unusual, in practice, for the DIFC to consent to the incorporation of a company where it does not believe that such company will benefit the DIFC. In short, the DIFC Funds regime does not therefore readily lend itself to the provision of DIFC holding companies and DIFC SPVs sitting below the Fund vehicle.

### **Options/Suggestions**

6. It would be advantageous to Authorised Firms in the DIFC if they could get easier access to local assets in Dubai and the rest of the UAE for investment by a DIFC Fund. Ideally this access would extend to assets located throughout the GCC with the target jurisdictions of funds rarely being limited to just Dubai or the UAE.
7. In relation to equity investments, there is a direct parallel between a fund which has a minimum of 51% of investors with UAE nationality and a DIFC company with such ownership and it would be beneficial to Fund managers and investors to have the capacity to invest in equity investments as if the Fund were clearly treated in the same way as a UAE (and ideally GCC) company (provided the relevant foreign ownership restrictions are complied with) without any additional formalities.
8. Listed Funds which are professionally managed could have a beneficial effect on the Dubai real estate market by facilitating foreign investment in the UAE if they are permitted to own real estate in Dubai (outside of the existing designated areas). Real Estate Investment Trusts could be suitable vehicles for such real estate ownership, although a general lifting of foreign ownership restrictions to accommodate DIFC entities would be preferable.
9. The Panel suggests that representations be made by the DFSA initially to the Dubai government which should have the greatest interest in supporting the DIFC and Funds set up in the DIFC, although an extension to the UAE as a whole, and indeed the wider region, would be ideal.
10. It would be advantageous if the current practical and legal restrictions to incorporating "holding companies" and SPVs in the DIFC were reformed and the process for incorporating a DIFC entity were streamlined (both in terms of time and cost).

### **Key Recommendations**

11. The Panel recommends to the DFSA that:
  - 11.1 the DFSA investigates the possibility for DIFC Funds (including listed Funds and Investment Trusts) to be clearly treated in the same way as UAE (and ideally GCC) companies for the purposes of real estate and equity investments in Dubai and the UAE as a whole (and ideally throughout the GCC); and

11.2 the DFSA explores the facilitation of the use of DIFC "holding companies" and SPVs for Fund purposes.

## **Issue 9 – Other Broad Issues and Recommendations**

### **9.1 Consideration of establishing an ongoing practitioner panel assuming a role in education (practitioners and investors)**

### **9.2 Consideration of the role of the industry councils established by DIFCA and how it integrates with the other proposed ongoing practitioner panel**

### **9.3 Seed capital and other incentives by the DIFC as ways of attracting fund establishment in the DIFC**

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

### **9.1 Consideration of establishing an ongoing practitioner panel assuming a role in education (practitioners and investors)**

#### **Background**

#### **Introduction**

1. The Panel also explored other avenues through which the DFSA may, on an on-going basis, promote a higher level of industry participation and engagement with the DFSA. One such option is the use of industry groups and practitioner/advisory panels which are used by regulators in other jurisdictions. The practitioner panel set up by the FSA (the **UK Panel**) provides a good example (see <http://www.fs-pp.org.uk/about/background.html> for details). The UK Panel was set up by the FSA to represent the interests of practitioners but is independent of the FSA. Its remit is to provide input to the FSA from the industry in order to help the FSA meet its statutory objectives. Members of the UK Panel are appointed by the FSA and are drawn from the most senior levels of the industry to represent the various sectors within which the regulated financial businesses operate, such as insurance, banking and securities.

#### **Options/Suggestions**

2. In many developed financial markets, there are well resourced and well established trade and consumer representative bodies that advocate and represent industry and consumer views and interests to the regulator to achieve the right balance in regulation. Such bodies evolve over a period of time. Given the nascent nature of the DIFC, such bodies are yet to emerge. In the meantime, the Panel is of the view that the interests of the DIFC and the regulated community would be better served by the DFSA taking the initiative to establish a practitioner panel, with an on-going role to provide the DIFC financial services industry with a voice in regulatory matters. For example, the DFSA often publishes consultation papers relating to its regulatory initiatives involving legislative changes. Such a DFSA practitioner panel could liaise better with industry practitioners in the DIFC in formulating appropriate industry responses for DFSA consideration. While the DFSA practitioner panel members are to be drawn from the financial services firms in the DIFC, those members will

not be the representatives of the particular firms. Such a DFSA practitioner panel could also undertake an investor education role.

3. Accordingly, such a practitioner panel will provide a further mechanism through which a two way dialogue between the industry and the DFSA can be better promoted. It is not, however, intended to replace any formal or informal trade associations, industry bodies and/or working groups and their interaction with DIFC authorities and/or the DFSA. Instead, such a DFSA practitioner panel would provide an over-arching representative role of industry views affecting the regulated community. While the Panel believes that such a DFSA practitioner panel should at the same time have a wider coverage of the DIFC regulated community, DIFC Fund managers will have a key role to play in the practitioner panel in promoting the envisaged growth and development of the DIFC Funds regime.

### **Key Recommendations**

4. The Panel recommends to the DFSA that it should take the initiative to develop a DFSA practitioner panel along the lines of the UK Panel, taking account of the nascent nature of the DIFC financial services industry and the need to promote the development within the DIFC of a stronger industry voice. Such a DFSA practitioner panel should (a) have industry wide representation from all the sectors represented by financial services firms in the DIFC, (b) have representatives from other regulatory authorities relevant to the DIFC such as DIFCA as appropriate (see also at Issue 9.2), and (c) be consulted by the DFSA on a regular basis.

## **9.2 Consideration of the role of the industry councils established by DIFCA and how they integrate with the other proposed ongoing practitioner panel**

### **Background**

1. DIFCA has established four industry councils whose remit is to advise the DIFC board on developments within their respective industries. These councils are aligned with the business development silos within the DIFC, namely (a) Wealth Management, (b) Banking and Brokerage, (c) Reinsurance and Captives, and (d) Islamic Finance.

### **Options/Suggestions**

2. These councils should proceed under their current respective terms of reference agreed with DIFCA and not be formally integrated within the DFSA practitioner panel (discussed at Issue 9.1).
3. To foster alignment and co-operation with the DFSA practitioner panel, it is appropriate that chairpersons of these councils be members of the DFSA practitioner panel. This membership need not be mandatory and it will be up to the relevant councils and DIFCA whether they see sufficient overlap in the objectives and duties of the DFSA practitioner panel to consider representation on the DFSA practitioner panel.

### **Key Recommendations**

4. The Panel recommends to the DFSA that:
  - 4.1 the chairpersons of the four DIFCA industry councils be invited to be members of the DFSA practitioner panel; and

- 4.2 DIFCA and the four industry councils concerned decide whether there is sufficient overlap in the objectives and duties of the DFSA practitioner panel for such an invite to be accepted.

### **9.3 Seed capital and other incentives by the DIFC as ways of attracting fund establishment in the DIFC**

#### **Background**

1. The Panel expects that funds industry growth will come in part from the smaller firms. As identified in the other Sections of this Report, overall cost factors significantly influence a firm's decision where to establish its presence and to domicile its funds. A key factor in these decisions is the cost of office accommodation.
2. Firms generally seek small size and inexpensive accommodation in order to keep costs to a minimum. In many cities small firms share premises and benefit from the centralised provision of support services such as IT, data services etc.
3. A number of financial centres have offered various incentives, including the provision of seed capital, in order to attract certain sectors of the financial services industry to establish a presence.

#### **Options/Suggestions**

4. The Panel believes that the provision of cost-effective basic accommodation and seed capital would greatly assist firms in covering costs in the early stages of fund establishment.

#### **Key Recommendations**

5. The Panel recommends to the DFSA that:
  - 5.1 DIFC Investments (**DIFCI**) establishes a formal process to consider allocation of seed capital to DIFC Funds;
  - 5.2 DIFCI and DIFCA approach other Dubai government entities to participate in the seed capital programme;
  - 5.3 the DIFC considers provision of small size and simply fitted-out accommodation which fills the existing gap between DIFC leased premises and the DIFC business centres for smaller firms; and
  - 5.4 the DIFC considers establishment of the hedge fund hotel concept in the DIFC whereby firms benefit from lower cost premises and economies of scale brought about by shared services.

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

### Background

1. If one considers the IOSCO principles applicable to collective investment schemes it is noticeable that they primarily consider themselves with open-ended investment schemes. When the DIFC Funds regime was initially established it followed IOSCO principles in a number of instances but it did not make the distinction between open-ended and closed-ended regimes.
2. Consequently, a number of provisions in the DIFC Funds regime (particularly in relation to duties in relation to fund property, valuation and pricing of fund units and reporting requirements) are made applicable to all funds established in the DIFC but are in reality only relevant to open-ended funds, i.e. funds that allow for regular redemption of units, as opposed to closed-ended funds that typically self-liquidate upon a specific date or event occurring.

3. To begin with, Article 21(3) of 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."*

4. This obligation is then expanded on by the requirements in section 6.7 of CIR Rules, which provide as follows:

*"Rule 6.7.1 (1) An Operator of a Public Fund must, at all times during the dealing day, be willing to issue and effect the sale of Units in the Fund to any eligible Client within any conditions in the Constitution and the Prospectus which must be fair and reasonable as between all Unitholders and prospective Unitholders for whom the Operator does not have reasonable grounds to refuse such sale.*

*(2) An Operator must, at all times during the dealing day, effect a redemption on the request of any prospective Unitholder within any conditions in the Constitution and the Prospectus of Units owned by that Unitholder, unless the Operator has reasonable grounds to refuse such redemption.*

*(3) On agreeing to a redemption of Units within (2), the Operator must pay the full proceeds of the redemption to the Unitholder within any reasonable period specified in the Constitution or the Prospectus, unless it has reasonable grounds for withholding payment.*

*(4) Payment of proceeds on redemption must be made by the Operator in any manner provided for in the Prospectus which must be fair and reasonable as between redeeming Unitholders and continuing Unitholders.*

*(5) If Fund is a closed ended Public Fund, the Operator must have in place arrangements to ensure that the issue, sale and redemption of Units of the Fund is consistent with the closed ended nature of the Fund. The Operator may also make provision for the issue of Units of the Fund through Private Placement, provided those provisions are not inconsistent with the closed ended nature of the Fund."*

5. The Panel notes that if the 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. The Panel also notes that CIR Rules referred to above provide some flexibility for a closed-ended Fund not to have redemptions by subjecting the redemption requirements to "... any conditions in the Constitution and the Prospectus..." , so that to the extent the Constitution is required to state whether a Fund is closed ended or open ended and the Prospectus is required to set out whether or not redemption is provided, an Operator of a closed ended Fund which has stated the non-availability of redemptions in these documents could be argued as not having that obligation.
6. The Panel believes that these provisions create a significant ambiguity relating to the application of the redemption obligations to a closed-ended Fund, especially as the over-arching obligation to provide redemption mechanisms are set out in the CI Law in mandatory terms. Therefore, the Panel recommends that the law be clarified so that the redemption obligations apply only to open ended Funds.

### **Options/Suggestions**

7. The Panel suggests that a review is undertaken to see which requirements in the DIFC Fund regime are applicable to open-ended funds and create this distinction in the rules by exempting closed-ended investment vehicles from these requirements as appropriate.
8. Consideration should also be given to the restrictions contained in the DFSA Rules (e.g. CIR 13.4.3 and CIR 13.5.3) pertaining to single investment rules. There is a movement towards deal specific investment vehicles (as opposed to funds that have single investment restrictions) that can raise capital as and when required for specific transactions.

### **Key Recommendations**

9. The Panel recommends to the DFSA that:
  - 9.1 a review is undertaken in respect of the CI Law and the CIR to create exemptions for closed-ended funds where the requirements are more applicable to open-ended funds; and
  - 9.2 this review includes Article 21(3) of the CI Law and Rules 6.3, 9.3, 9.6, 13.4.3 and 13.5.3 and Appendix 3 to the CIR.

## Issue 10 – Panel Conclusions: General Strategy and Positioning for the DIFC Funds Regime

### Background

1. Against the backdrop of the preceding Issues, this Issue 10, which considers the general strategy and positioning for the DIFC Funds Regime, concludes this Report. Most of the Key Recommendations made under the preceding Sections of this Report are designed to influence the nature and level of regulation applying in the DIFC. Undoubtedly the competitive pressures or advantages that apply to funds industry participants in the DIFC are, to some extent or other, impacted upon, and influenced and shaped by, the applicable regulatory regime. To set the context for the Panel's Key Recommendations relating to how the DFSA should best position the DIFC Funds regime, those considerations and their impact are briefly examined below, before addressing the general strategy for achieving the desired positioning. Moreover, as noted in the Overview, in the Panel's view the timing is right for the revitalising of the DIFC Funds industry as the DFSA is currently faced with a unique opportunity to attract fund management business given the dislocation going on in the funds industry.
2. What strategy the DFSA should adopt in respect of DIFC Funds going forward will depend upon where the DFSA sees the DIFC Funds regime as being positioned. This positioning, which the Panel believes is a critical factor in determining the appropriate strategy for promoting the DIFC Funds regime, will be both influenced and determined by a variety of factors. With no particular order of priority, they fall into three categories:
  - (a) the physical location of the DIFC;
  - (b) the nature and level of regulation that apply to the funds industry participants in the DIFC; and
  - (c) competitive pressures or advantages that apply to the funds industry in the DIFC.

#### *Physical location of the DIFC*

3. The DIFC's location in the UAE, sitting on the crossroads of the MENA region, Europe, and the West, undoubtedly gives it a significant advantage in terms of accessibility from its location to both investors and service providers across the globe. Dubai has in particular enjoyed a strong position in the Middle East in terms of its high quality infrastructure and the life style comforts promoted by that infrastructure. In addition, the DIFC has a significant tax advantage in that all entities and individuals located within the DIFC, including DIFC Funds, attract a zero rate of tax for 50 years, together with a guarantee of tax free repatriation of profits during that period.
4. To facilitate better the funds industry in the DIFC to take full advantage of the infrastructure facilities and other benefits available in its physical location, the regulatory regime that applies to those activities needs to be finely calibrated to provide the right level of regulatory protection to investors without saddling the industry with undue regulatory requirements that increase compliance costs without adding any significant benefit to investors or industry participants. While these are addressed in greater detail in the Key Recommendations, they are highlighted below for convenience of reference.

*The nature and level of regulation that apply in the DIFC*

5. The DIFC has a fairly new custom-built regulatory regime to regulate the funds industry (see Appendix 1 for an overview of the DIFC Funds regime). The Panel understands that while this regime is evidently modelled on the UK regime, it also contains features borrowed from other well established regimes such as in Australia, Hong Kong and Singapore. Like most other international securities regulators, the Panel understands that the DFSA's aim is to have its regulatory regime well aligned with IOSCO principles for collective investment schemes. It is also the Panel's view that within this framework, there is ample scope for improvement to be made to the DIFC Funds regime to make it more attractive to the funds industry as a whole. As became evident to the Panel through its review, some elements of the current DIFC Funds regime in fact act as regulatory impediments to the growth of the funds industry in the DIFC, rather than promoting its growth. Such areas which make the DIFC Funds regime not the "right fit" for its fledgling funds industry include:
  - 5.1 the current restriction that Operators of Funds are prohibited from operating funds located in other jurisdictions, which seems to run contrary to the international flavour of the DIFC, and distorts the ability of DIFC Operators of Funds to utilise the DIFC to the fullest extent in managing their international businesses. Similar constraints arise for fund managers in other well regulated jurisdictions when trying to locate some of their funds business in the DIFC (see the Key Recommendations at Issue 1 to remove these barriers);
  - 5.2 the restrictive nature of the range of Foreign Funds which Authorised Firms in the DIFC can distribute Units of, which can be relaxed by taking into account the high-net-worth and sophisticated nature of individual investors and the benefit of alternative regulation arising from the COB standards applying to Authorised Firms (such as suitability assessments) (see the Key Recommendations relating to marketing of Units of Foreign Funds at Issue 2 and Exempt Funds at Issue 5); and
  - 5.3 the overly burdensome Shari'a compliance requirements (see the Key Recommendations at Issue 7) and Independent Oversight requirements (see the Key Recommendations at Issue 6).
6. In addition to the above, the Panel is of the view that the DFSA may find other areas relating to the DIFC Funds regime which may warrant further refinements and relaxation, taking account of considerations such as the benefit of alternative regulation flowing from another layer of regulation already applying to the activity, or the specific nature of the investors involved and their legitimate expectations.

*Competitive pressures or advantages that apply to the funds industry in the DIFC*

7. Competitive pressures and advantages that apply to the funds industry in the DIFC are key drivers that could either propel the industry forward or retard the industry by removing its attractiveness to the users. There are indeed a number of obvious advantages. For example, a zero tax regime applying to DIFC Funds and fund participants in the DIFC, the benefits of DTAs which the UAE has entered into with some jurisdictions, the bespoke regulatory regime based on the common law, as well as the DIFC's own courts and arbitration system are some of those obvious advantages. However, the Panel is aware that these advantages alone have so far not been adequate to attract a significant number of funds industry participants to the DIFC, as is evident from the data available to the Panel (see the Overview, paragraph 1.2). In the Panel's view, some of the key detractors to the DIFC becoming a more attractive place for the funds industry are:

- 7.1 the high cost of establishing and operating in the DIFC, such as the regulatory costs of licensing and authorisation, the cost of office premises etc. (see the Key Recommendations at Issue 3);
- 7.2 the unnecessary compliance costs together with some of the overly burdensome requirements which act as impediments (as identified in paragraph 5 above); and
- 7.3 as was noted under Issue 1, the lack of familiarity and ready expertise relating to the DIFC Funds regime among the funds industry participants due to its relative newness compared to other more established and better promoted regimes.

### **Positioning of the DIFC Funds regime**

8. In light of the above considerations, the Panel has considered the issue of where the DIFC Funds regime could and should be positioned. Undoubtedly, the DIFC Funds regime should not be subject to a deregulatory move solely to attract more industry participants to the DIFC. The Panel does not believe that the DFSA's efforts in promoting the DIFC Funds regime would encompass such a move, especially in light of its high regulatory objectives, and in the aftermath of the recent financial markets crisis which has led to a more rather than less regulatory approach by regulators towards financial markets and activities. Nevertheless, there should be change to the DIFC Funds regime in order to inject greater vitality into the DIFC Funds industry.
9. Instead, the Panel believes that the DFSA should aim to place the DIFC Funds regime in a position that not only provides an adequate level of regulation without making it unduly burdensome but also which is much more visible and accessible to the funds industry and investors. For this purpose, the DFSA should look for inspiration towards the more flexible and reputable smaller jurisdictions which are well marketed and hence have been able to attract a fair share of the funds business from the longer established major jurisdictions.

### **Strategy for achieving the right positioning for the DIFC Funds regime**

10. The Panel is of the view that a multifaceted approach is needed to attract to the DIFC Funds regime the appropriate level of recognition and market share. Such measures should include the following:
  - 10.1 the DFSA providing greater assistance to the funds industry participants to build their internal expertise and familiarity with the DIFC Funds regime. For this purpose, the DFSA should hold frequent seminars, workshops and the like for industry participants to promote their knowledge and understanding of the DIFC Funds regime. Such initiatives, though costly in terms of time and resources required, are a necessary expense where a regime is new, and help to reduce the incidence of industry practitioners using other regulatory regimes with which they are more familiar;
  - 10.2 the DFSA representatives undertaking promotional visits to major industry participants located in other jurisdictions. While longer established regulators in major jurisdictions may consider this approach unnecessary or intrusive, smaller jurisdictions by way of their regulators and industry participations (lawyers/administrators etc.) do utilise such means to promote their jurisdictions more effectively;
  - 10.3 the DFSA promoting to fund managers the attractions of the DIFC in terms of, for example, infrastructure, quality of life, tax benefits etc.;

- 10.4 the DFSA providing more web-based material to assist industry practitioners. For example, practitioner guides relating to the DIFC Funds regime would assist practitioners to "connect with" the DIFC Funds regime more readily. Such material could also be used as part of the DIFC Funds regime promotional campaign by the DFSA;
- 10.5 the DFSA establishing an on-going practitioner panel to assist the DFSA in bringing to its notice any changes in the markets, and to take back to the industry information relating to any regulatory developments. Such a practitioner panel can assist the DFSA in its promotional and educational campaigns for the funds industry (see the Key Recommendations at Issue 9.1);
- 10.6 the DFSA taking the necessary steps to remove swiftly the unduly burdensome regulatory requirements identified in this Report, particularly those relating to Independent Oversight and Shari'a compliance, and the reduction of regulatory and other costs, based on the Key Recommendations in this Report; and
- 10.7 the DFSA working with DIFCA to explore possible means through which appropriate incentives such as infrastructure support can be provided to funds industry participants, such as making available to those wishing to start up businesses in the DIFC cheaper cost business premises and facilities and, if seed capital is also to be made available, providing transparent processes through which funds industry participants can access such seed capital. The latter should be in addition to measures adopted by the DFSA to lower regulatory costs of current industry participants in the DIFC, which are referred to at paragraph 10.6 above.

## **Key Recommendations**

11. The Panel recommends that the DFSA adopts a clearly defined, long-term strategy for promoting and maintaining the DIFC Funds regime, which should encompass:
  - 11.1 aligning the long-term goals of the funds industry with the interests of the DIFC as a whole, by identifying how investors and other industry participants would benefit in the long term from such a strategy. For example, the DFSA should focus on measures that benefit the long-term growth of the funds industry in the DIFC, such as initiatives that bring about a stable, lower cost regime, the benefits of which would naturally flow to both investors and the funds industry. Such measures would include the lowering of regulatory costs (which are within the DFSA's powers) as well as infrastructure costs which, although outside the DFSA's immediate powers, can nevertheless be sought to be lowered through initiatives involving the DFSA working in conjunction with DIFCA and other relevant authorities to the extent possible;
  - 11.2 exploring means by which the DIFC can be better promoted as the "hub" for Shari'a funds in the region, in particular taking into account the Panel's Key Recommendations set out in Issue 7;
  - 11.3 making the DIFC Funds regime itself the central attraction of the DIFC to the funds industry by highlighting the attractive features of the regime, which are to be enhanced by implementation of the Panel's Key Recommendations in this Report;
  - 11.4 in order to achieve a critical level of acceptance with both fund managers and investors, undertaking focussed and strong marketing and educational initiatives, as referred to in paragraphs 10.1, 10.2 and 10.3 above, both to promote the profile of the DIFC Funds regime

among industry participants as well as to build their familiarity and expertise relating to the DIFC Funds regime;

- 11.5 attracting fund managers to the DIFC by promoting its advantages, by example on account of infrastructure, quality of life, tax benefits etc., which are also to be further strengthened and enhanced by the Key Recommendations in this Report;
- 11.6 establishing an on-going industry practitioner panel (see the Key Recommendations at Issue 9.1), to promote a higher level of industry participation with the regulatory initiatives, to assist the DFSA in its promotional and educational activities, and to facilitate better dialogue with industry practitioners and the regulator, especially during the current nascent stage of the DIFC Funds industry where there is little representation of consumer and industry interests through consumer protection and self-regulatory industry organisations; and
- 11.7 exploring avenues through which seed capital and other financial incentives can be channelled to the funds industry, see further the Key Recommendations at Issue 9.3, paragraphs 5.1 and 5.2.

## APPENDIX 1

### OUTLINE OF THE DIFC'S COLLECTIVE INVESTMENT FUNDS REGIME

1. The DIFC's Collective Investment Funds regime is established under the CI Law and the CIR. Collective Investment Funds are defined as those arrangements where:
  - (a) the purpose or effect of which is to enable persons taking part in the arrangement (participants) to participate in profits or benefits arising out of the acquisition, holding, management or disposal of the property or other assets of the arrangement;
  - (b) the participants do not have the day-to-day control of the management of assets or property of the arrangement; and
  - (c) the assets or property of the arrangement are pooled or managed as a whole.
2. Certain arrangements that otherwise fall within this definition are expressly excluded, such as franchises and time share rights. Refer to Article 15(1) of the CI Law for the comprehensive definition of Collective Investment Funds and Rule 2.3 of the CIR for express exclusions.
3. Arrangements that fall within the above definition and are not expressly excluded are Collective Investment Funds. Such Collective Investment Funds are categorised as either Domestic Funds or Foreign Funds. Domestic Funds are those domiciled in the DIFC and Foreign Funds are those domiciled outside the DIFC.
4. Domestic Funds fall into two categories: Public Funds and Private Funds. The distinction between these two types of DIFC Funds is that while Units of a Public Fund can be offered to the public, and can be invested in by either Retail or Professional Clients, a Private Fund can only have 100 or less investors who qualify as Professional Clients. Private Funds can only seek investments by way of 'private placement' and not by way of a public offering. Professional Clients are defined in COB as Persons who have net assets of at least USD500,000 and sufficient experience and understanding of relevant financial markets, products or transactions and risks associated with such markets, products or transactions. Retail Clients are those who do not qualify as Professional Clients.
5. The key elements of the DIFC's Collective Investment Funds regime for all Domestic Funds (whether Public or Private) include that they must:
  - (a) be operated by an Authorised Firm that has an endorsement to Operate Collective Investment Funds;
  - (b) comply with certain Fund Administration standards relating to compliance with anti-money laundering rules and holding of Client Money and Assets, delegation and outsourcing and record keeping requirements;
  - (c) have constituent documents that meet certain prescribed standards;
  - (d) comply with valuation, pricing and other related requirements;
  - (e) be subject to accounting and audit requirements, including compliance with the relevant audit standards, and be subject to both internal and external audit requirements, the latter having to be conducted by a registered auditor;

- (f) provide certain periodic reports, including annual and interim reports; and
  - (g) if a specialist type of DIFC Fund, such as a Property Fund, Private Equity Fund, Islamic Fund or Hedge Fund, be subject to fund-type specific additional requirements.
6. Domestic Funds which are Public Funds attract, however, a more extensive regulatory regime when compared to Private Funds. For example, while a Public Fund requires a full Prospectus, a Private Fund requires only a Short Form Prospectus containing much less prescribed information. A Public Fund is required to have an Independent Oversight Committee, which is not required for a Private Fund. Similarly, while a Public Fund needs to be registered with the DFSA prior to any offer of its Units to the public, only a notification to the DFSA is required prior to a private placement of Units in a Private Fund. Public Funds are subject to certain borrowing and investment restrictions while Private Funds do not attract those restrictions.
7. Foreign Funds, not being Domestic Funds by being domiciled outside the reach of the jurisdiction of the DIFC, trigger the DIFC requirements only if the Units of such Foreign Funds are distributed or marketed in or from the DIFC. Accordingly, the distribution of Units of Foreign Funds can only be undertaken by Authorised Firms provided such Foreign Funds qualify as eligible Foreign Funds. The eligibility criteria require Foreign Funds either to be regulated in a recognised jurisdiction or to be subject to alternative comparable regulation. The DFSA has established a list of jurisdictions recognised for this purpose and can also consider other jurisdictions on a case-by-case basis. Distribution of Units of Foreign Funds attracts certain conduct rules set out in the CIR.
8. Finally, it is important to note that in addition to the requirements noted above, there are other overarching principles enshrined in the CI Law which are designed to provide investor protection. For example:
- (a) Operators of Domestic Funds must act honestly, exercise the degree of care and diligence that is expected of an Operator, and act in the best interest of the Unitholders of the Domestic Fund. If there is a conflict of interest between the interests of the Unitholders and that of the Operator, it must give priority to the Unitholders' interests;
  - (b) Operators must ensure that all Unitholders of the same class are treated equally, and Unitholders of different classes fairly; and
  - (c) Operators must also ensure that the property of the Domestic Fund is subject to safe custody provisions and is held separately from the property of the Operator and any other fund that the Operator operates.
9. The DIFC's Collective Investment Funds regime is compliant with IOSCO standards for regulation of collective investment schemes.

