The Growing Popularity of the DIFC and the ADGM over the Cayman Islands as a Jurisdiction of Choice for MENA-based Private Equity and Venture Capital Funds

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"The increased popularity of UAE jurisdictions has had a snowball effect. Clients that would have in the past without hesitation gone to other jurisdictions are asking more and more questions about DIFC and ADGM and the rate at which we are being asked to develop local structures is slowly but surely approaching a tipping point."

–*Dennis Ryan*

For any potential manager looking to establish a VC and raise and manage funds in the region, one of the key considerations will be the jurisdiction in which the fund will be set up.

Until recently, the Cayman Islands have been the popular choice for private equity and Venture Capital (''VC'') funds in the MENA region. However, we have been witnessing a growing trend for domiciling these types of funds in the Dubai International Financial Centre (''DIFC'') and the Abu Dhabi Global Market (''ADGM'').

This article looks to provide some key insights into the growing popularity of UAE-based offshore fund domiciling.

One question we are frequently asked, is why not follow the legal fund structures used by the established Silicon Valley VC funds? The first thing to remember is that in the US private equity and venture capital funds are typically established using a Delaware platform or a Cayman Islands platform for reasons, such as tax efficiency in a highly taxed environment, which are specific to the needs of investors in that specific place. This is the primary reason that this remains the dominant structure used by Silicon Valley and New York funds to this day.

Those tax drivers, however, are of minimal relevance to potential fund managers and investors from the MENA region looking to deploy in regionally based portfolio companies. This is one of the key reasons why we are seeing a growing trend away from domiciling private equity and VC funds in the Cayman Islands to domiciling them in the DIFC and the ADGM.

What are the other reasons for the trend?

The DIFC and the ADGM offer very similar platforms to the Cayman platform in that they apply common law and have very proactive and responsive regulators; the key differentiator being that DIFC and ADGM are regionally based.

Dubai is consistently highly ranked in the Global Financial Centres Index which has been in existence for 14 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.

The ADGM is the newest regional financial centre. It is an attractive jurisdiction for financial start-ups because its regulator is proactive and seeking to position itself as a dynamic and pro-business financial free zone.

Both the DIFC and the ADGM have been creative in enhancing their private equity platforms. They offer a diverse choice of fund structures and licensing options, creating a unique regional platform to launch, distribute, manage, domicile and promote all types of private equity (including VC) funds. Another interesting and unique feature is their ability to support a domestic private equity structure as required by public-private partnerships; very much a growing trend encouraged by governments in the region. Finally, they also understand and have instituted a regulatory framework for Sharia compliance and Islamic finance generally which addresses a need that the traditional 'offshore' jurisdictions do not have.

In spite of the region's mixed financial fortunes in recent years, headline-grabbing tech exits such as the acquisitions of Souq.com by Amazon and Careem by Uber are driving extraordinary momentum in the VC space. Tantalised by the rich exits achieved by the early stage investors in these deals, institutions, high-net-worth individuals and family offices from this region have started to diversify their portfolios in new ways.

Undoubtedly, private equity was the predominant 'alternative' asset class in the late 90's and early 'noughties'. However, inherent in the PE model was the requirement that LPs would deploy between USD 10m and USD 100m with fund managers whose strategy was to deploy their committed capital into 10 or 12 portfolio companies with a fairly rigid 'hold period' of around five years. But with high-profile PE failures and a fatigue with the 'two and twenty' compensation model, we have seen a real move by regional investors to reassess the PE model and towards taking similar positions in funds where the GP will look at a much higher volume of earlier-stage deals. VC is, of course, a subset of PE and certainly the pre-cursor to growth stage PE so the investors are not changing focus entirely. Most VC GPs still opt for a 'two and twenty' model but, for the investors, the strategy is now more nuanced with the following being the typical thesis:

- much higher deal volume;
- much smaller ticket sizes;
- co-investment with other funds being the norm and not the exception;
- seeking out earlier stage valuations; and
- accepting that the failure rate can be high but where the smaller proportion of winners will deliver more lucrative exits.

VC funds do, of course, come with substantially diverse investment theses where the strategy can favour specific verticals, business models, geographies and funding round stages. The number of seed funds that are popping up is impressive but, typically, VCs establishing themselves in the region are looking at either the Seed to Series A categories or the Series B to C categories with a few of the bigger funds keeping dry powder, as an integral part of their investment thesis, to double-down in follow-on rounds on their star performing portfolio companies. All of this means that the number of funds and GPs appearing in the VC space is already much higher than the PE firms of yesteryear.

Further, due to a key VC differentiator being the much smaller ticket sizes, there are multiple options for a much larger body of investors who want to get into the space. This is significantly deepening the pool of available investors in the region and another reason why the DIFC and the ADGM have an incentive to establish long-term solutions of their constituents' needs and, increase the offers and services addressing their issues.

Finally, we have also observed a growing trend of international fund managers seeking liquidity in the region. As a regionally based specialist legal counsel, and with our unrivalled understanding of the local market and regulatory environment, we have found ourselves as the first port of call for many such fund managers with their unique fundraising objectives leading them to set up in the DIFC and the ADGM.

> "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 proactive, cost-effective and extremely creative at meeting and increasingly exceeding the demands of sponsors and private equity and VC fund managers."

Do you see any particular developments on the horizon for either the DIFC or the ADGM?

The DIFC and the ADGM have made significant strides in the VC arena. The ADGM recently introduced a calibrated VC fund manager framework streamlining the applicable regulatory requirements for certain types of VC firm to be established with greater ease and speed. The subscription for such firms is limited to USD 100 million unless otherwise agreed with the regulator. The waiver of most of the prudential regulatory requirements and the absence of minimum regulatory capital requirements are key features of such licenses. To assist a VC fund in the ADGM to save costs, the regulator does not require the GP to appoint an internal auditor, independent custodian, independent valuer or independent fund administrator. These are very attractive features for start-up funds. This new framework is bespoke to the ADGM and has many features aimed at attracting VC managers and GPs to set up in this jurisdiction.

The DIFC has also recognised and responded positively to the growing regional appetite for VC as an asset class, establishing the DIFC's USD 100 million FinTech Fund in 2017 which is aimed at investing in start-ups from incubation through to the growth stage in order to 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.

What about fund managers who are marketing or promoting a foreign fund in the region. Do they benefit by establishing their investment vehicles on those two platforms?

Marketing and promotion of foreign funds in the United Arab Emirates imposes additional requirements that domestic funds established in the DIFC or the ADGM do not face. A fund manager who wishes to promote a foreign fund in the UAE has a duty to register the fund with the Securities and Commodities Authorities (‘‘SCA’’), to annually renew its registration and subject itself to certain prescribed exceptions.

Registration of a foreign fund requires the funds to be registered or regulated within foreign jurisdictions 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 its 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.

The attraction in establishing a VC 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. It will enable local fund managers 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.

> “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.”

What effect will that have on the region?

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 proactive, 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 has resulted in fund managers embracing the DIFC and the ADGM as jurisdictions of choice over the Cayman Islands for MEASA-based investors and investments. This 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.