Mixed Messages on Fund Changes

Market still adjusting to regulatory changes, but early indications suggest the need for greater clarity

Summary

Within the space of a few months last year, regulators in the UAE and Saudi Arabia made extensive changes to the rules governing the regulation and distribution of investment funds in their respective jurisdictions. Industry feedback suggests that the actions of the UAE's Securities and Commodities Authority may have done more to reduce market uncertainty.

Key Points

- Mutual fund assets under management in the UAE increased from €21.9 billion (US$24.9 billion) at the end of last year to €26.5 billion by the end of April 2017.
- Following two years of significant growth, mutual fund assets under management in Saudi Arabia declined by more than 30% during 2016.
- Foreign investment is estimated to account for less than 17% of mutual fund assets under management in Saudi Arabia

In separate developments during the second half of 2016, the UAE's Securities and Commodities Authority (SCA) issued new mutual fund regulations and the Capital Markets Authority of Saudi Arabia (CMA) adopted new investment funds regulations.

The new rules appear to have had a positive impact on mutual fund assets under management in the UAE, with analysis by Cerulli indicating that they rose from €21.9 billion (US$24.9 billion) at the end of last year to €26.5 billion by the end of April 2017.

In the same month, Goldman Sachs Asset Management became the first firm to register foreign investment funds for retail investors in the UAE under the new mutual fund regulation with a range of funds including equity, fixed-income, multi-asset and alternative investment solutions. The firm's head of third-party distribution for the Middle East and Africa said the low-yield environment underscores the need for innovative investment solutions that deliver diversified sources of income and rigorous risk management.

A UAE-based lawyer describes the new regulations as a considerable simplification of the requirements for the promotion of foreign funds, with seven articles containing 22 clauses under the 2012 regulations reduced to just one article of five clauses, perhaps reflecting that most foreign funds are promoted on a cross-border basis or under the private placement exceptions.

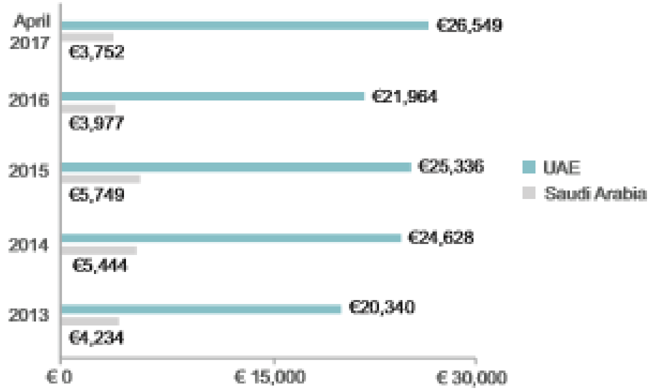
The new regulations also introduced the concepts of feeder funds and umbrella funds. A feeder fund is a public investment fund or part of a group of funds for an umbrella fund which invests at least 85% of its assets in the units of a public master fund or foreign public fund and is excluded from investing in negotiable securities and certain other investments determined by the SCA. An umbrella fund is also a public investment fund but one whose investment policy is represented in establishing affiliate sub-funds.

However, another local lawyer suggests that the regulations have create additional hurdles for those promoting foreign funds in the UAE and will impact foreign firms selling their funds to local investors on a cross-border basis as well as to financial institutions in the UAE financial free zones which promote both foreign and free-zone funds. "For many such financial institutions, the registration of their funds with the SCA (and cost of annual renewal) may involve a cost/benefit analysis," he says.

A senior investment research analyst at Aranca notes that foreign funds have lost several exemptions—one of the most important of which was the private-placement

UAE and Saudi Arabia Mutual Fund Assets Under Management, 2013–April 2017 (€ millions)

Cerulli analysis indicates that new rules have had a positive impact on mutual fund assets under management in the UAE.



Note: Excludes funds of funds | *Sources: Broadridge, Cerulli Associates* exemption—while fund fees have risen significantly. Foreign funds are required to renew their registration annually, which will require submission of annual renewal fees.

Under the previous regulations, private placements by both domestic and foreign funds were exempt from any approvals and licensing requirements. Under the new regulations, the only means by which a foreign fund can market its units in the country is through reverse solicitation where the investor who intends to buy units of foreign funds should apply for it on its own initiative and the foreign fund should not have promoted its units to the investor.

Implications of the new rules are seen to be fairly broad.

Authorization process

According to the head of asset management at Al Masah Capital Management, the new rules introduced in Saudi Arabia and the UAE are fairly broad in their implications and do not seem to target certain product types. The focus is on clearly identifying the origin of the fund and the authorization process it has to go through in order to be distributed legally.

Even though it is some six months since the issuance of the new rules, it is still relatively early to definitively determine their effect on the market, he says. "Over time we will see the true impact, especially as we go through different market cycles. Since the issuance of the rules, regional markets have gone through a volatile, negatively inclined period which in itself would have hindered new fund launches."

Top 20 Funds in UAE and Saudi Arabia by Assets Under Management, 2015–February 2017 (€ millions)

Foreign funds are required to pay a fee to renew their registration each year.

			AUM			NNF		
Rank	**Fund Name**	**Fund Domicile**	**2015**	**2016**	**Feb-17**	**2015**	**2016**	**Feb-17 YTD**
1	AlAhli Saudi Riyal Trade	Saudi Arabia	€ 3,838	€ 4,129	€ 5,251	-€ 590	€ 117	€ 76
2	Samba Saudi Riyal International Trade Finance	Saudi Arabia	1534	1843	2711	-448	208	108
3	Al Rajhi Capital Commodity Mudarabah SAR	Saudi Arabia	2048	1493	2541	-353	-618	294
4	AlAhli Diversified Saudi Riyal Trade	Saudi Arabia	2168	1613	1847	207	-611	229
5	RiyadC-Commodity Trading Fund (SAR)	Saudi Arabia	935	638	1279	-122	-321	226
6	Al Jazira Al Qawafel	Saudi Arabia	317	624	861	73	270	95
7	ANBI - Al-Mubarak SAR Trade Fund	Saudi Arabia	382	595	772	-62	189	34
8	HSBC Amanah Saudi Equity-ASF	Saudi Arabia	527	509	484	-63	-31	4
9	Samba Local Shares Trading - Al Raed	Saudi Arabia	551	507	471	-18	-16	-1
10	HSBC Amanah SAR Trading-ART	Saudi Arabia	427	351	441	-115	-94	49
11	Caam Saudi Fransi AlBadr Saudi Riyal	Saudi Arabia	338	285	441	50	-65	6
12	FALCOM SAR Murabaha	Saudi Arabia	173	188	271	-177	8	7
13	RiyadC-Riyad Equity Fund 2	Saudi Arabia	297	289	266	-25	-12	-1
14	SHC Al Yusr Morabaha & Sukuk	Saudi Arabia	135	173	256	35	29	38
15	AlAhli Saudi Trading Equity	Saudi Arabia	239	249	237	-65	-15	10
16	AlAhli Diversified US Dollar Trade	Saudi Arabia	225	248	234	25	12	5
17	Jadwa Saudi Riyal Murabaha	Saudi Arabia	333	266	233	305	-93	-7
18	SAIB BNP Paribas AMC Trade Finance	Saudi Arabia	215	127	225	-85	-93	17
19	Samba US Dollar International Trade Finance	Saudi Arabia	78	194	196	1	105	-13
20	Al Rajhi Capital Commodity Mudarabah USD	Saudi Arabia	98	155	172	-76	50	11
		Total	**€ 13,911**	**€ 13,486**	**€ 18,129**	**-€ 1,674**	**-€ 963**	**€ 1,174**

Note: Excludes funds of funds

Sources: Broadridge, Cerulli Associates

Rules Governing the Regulation and Distribution of Investment Funds During Reverse Solicitation for the United Arab Emirates and Saudi Arabia, 2016

The UAE has made a concerted effort to clarify and codify reverse solicitation.

	Changes on Reverse Solicitation
United Arab Emirates	2016 regulations have codified the practice of reverse solicitation, expressly identifying it as an exemption.To take advantage of this exemption: (i) an investor must have made an application—on its own initiative—to offer or buy specific units in foreign funds outside of the UAE; (ii) the fund must not have been promoted to the investor in question by the fund or its promotors or distributors; and (iii) there must be documentation to support the above. This formalized exemption removes the risk that was inherent in relying upon mere custom.
Saudi Arabia	Reverse solicitation is unfortunately not addressed in the new IFRs, as it was considered to fall outside the scope of the former IFRs (and therefore not trigger any of the licensing or registration provisions that would otherwise apply). However, in practice reverse solicitation was tolerated by the Capital Markets Authority of Saudi Arabia (CMA), provided the investor was an exempt person (as defined in the CMA's Securities Business Regulations of 2005)8 and either (i) had received permission from the CMA to invest in a foreign fund that was not being offered by a CMA-licensed person or (ii) had initiated the request on its own initiative from outside the kingdom.

Source: Dechert

Aranca's senior investment research analyst agrees that no specific restrictions have been placed on certain product types, apart from the closure of the difference between public and private placements in the context of UAE-based foreign funds. This may, in theory, reduce the foreign fund promoters' operating costs compared with the extensive obligations in the previous regulations.

The definition of a mutual fund remains unchanged from the 2012 regulations, while the definition of foreign fund now incorporates not only mutual funds that are established outside of the UAE but also funds incorporated in any of the financial free zones such as the Dubai International Financial Centre and the Abu Dhabi Global Market.

Al Masah Capital Management's head of asset management is confident that the new rules have enhanced the fund environment by simplifying a process that was prone to misunderstanding—especially in the UAE where there are multiple onshore and offshore jurisdictions. "The new regimes show that both UAE and Saudi market authorities are staying proactive and evolving as the markets evolve, which should provide comfort to existing and new investors," he says.

In Saudi Arabia, a foreign fund can still be offered within the country by way of private placement, while the regulations governing the resale and transfer of the privately placed units have also been relaxed.

> Fund managers that understand the new fund regime, create product and strategy types that appeal to investors, and keep a reasonable profit and cost ratio will be the winners.

High overheads

The simplification of the rules should in practice lower client costs but the reality, keeping in mind the relatively small average fund size in the region and high overheads, continues to present challenges. Fund managers that understand the new fund regime, create product and strategy types that appeal to investors and keep a reasonable profit and cost ratio will be the winners as regional markets evolve.

The UAE has made a concerted effort to clarify and codify reverse solicitation—where previously there was a loose understanding and implementation, the new rules formalize the process. The CMA has not addressed this issue to the same extent, which means that managers will have to wait for further clarity until at least the next rule change.

Aranca's senior investment research analyst notes that the UAE regulations have meaningfully clarified the scope to apply for an exemption. An investor who intends to buy units of foreign funds should apply for it on their own initiative, the foreign fund should not have promoted its units to the investor and there must be sufficient documentation to support these conditions. "The new set of regulations in Saudi Arabia does not offer any clarity on the practice," he concludes. "The CMA has not addressed the controversial issue of reverse solicitation and it is advisable for foreign funds to be careful before opting for this approach." ◆