# Reversal of Fortune: The Growing Popularity of the DIFC and the ADGM over the Cayman Islands as a Jurisdiction of Choice for MEASA-based Private Equity and Venture Capital Funds

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The Cayman Islands have historically been a popular choice for the formation of private equity and venture capital funds for Middle East, Africa and South Asia ('MEASA') based investments. Recently, however, we are witnessing a growing trend for domiciling these types of funds in the Dubai International Financial Centre ('DIFC') and the Abu Dhabi Global Market ('ADGM'). Let's examine the factors that appear to have led to this reverse of fortune.

## Background of Private Equity Platforms

In the North American market, private equity and venture capital funds are typical established using a Delaware platform with Cayman domiciled alternative investment vehicles formed on a deal-by-deal basis to address particular tax and regulatory concerns. Typical structures include limited partnerships, limited liability companies and trusts however, the exempted limited partnership structure is the most commonly used structure where subscribers invest in an equity interest in the partnership and the general partner or fund manager will participate in the performance of the fund as a 'carry' participant either through subscription for units in the fund or through a separate carry entity. 'Carry' or 'carried interest' is a share of the profits of an investment paid to the general partner or fund manager as compensation regardless of whether they make a contribution to the fund. Carried interest compensation is typically agreed at about a quarter of the fund's annual profit. It is intended to motivate the general partner or fund manager to increase the fund's performance. Carried interest is typically only paid if the fund's returns meet a certain threshold. Since carried interest is considered a return on investment in taxable jurisdictions, it is taxed at a capital gains rate and not an income rate.

Regionally-based fund managers have also typically used a Cayman Islands platform for establishing their private equity and venture capital funds coupled with the incorporation of local SPV's for investing in MEASA-based investments.

## Reasons for the Popularity of the DIFC and the ADGM

## as Fund Jurisdictions

We have witnessed a growing movement in the MEASA region away from domiciling private equity funds in the Cayman Islands to domiciling them in the DIFC and the ADGM. Fund managers are quick to point out the following reasons for this trend:

- the DIFC and the ADGM offer a unique choice of options and platforms to meet the desires of business ventures in the region. They have been very creative at enhancing the private equity platforms that were traditionally offered by offshore jurisdictions like the Cayman Islands. They offer a diversity of choices for the ideal fund structures and licensing options resulting in an unique regional platform to launch, distribute, manage, domicile and promote all types of private equity funds;
- there is a momentum driving private equity activity in the region due, in part, to institutions, high-net-worth individuals and family offices looking to diversify their portfolios by creating a broader local investor-base for regionally themed funds;
- governments in the region are also considering public-private partnerships creating another opportunity for domestic private equity structure;
- fund managers are responding to the desire of venture capitalists, many originating in the United States, the United Kingdom, Europe and Asia, who are looking for liquidity with regional partners supported by highly skilled locally-based service providers and legal counsel who understand the local market and regulatory environment to assist with their unique fund raising objectives;
- the DIFC and the ADGM understand and have instituted a regulatory framework for Shari'a compliance and Islamic finance generally.

## The Growing Popularity and International Recognition of the DIFC and ADGM

### *Proactive and Responsive Regulators*

The DIFC and the ADGM offer similar platforms to those offered in the Cayman Islands, however, both the DIFC and the ADGM offer their clients a regionally-based common law platform with very proactive and responsive regulators. The DIFC is a leading global financial center ranking 8th in the Global Financial Centres Index ('GFCI'). It has been in existence for 17 years now. Many international and regional banks, asset managers and investment advisors are established in the DIFC making it an attractive jurisdiction for financial firms seeking to establish themselves in the region. Alternatively, the ADGM is the newest offshore financial ecentre. It is an attractive jurisdiction for financial start-ups because of its pro-active regulator seeking to position itself as a dynamic and pro-business financial free zone.

### *Venture Capital Initiatives*

The DIFC and the ADGM have made significant strides in the venture capital arena. The ADGM has recently introduced a calibrated venture capital fund manager framework in the region. It has streamlined the applicable regulatory requirements for unlisted, exempt or qualified investor closed-ended private equity venture capital platforms that offer equity positions in domestic companies by way of private placement to 'Professional Clients'. The subscription is limited to US$100 million unless otherwise agreed with the regulator. The features of this regime include the waiver of most of the prudential regulatory requirements. Further, there are no minimum regulatory capital requirements. Building on an objective of decreasing costs for establishing a VC fund in the ADGM, the regulator does not require the VC fund manager to appoint an internal auditor, independent custodian, independent valuer or independent fund administrator. These are very attractive features for start-ups. This new framework is bespoke to the ADGM and has many features aimed at attracting VC managers to set up in this jurisdiction.

The DIFC has also recognised and responded positively to the growing regional venture capital market. The DIFC’s US$100 million FinTech fund was announced during the inaugural Global Financial Forum (‘GFF’), organised by DIFC at the end of 2017. The FinTech-focused fund is set to accelerate the development of financial technology by investing in start-ups from incubation through to growth stage and help FinTech firms looking to access the MEASA markets. The FinTech fund objective is to leverage the DIFC’s FinTech platform consisting of attractive experimental licenses, market leading pricing and collaborative spaces.

## *Marketing Initiatives (Passporting)*

Marketing and promotion of foreign funds in the United Arab Emirates (‘UAE’) imposes additional requirements that domestic funds established in the DIFC or the ADGM do not face. The Securities and Commodities Authority (‘SCA’) Chairman Resolution No. 9 R.M. of 2016 (Concerning the Regulation on UAE) Mutual Funds) (‘Fund Regulations’) and the Chairman of the SCA Board of Directors Resolution No. 3 of 2017 Concerning the Organization of Promotion and Introduction, set out the requirements for the promotion of foreign funds in the UAE. A fund manager who wishes to promote a foreign fund in the UAE has a duty to register the fund with the SCA, annually renew its registration and, subject itself to certain prescribed exceptions (i.e., reverse solicitation and promotion to qualified investors other than natural persons), appoint a local promotor. Registration of a foreign fund requires the funds to be registered or regulated within their foreign jurisdiction or otherwise be able to demonstrate that the fund is not exempted from any regulation or supervision rules or the regulations for preparing and issuing periodic reports at is domicile of incorporation. The SCA will look at each application on a case-by-case basis to determine if the particular applicant meets this standard. While a certificate of good standing from the foreign jurisdiction is occasionally sufficient to meet this threshold (i.e., notably, in our experience, for Cayman Islands’ segregated portfolio companies), often the SCA will require that the foreign fund demonstrate that it is registered or regulated in its home jurisdiction. Since closed-ended private equity funds are not typically regulated in the Cayman Islands, often fund managers will voluntarily register such funds with the Cayman Islands Monetary Authority and incur the additional costs to satisfy the SCA’s registration requirements.

The attraction in establishing a private equity fund in the DIFC or the ADGM is the ability to promote such funds throughout the UAE following the recently signed Passporting Agreement by the SCA, the DIFC and the ADGM. The Passporting Agreement facilitates the mutual promotion and oversight of investment funds established in the different jurisdictions within the UAE with the objective of having greater diversification of investment opportunities and products. The passporting regime enables investors to access growth opportunities with greater ease and efficiency. It will invariably bolster the UAE’s economic diversification strategy and attract more foreign direct investment and new investors and institutions to participate and support the growth of the local economy and the development of the region.

The passporting rules will enable a local fund manager authorised by the DIFC, the ADGM or the SCA to market their funds throughout the UAE without the need for further authorisation or approval, provided they meet the relevant requirements and notify the respective regulators. Fund managers are required to identify the jurisdictions in which they plan to promote their funds and provide a copy of the offering documents. If the fund manager will be engaging placement agents, he/she will need to disclose this information to the relevant regulator. The respective regulators are obligated to maintain a register of passported funds. They have the power to remove a fund from its register if the regulator determines that the fund manager is not complying with the rules, the fund is wound up, or if one of the other regulators or the fund manager requests that the fund be removed.
The passporting rules afford domestic funds in the UAE a significant advantage over foreign funds that wish to promote their funds in the UAE in that they provide a further significant motivation for fund

managers to choose to establish their private equity platforms in the UAE.

## Conclusion

The DIFC and the ADGM have gained international recognition as world-class regulators offering private equity platforms that are competing in a very meaningful way with the traditional Cayman Islands funds regime. They are doing so by being pro-active, cost-effective and extremely creative at meeting and increasingly exceeding the demands of sponsors and private equity and VC fund managers. Each regulator has created flexible fund platforms that are enhanced by the ease of marketing and promotion throughout the UAE through a passporting regime that is resulting in fund managers embracing the DIFC and the ADGM as jurisdictions of choice over the Cayman Islands for MEASA-based investors and investments.

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