Hedge Fund Regulation in the DIFC

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Introduction

To regulate or not to regulate hedge funds has been a question that many international regulators have faced. The question now is to what extent regulation will be imposed, not when it will be imposed. More recently, the estimated US$1,6000bn (£800bn, €1,200bn)[2] industry has faced much scrutiny concerning the rewards given to their senior managers, not to mention the added voices of financial regulators concerning the lack of regulation and the risk that hedge funds pose to the stability of the financial markets.[3] Irrespective of their popularity and high returns regulators will struggle dealing with hedge funds, because clamping down on them is politically difficult as the industry is large and competitive. Notwithstanding this, because the industry is growing so quickly and without full transparency, regulators in the future will have to be more vigilant on their stance and cautious in the policy direction they take in attempting to regulate them.[4]

The importance of hedge funds to the global capital markets has often been articulated in the main financial newspapers and business commentary. For example US, UK & European regulators have expressed concern in recent meetings "that investment banks may be allowing hedge funds to increase their borrowing capacity using collateral that could lose its value rapidly in a financial crisis".[5] The importance of hedge funds to this extent is recognized by the technical committee of the International Organization of Securities Commission (IOSCO) that has put out a recent consultation paper that considers principles for the valuation of hedge fund portfolios.[6] This report acknowledges the complexity of hedge fund portfolio strategies and the instruments and provides an approach when considering the different valuations of the actual hedge funds themselves. The question is not how many people or regulators understand hedge funds, rather it is, what information can you get from the operators to make an informed decision about the fund and regulation of them.

New DIFC Regime

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[2] Financial Times, Tobias Buck, 9 May 2007

[3] Financial Times, 20.02.07 Tobias Buck, "Hedge funds and Private Equity are good for the market" and

Financial Times, 19.02.07 James Mackintosh "Hedge funds seek return to riskier game"

[4] Financial Times, 12.02.07 Bertrand Benoit and Ralph Atkins "Vigilance called for as hedge funds boom"

[5] Financial Times, 30.01.07 Ben White and Jeremy Grant "Regulators concerned at hedge fund collateral"

[6] IOSCO, Consultation Report "Principles for the valuation of hedge fund portfolios" March 2007

In the Dubai International Financial Centre (DIFC), the Dubai Financial Services Authority (DFSA) seeks to regulate hedge funds, the operators, the managers, custodians, advisors and auditors. In the US, the Securities Exchange Commission (SEC) has suffered a set back in its desire to gain oversight of hedge funds and hedge funds advisors and was met with a severe challenge in 2006.[7] Other international financial centers concentrate more on the registration of hedge funds and allow for cross boarder promotions.

The DIFC is one of a few jurisdictions [8] in the world that has a full legislative scheme in place that regulates hedge funds including managers, operators, custodians, auditors and advisors. The legislation has been home grown and developed in the DIFC to establish the centre as a major internationally recognized funds centre. The main core of legislation which facilitates the funds regime is as follows:

- The Collective Investment Law 2006
  Collective Investment Rules

- Companies Law 2004
  Investment Companies Regulations

- Limited Partnership Law 2006
  Limited Partnership Regulations

- Regulatory Law 2004
  Regulatory Law Amendment Law 2006

- The DFSA Rulebook
  CIR Module and other Modules

During the development of the DIFC Collective Funds Regime a policy approach was taken to address all the areas that were seen where most of the regulatory difficulties have arisen over the failing hedge funds in recent years. There had to be an even handed approach where a realistic and proportionate regulatory position was considered suitable for a market that to this day is still more or less unregulated and not transparent. Having regard to these considerations the DIFC objective was to establish a well regulated on-shore centre that would attract a hedge fund industry to operate from the DIFC.

The Essential Characteristics

The essential characteristics of the DIFC collective investment regime is to classify hedge funds as a specialist fund and then to allow them to be divided into two categories, on the one hand domestic funds and on the other foreign funds. This division relates to the way that they are marketed locally and internationally.

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7 see Goldstein V Securities & Exchange Commission No 4-1434-DC Cir June 23, 2006
8 Australia, Hong Kong, Japan and some European countries have similar regimes

Domestic funds are those incorporated and domiciled in the DIFC with two distinctive classes being public or private funds. Participation in these funds is limited to qualified investors who are sophisticated in relation to investing their wealth and who have a net asset worth of at least US$1million or more. The regulation of a specialist domestic fund which is a hedge fund will require compliance in the following areas:

- A single operator who is within the DIFC and licensed by the DFSA;
- An investment vehicle registered or incorporated which is located in the DIFC;
- The appointment of eligible custodian;
- The appointment of registered auditor;
- Three core functions must occur within the DIFC, these are:

    a. Valuation and pricing;
    b. Issue and redemption; and
    c. Fund register and records; and

- Annual and interim of financial reporting, filed with the DIFC.

A hedge fund, before it commences operation, must register with or notify the DFSA providing details of the fund. Hedge funds must comply not only with the collective investment law but also the rules in the CIR module of the DFSA rulebook in regard to the everyday operation of the fund.

A hedge fund operator is required to ensure that the legal title of the funds' assets are registered with an eligible custodian, which generally speaking, would be a bank or a custodian that is subject to registration and has equivalent financial resources.

A hedge fund operator in the DIFC is required to publish a prospectus which contains certain proscribed information and also sufficient information for a prospective investor to make an informed decision in relation to investing in the fund.

Selling and Marketing

The DFSA also regulates the selling and marketing of foreign and domestic hedge funds by using the following regulatory tools:

- Mandatory prospectus disclosure;
- Regulatory status of operator;
- Marketing of designated funds from a recognized jurisdiction; and
- Criteria for the investment manager and custodian to meet.[9]

[9] The DFSA has issued a notice that lists countries and territories that are recognized jurisdictions for the purposes of its Collective Investment Law 2006. These jurisdictions include Australia, Canada, EU member states, Guernsey, Hong Kong, India, Isle of Man, Jersey, Singapore, South Africa, Switzerland, United Kingdom and United States of America

In addition, there are strict rules in relation to marketing domestic and foreign funds, which only allow persons who are authorized firms i.e. those licensed by the DFSA, to market funds. A domestic fund can not be marketed in or from the DIFC unless it has been registered by the DFSA or been notified to the DFSA. In relation to the marketing of a foreign fund it must be a designated fund from a recognized jurisdiction or a foreign fund that has appointed an investment manager and custodian authorized by the DFSA.

There is guidance in the DFSA rules in relation to the following areas:

- Risk management processes;
- Valuation and pricing;
- Investment strategy and process; and
- Banking arrangements and operational controls.
- Evaluation of prime brokers; and
- Fund of hedge fund investments

The rules also require the establishment of a committee to monitor the operators compliance with obligations and the requirements in the rules. The law places duties on those individuals involved and conducting the oversight function,[10] including the requirement to be independent[11]. The DFSA is also currently developing a code of best practice for hedge funds which it hopes to have completed by year end. When the DFSA finalises its approach, I anticipate that there will be further elaborations on these issues.

Regulatory Tools

The Collective Investment Law places duties on the operator, its agents and employees to act honestly and in the interests of its unit holders including not to take advantage of their position.[12] Where there is misconduct, the DFSA may remove an operator or appoint a new operator, alternatively it may place conditions on its license.[13] Such Regulatory tools may be used without recourse to formal proceedings. However, where the misconduct is more serious, the DFSA may petition the DIFC court[14] or the Financial Markets Tribunal[15] to protect the interests of unit holders, appoint a temporary operator or if appropriate wind up the fund. The court can make other orders which are in the interest of the unit holders.[16]

The DFSA can take regulatory action in relation to misconduct with respect to domestic or foreign funds. These may be for non compliance with the rules or law or issues concerning misleading and deceptive material statements in respect of a fund.[17] More

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[10] Collective Investment Law of 2006, Article 33
[11] Ibid, Article 34
[12] Collective Investment Law 2006, Article 26
[13] Collective Investment Law 2006, Article 27(1)
[14] The DIFC Court is an independent court which applies common law principles. The Chief Justice of the court is His Honour Sir Anthony Evans
[15] A Tribunal created under the Markets Law 2004 to deal with securities matters in the DIFC.
[16] Collective Investment Law 2006, Article 28
[17] Ibid, Article 22

recently, regulators are asking questions about offshore leverage vehicles that have allowed US based banks to extend credit to hedge funds beyond limits imposed by US law in relation to which there has not been clear disclosure. Under the current US regime this is information which is not easily obtainable to regulators but import none the less to understand the exposure of banks and hedge funds in the financial market. Under the DFSA regulatory tools this type of financial information would be obtainable using supervisory tools.

Investigations in relation to hedge funds may be commenced under the Regulatory Law.[18] The regulatory tools also include appointment of an auditor, compulsory winding up or civil proceedings where loss and damage has been suffered. In a case where there is market misconduct in relation to funds such as insider trading appropriate enforcement action can be taken under the Markets Law.[19] It will be increasing important to have these types of laws in place for the future as one can see circumstances where they will be needed. For example, in the US regulators have strengthened their market surveillance methods amid concern that hedge funds and other large investors are systematically engaging in hard to detect forms of insider dealing.[20] Appropriate enforcement matters can either be taken before the DIFC court or the Financial Markets Tribunal which apply common law.

Conclusion

The development of the DIFC collective investment regime takes into account the most important requirements that are needed to effectively regulate hedge funds without interfering with their commercial objectives. The regime classifies a hedge fund as a type of specialist fund and subjects it to requirements of relevant legislation and DFSA regulatory oversight. The DIFC laws and DFSA rules go no further than considering the areas of greatest concern in dealing with these types of funds and ensure an appropriate segregation and disclosure.

Internationally, there has been a call for more vigilance as the hedge funds industry is at an all time high. The fast growth in this specialist industry requires a clear and appropriate stance from regulators, but at the same time this stance cannot afford to be too bureaucratic that would dampen the enthusiasm of fund managers seeking high returns in the financial markets. However, safeguards in this industry cannot be received without imposing the minimum regulatory requirements and the DFSA has sought to do just this. Although hedge funds have contributed to the efficiency of the world financial markets they cannot, without being responsible, go unregulated for too much longer, given their interaction and importance to these financial markets.

In essence the DFSA collective investment legislation puts forward a workable and proportionate regime for hedge fund regulation that seeks not to unnecessarily impose needless burdens, but establishes fundamental regulatory underpinnings so that their place in the market is understood and appropriately disclosed.

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[18] Regulatory Law DIFC Law 1 of 2004, Articles 78,80 & 99

[19] Markets Law DIFC Law 12 of 2004, part 8 Prevention of Market Misconduct

[20] Financial Times 15.02.07 Brooke Masters “US regulators target hedge funds”

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