ANALYSIS: Chinese private fund managers face regulatory, cultural risks when moving into Gulf

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Chinese private fund managers, such as hedge funds, venture capital and private equity managers, face several challenges when moving into the Gulf region. These include their unfamiliarity with local regulatory regimes, differing levels of efficiency and a lack of local connections with limited partners.

That is against the backdrop of geopolitical tensions between Beijing and Washington, triggering venture capital and private equity funds to court Middle Eastern wealth. China increasingly embraces close ties with powers in the Middle East. For example, Beijing brokered discussions for restoring diplomatic relations between Saudi Arabia and Iran in March 2023.

Private fund managers are also facing increasingly tight regulatory scrutiny back home, in particular computer-driven "quant" funds, as Chinese authorities have accelerated their crackdown on "abnormal trading behaviour" to try to revive investor confidence.

"[The] fundraising process in the Middle East region is quite sophisticated, [especially] for the Chinese investment managers," Melody Yang, partner at law firm Simmons & Simmons in Beijing / Shanghai, told a webinar.

The webinar was co-hosted by Simmons & Simmons and Beijing Fund Town, an office park dedicated to the private funds sector in China. It brings together legal, tax and regulatory compliance talent in one location.

Chinese private fund managers' lack of understanding of the local regulatory system, Middle Eastern culture and command of the English language has exacerbated difficulties in their fundraising process.

The UAE is a federation of seven independent city-states, each with its own judicial capacity. Two financial free zones, Dubai International Financial Centre (DIFC) and Abu Dhabi Global Market (ADGM), service international investors in a manner comparable to the Cayman Islands and British Virgin Islands (BVI).

Despite a friendly and mature legal system established under common law in both the DIFC and ADGM, Chinese private fund managers still find it challenging to expand into the Gulf due to differing levels of efficiency, low access to information and uncertainties about potential changes in local market policies.

"Therefore, we must help bridge the gap and improve the level of [the] playing field," said Howard Ching, director of asset management at KPMG China in Shanghai.

Ching spoke at a seminar focusing on Chinese private fund managers' UAE expansion. The seminar was hosted by DBS Bank Hong Kong, Amicorp Group and KPMG China and co-hosted by the Chinese Overseas Private Funds Association (COPFA) in Shenzhen, China.

COPFA is a Hong Kong-based nonprofit organisation that helps support Chinese private fund managers' global ventures.

Chinese investment managers' UAE ventures are part of the country's effort to help its private sector expand abroad, including financial services and investment management.

Funds distribution under DIFC

Hong Kong fund managers, licensed as "type 9 asset management" under the Securities and Futures Ordinance by the securities regulator, have long preferred to set up Cayman Islands-domiciled, open-ended fund company vehicles, mostly for running hedge funds. The Securities and Futures Commission (SFC) introduced the open-ended fund company as a new legal vehicle to Hong Kong in 2018 to grow Hong Kong-domiciled hedge funds.

"Cayman-domiciled private funds managed by a type-9-licensed Hong Kong fund manager is a widely accepted method for distributing foreign funds to the DIFC," Yang said, adding that Chinese private fund managers may begin their UAE funds distribution journey by first becoming a qualified Hong Kong fund manager.

It is difficult for Chinese private fund managers to open bank accounts in Hong Kong prior to obtaining a Hong Kong fund manager licence because of the stringent regulatory compliance measures, including anti-money laundering (AML) and combating the financing of terrorism (CFT) requirements, said Josephine Chung, director at CompliancePlus Consulting in Hong Kong.

Managers must be mindful of substantial shareholding disclosures and comply with continuous litigation disclosure requirements when applying for a Hong Kong fund manager licence, Chung said. Foreign funds domiciled outside the DIFC can be marketed in the financial free zone by firms authorised by the Dubai Financial Services Authority (DFSA).

Such firms can market units of foreign funds "if, [for example], the foreign fund meets the criteria for a designated fund, e.g., Hong Kong-domiciled funds authorised by the SFC under section 104 of the Securities and Futures Ordinance in a recognised jurisdiction, e.g., Hong Kong," the SFC said in a paper titled "Offering of Hong Kong Domiciled Funds in DIFC," published in early April.

This followed a high-level roundtable discussion held by Hong Kong and Dubai financial authorities on opportunities for Hong Kong asset managers to distribute funds in the DIFC.

"Chinese private investment managers who obtain a 'domestic fund manager' licence from the DFSA are eligible to directly distribute [their] private funds to the local investors," said Yuying Wang, managing associate at Simmons & Simmons in Beijing.

A fund or asset manager will require a category 3C prudential licence to become authorised as a domestic fund manager, according to a report titled "A Guide to the DIFC's Fund Regime," published by Waystone, a compliance solutions provider.

Chinese managers can also employ a qualified third-party entity to help distribute their funds in the DIFC without obtaining a domestic fund manager licence from the DFSA, Wang said. "Many commercial banks are qualified to act as a third-party entity, or the investment manager can also engage with a placement agent locally."

Cultural, regulatory influence on fundraising

Despite a 22% fall in fundraising across private market asset classes globally as of late 2023, the Middle East has still been growing, said James Yu, principal at Atlantic Pacific Capital in Hong Kong.

"The main trend [is] that Middle Eastern limited partners are definitely set to grow," said Yu, who acts as a placement agent. Data from the Global Private Capital Association shows that private capital investment in the Middle East grew 30% in 2022 to $19.8 billion, from $15.2 billion in the previous year.

Sovereign and pension funds continue to play a significant role in fundraising. Emerging investment managers should closely examine family offices and ultra-high-net-worth individuals, whether through a private wealth channel or through multi-family offices that manage money on their behalf.

Culturally, the UAE is a relationship-driven society, which defines business conduct. Fundraising should be planned for at least 12 to 18 months, as "it takes time for those local limited partners to get comfortable with you," Yu said.

The complexity of the UAE's fundraising process stems from three different regulators overseeing onshore activities, the Dubai International Financial Centre and the Abu Dhabi Global Market, Yang said.

"Limited partners categorised under different governing bodies are subject to different regulations," Yang said.

Understanding the different types of limited partners, whether sovereign, pension fund, family office or high-net-worth individual, is crucial because different regulations govern different types of limited partners. The nature of how an investment manager engages with a limited partner is also important. Whether it is through someone's introduction so that a manager proceeds with a roadshow for the limited partner, the manager needs to do a one-on-one call, or the limited partner contacts the manager first.

"The different nature of action and engagement during the fundraising process will be taken into consideration by the DIFC regulator, as ultimately these free-zone financial regulatory authorities are aiming to protect their investors' interests," Yang said.

Private managers should talk to experienced people in the industry. This will help them navigate the landscape based on "what you're trying to do, from where and who you're targeting," said Gregory Man, partner and head of finance and financial regulation (Middle East) and global head of Islamic finance at law firm Bird & Bird in the UAE.

Investment strategies must comply with codes of conduct, such as when tapping into Islamic liquidity, which means the portfolio should be Sharia-compliant. Managers must be accountable and transparent toward local investors.

(Yixiang Zeng, Regulatory Intelligence)

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