DFSA response to public comments on Consultation Paper No. 93 - Qualified Investor Funds

Overview

1. On 22 December 2013 the DFSA released Consultation Paper 93 (CP93). Public consultation on these proposals closed on 20 February 2014 and we received six sets of written comments. The DFSA thanks stakeholders for providing their thoughtful comments on our proposals. This paper explains the position adopted by the DFSA regarding the key points raised by public comments on CP93 proposals and the rationale for doing so.

2. We proposed in CP93 introducing a new category of fund – a Qualified Investor Exempt Fund – to be marketed by private placement to professional investors willing to invest at least USD 1 million. We proposed that many of the detailed requirements applicable to Exempt Funds would be disapplied for such a fund, so that the regulatory regime would be more appropriate for this segment of the funds market.

3. We received a number of comments, in writing and in meetings, that the name of the new fund category should be simpler. We, therefore, proposed changing the name to the simpler Qualified Investor Fund or “QIF”. We note that this term, or close variants, is already used in other jurisdictions, such as Ireland (QIF) and the UK (QIS).

4. His Highness the Ruler of Dubai enacted the changes to the Collective Investment Law 2010 necessary to introduce the new fund category on 24 July 2014. The revised law came into force on 21 August 2014 and relevant changes to the Collective Investment Rules (CIR) Module of the DFSA Rulebook came into effect on the same day. The new category of fund is, therefore, now available to those who wish to make use of it.

5. In this paper (except where otherwise indicated):
   (a) capitalised terms generally have defined meanings in the DFSA Glossary (GLO) module;
   (b) a reference to a “proposal” is a reference to a CP93 proposal, including any additional changes to those proposals that resulted from public comments.

6. This paper will be of interest to:
   (a) Fund Managers and asset managers;
   (b) other providers of services to Funds, such as Trustees, Fund Administrators and depositaries;

(c) institutional and other professional investors; and

(d) advisors to the above.

Summary of public responses to the key issues in CP93 and the DFSA's response

General comments

7. Consultation respondents were generally positive about the proposed new fund category and associated rule changes. A consistent theme in their comments was that this should make the DIFC a more attractive place to domicile funds. Respondents were also supportive of the proposed changes in the DFSA's process for authorising Fund Managers and Funds in relation to the new category of fund.

Proposals on custody

8. We had proposed a model for custody where the Fund Manager of a QIF could:

   (a) appoint an Eligible Custodian; or

   (b) opt to act as custodian itself, in which case the Fund Manager would:

      i. need to move from prudential category 3C (capital requirement of USD 500,000) to category 3B (capital requirement of USD 4 million), to ensure that there is parity with prudential regulation applicable to stand-alone custody providers; and

      ii. face an additional obligation that it must have in place effective arrangements to ensure that the Fund property is not available to creditors of the Fund Manager in the event of the Fund Manager's insolvency.[1]

9. We also asked three specific consultation questions in this area, including whether different requirements than those consulted on should apply to QIFs that are Private Equity Funds.

10. A number of respondents felt that our custody proposals were too prescriptive, and/or too onerous, for the proposed nature of QIFs. Respondents were sceptical that any Fund Manager would choose to act as custodian for a QIF, given the prudential consequences described in paragraph 8(b)(i). We considered their arguments in detail.

[1] We note that all fund managers, whether they hold custody or not, are already subject to the overarching obligation to clearly identify fund property as fund property, and to hold such property separately from the manager's own assets, and those of any other funds it manages (CI Law Article 22(2)(f)).

11. We did not think that consultation respondents made the case that there should be no specified custody requirements at all for QIFs. But we did feel that there was merit in the arguments put forward that the proposals were too onerous for QIFs.

Position at the time of consultation

12. Our regime at the time of consultation required an Eligible Custodian to hold fund property as compared to the Fund Manager itself holding fund property, and was intended to mitigate at least two risks:
    (a) that fund property would become available to satisfy creditors of the Fund Manager if that manager becomes insolvent, due to co-mingling of the property of the Fund and the assets of the Fund Manager; and
    (b) fraud.

13. In addition, higher capital requirements for an Eligible Custodian are largely intended to mitigate the operational risks that would arise in such a business.

14. We already allowed alternative custody arrangements (i.e. not an Eligible Custodian) for both Public Funds and Exempt Funds that are:
    (a) Private Equity funds; or
    (b) Property Funds, where title to fund property is held by a Special Purpose Vehicle.

15. Benchmarking of the funds regimes in other jurisdictions revealed a wide spectrum of requirements from, at one end, an eligible custodian having to be appointed in every case to, at the other end, no custodian having to be appointed at all. Our view was that some of these requirements were too onerous and some too lenient.

16. In response to this, the regime now in force allows that the Fund Manager of a QIF can:
    (a) appoint an Eligible Custodian; or
    (b) if the QIF is a Property or Private Equity Fund, act as custodian itself, provided it has in place effective arrangements to ensure that the Fund property is not available to creditors of the Fund Manager in the event of the Fund Manager's insolvency.

17. We felt that the risks arising could be adequately addressed through compliance with the requirements above, bearing in mind the intended nature of QIF investors. Fund property, where the Fund is a Private Equity or Property Fund, would usually be (relatively) illiquid and transactions relatively infrequent in comparison to, say, a Fund with an active trading

strategy in listed securities. The risk of fraud and the operational risks arising from holding custody would, therefore, be substantially reduced. We felt these rules would provide more appropriate regulation of QIFs and would be reflective of the views received from stakeholders.

Limits on investment and the number of investors

18. We consulted on a structure that was intended to provide three distinct options for Fund Managers wishing to set up and market Funds from the Centre.

Type of Fund	**Public Funds** (current)	**Exempt Funds** (current)	**Qualified Investor Funds (QIFs)** (proposed)
Level of regulation	Detailed regulation in line with IOSCO standards	Somewhat less stringent than for Public Funds	Significantly less stringent than for Exempt Funds
Investors	Retail Clients as investors	Professional Clients as investors	Professional Clients as investors qualifying through a higher minimum subscription
Investor limit	>100[2]	≤100	≤50
Minimum subscription limit	None	≥USD 50,000	≥USD 1 million

19. A number of consultation respondents criticised the proposed maximum number of investors for QIFs, arguing either for a higher number of investors or for no limit on the number of investors. Some respondents argued that we should reduce the minimum investment in a QIF to USD 500,000 from the proposed USD 1 million.

20. The model proposed was that the level of regulation for QIFs was reduced based on three factors – the size of the Fund in terms of investor numbers;

[2] It is not strictly accurate to say that a Public Fund must have more than 100 investors. A Fund is a Public Fund if it has one or more of the following features: (i) retail investors; (ii) public offer; or (iii) more than 100 investors.

the size of minimum investment and the level of sophistication of investors[3], with Public Funds attracting the highest level of regulation.

21. If we had said that a Fund with more than 100 investors must be a Public Fund, but that a Fund with 100 or fewer investors could be either an Exempt Fund or a QIF, this would have departed somewhat from this model of three distinct options. Similarly, having no limit for the number of investors in a QIF would require us to have reconsidered this element of the funds regime for the other fund categories, which we did not think was necessary or appropriate.

22. The idea behind the proposed regulatory regime for QIFs was that there would be a sufficiently small number of investors in such funds so that, in practice, they could – if they so wished – come together to take corporate action and also negotiate jointly with the Fund Manager, given their larger investments and professionalism. Similar carve-outs exist in other jurisdictions, but numbers can vary. For example, in Australia, 20 or fewer investors can set up unregulated funds.

23. The proposed investment limit in CP93 was based not on benchmarking, but on the actual minimum investments proposed by the seven Exempt Funds we have authorised over recent years.

24. The regime now in force prescribes for QIFs:

    (a) a maximum of 50 investors; and

    (b) a minimum investment of USD 500,000.

25. We proposed no change to the limit on the number of investors, for the reasons discussed above. On the minimum investment, we felt that a (lower) minimum of USD 500,000 still provided enough differentiation from the Exempt Fund category and so was consistent with our approach of having three distinct categories of fund.

<u>Other matters raised in consultation responses</u>

26. A number of comments were made about other aspects of the DFSA's funds regime, including the rules that apply to Property Funds. It was not appropriate to address these points as part of the work on QIFs, but we intend to look at the suggestions made as part of further work on our funds regime later this year and into 2015.

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3 Although it is clearly not universally the case, we think that it is a reasonable assumption to make that professional investors who can invest US $1 million in a QIF are, on average, somewhat more sophisticated than professional investors who can invest US $50,000 in an Exempt Fund.