KING & SPALDING

Client Alert

Financial Services Regulatory and Funds Practice Group

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New Prudential Rules for Investment Management and Advisory Firms in the Qatar Financial Centre

On 1 January 2015, new prudential rules for Investment Management and Advisory firms in the Qatar Financial Centre (QFC) came into force. The revisions, contained in the Investment Management and Advisory Rules 2014 (INMA), support the QFC Regulatory Authority's commitment to the continued development of the QFC as a leading financial and business centre in the Middle East and as a viable alternative to the UAE's Dubai International Financial Centre (DIFC). The Dubai Financial Services Authority (DFSA) made changes to its prudential rules back in 2012 in order to align the DIFC regime more closely with the requirements of Basel III.

It is often noted that the regulatory regimes of financial and business centres established in the Middle East with the aim of attracting international financial services institutions do not reflect the reality of the nature of the institutions that they host. The decision of the QFC Regulatory Authority to simplify its prudential rules in respect of investment management and advisory business and set them down in a stand-alone user-friendly rulebook represents a step in the right direction to addressing this perceived in-balance. This Client Alert outlines the new prudential requirements for firms undertaking Investment Management or Advisory business in the QFC and compares the position with that currently applied in the DIFC.

A New Rulebook

The QFC Regulatory Authority has scrapped its previous numbered prudential categories in favour of rules which apply to the type of regulated activities being undertaken: firms previously categorised by PIIB as a prudential category 3 or 4 firm will now be subject to prudential rules for Investment Management or Advisory businesses. Investment Management business encompasses the regulated activities belonging previously to prudential category 3 of dealing in investments as agent, managing investments, providing custody services, operating a collective investment scheme (CIS) and providing custody services to a CIS. Advisory business encompasses the regulated activities belonging previously to prudential category 4 of providing scheme administration for CIS, arranging deals in investments, arranging credit facilities, arranging the provision of custody services and advising on investments.

The DFSA, however, maintains the numbered prudential categories and splits the previously existing prudential category 3 into sub-categories: 3A (dealing in investments as matched principal or as agent), 3B (providing custody for a fund or acting as trustee for a fund) and 3C (managing assets or funds,

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providing trust services, providing custody other than for a fund), so as to permit for a more risk-sensitive and tailored application of prudential rules. The DFSA's prudential category 4 broadly equates to that which the QFC Regulatory Authority terms Advisory business.

One of the key differences between the regimes is the treatment of the regulated activities of dealing in investments as principal and as agent. In the QFC, a firm undertaking the regulated activity of dealing in investments as principal would fall within the requirements of the new Banking Business Prudential Rules 2014, whereas undertaking the regulated activity of dealing in investments as agent would mean the application of the rules in INMA. The position in the DIFC is more nuanced. A firm undertaking the regulated activity of dealing in investments as principal would be classified as a prudential category 2 firm and subject to rules similar to those provided for under the Banking Business Prudential Rules 2014. A firm dealing in investments as matched principal or as agent would be classified as a prudential category 3A firm under the DFSA rules. However, the DFSA rules for a prudential category 3A firm still provide for a Risk Capital Requirement and a Capital Conservation Buffer, whereas INMA does not.

Regulatory Capital Requirements

Under the previous prudential regime in place in the QFC, the minimum regulatory capital requirement consisted of three components: the Base Capital Requirement, the Risk Based Capital Requirement and the Expenditure Based Capital Requirement. In practice, for a majority of prudential category 3 or 4 firms, the regulatory capital requirements are driven off expenditure. The new rules acknowledge this reality and require firms undertaking Investment Management or Advisory business to hold regulatory capital consisting of a minimum paid-up share capital requirement (in lieu of the Base Capital Requirement) and the Expenditure Based Capital Requirement.

Previously, the Base Capital Requirements in the QFC have, for certain regulated activities, been higher than the equivalent requirements applicable in the DIFC (for example, the Base Capital Requirements for a prudential category 4 firm in the QFC was $250,000 compared to $10,000 in the DIFC). These nominal amounts remain unchanged (save for the amounts are now quoted in Qatari Riyals rounded to the nearest thousand as opposed to US dollars) but the requirements will be met through minimum paid-up share capital requirements. This is in contrast to the position in the DIFC, which permits a broader range of Common Equity Tier 1 capital to meet base capital requirements.

Under the QFC rules, the Expenditure Based Capital Requirement will constitute a standard ratio for all firms: 13/52 (25%) of the QFC entity's annual operating expenses. The DFSA applies the same ratio for its prudential category 3A, 3B and 3C firms; however, it applies a higher ratio for firms holding client money (18/52) and a lower ratio for its prudential category 4 firms (6/52). Although the simplicity of having a single ratio for all firms may be appealing, the DFSA's approach of applying a different ratio better reflects the risks attached to the activities being undertaken. However, where these ratios fall may well influence where new firms choose to establish operations in the Middle East.

Treatment of Branches

Regulatory capital requirements in both the QFC and the DIFC differ depending on whether the firm is established as a domestic firm or registered as a branch entity.

The minimum regulatory capital requirements set-down in INMA do not apply to a firm that is a branch entity operating in the QFC. The QFC Regulatory Authority does however impose a notification requirement on firms in the event that it breaches a prudential requirements set by its home State financial services regulator and may require copies of any prudential returns made.

In the DIFC the positon regarding branches is more involved than is the case in the QFC. A branch entity in the DIFC must ensure that it maintains at all times liquid assets and access to financial resources which are adequate in relation to the nature, size and complexity of its business to ensure that there is no significant risk that liabilities cannot be met as they fall due as well as ensuring that it complies with its home state financial services regulator's prudential requirements. Furthermore, the branch must have systems and controls to enable it to determine and monitor its capital requirements and determine whether the amount of its capital resources is, and is likely to remain, greater that the amount of its capital requirement.

Professional Indemnity Insurance
The Risk Based Capital Requirement for investment management and advisory business under INMA is removed and has been replaced by the requirement that firms put in place an adequate amount of Professional Indemnity Insurance (PII) determined by the firm's governing body having regard to the nature, scale and complexity of that firm's business. This acknowledges the fact that the greatest risk facing such firms is operational risk and that such risks can be effectively mitigated by PII cover as opposed to a regulatory capital add-on. This approach is also taken in the DIFC for prudential category 3B, 3C and 4 firms.

However, INMA does provide that a firm need not maintain PII if another firm is able to provide a guarantee in the amount of the minimum PII cover. However, the guarantor firm must have net tangible assets of more than QR35 million (approx. $10 million) and must be a group company where a group company meets this criteria. This position is not provided for under the DFSA rules; however, a number of firms have been granted a rule waiver in respect of PII requirements where the DFSA considers that the firm can place reliance on the financial resources of its parent to cover operational risk exposures.

King & Spalding
King & Spalding assists clients with establishing investment management and advisory entities in both the QFC and the DIFC and can provide bespoke structuring advice in respect of operations in the Middle East.

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