Quicksands: legal and enforcement rules affecting cross-border supply of financial products and services into the Gulf

Muhammad Abdullah Al-Harith Sinclair is a Partner in the law firm Pinsent Masons LLP and advises international clients on financial services marketing and selling restrictions applicable to targeting investors in the Arabian Gulf, using Pinsent Mason’s cost-effective “PRICE” (Prior Risk Information on Compliance and Enforcement) methodology.

Introduction: a garden of rich pickings surrounded by (new) thorns
The attraction of the petroleum-derived capital richness of potential investors located in the Gulf States (which are united together in a union called the Gulf Cooperation Council (GCC)) has never gone unnoticed by international asset managers and international securities marketing and sales firms. These investors include both sovereign wealth funds and other investors but something important has changed and that is the degree of care needed in accessing this market. While in the past the nature of financial regulation in the Gulf countries was relatively weak, vague and non-enforced, this has been fast changing in recent years. Recently, all the GCC countries have new stricter rules on cross-border marketing and selling of funds and securities to investors located in those countries and they also have greater enforcement of those rules.

The old days, or the Wild East
Back in 2007, and in relation to the United Arab Emirates (UAE), an excellent article was written by the editor of the International Financial Law Review called “Dubai and the UAE: Built on Shifting Sands”. The article stated that “Theoretically, there are fairly strict selling restrictions for securities in the UAE... and prior approval of the central bank should be obtained. But practically, as long as the offering does not involve widespread solicitation to unsophisticated investors, the central bank does not pursue issuers who have not strictly complied with the law.” The article mentions that “many in the region say this happens...speaking of “meetings with small groups in hotel rooms””.

The position now: a myriad of tougher regulatory rules and enforcement attitudes
If the rules in GCC countries on cross-border business funds and securities marketing and sales were shifting sands in 2007 then, by 2011, they are now treacherous quicksands of the first order. Those who wish to navigate the relevant rules and practices need guidance from lawyers who understand both international marketing practices and local laws and norms. The rules of the game have changed dramatically since 2007 – and in fact the winds of legal and regulatory change in this area had started blowing even before that.

A veritable revolution has occurred, and is still underway, in the financial regulatory laws and the enforcement attitudes the GCC countries. Legal, regulatory and enforcement reform has been an accelerating trend in these countries – but not necessarily along lines that are readily recognisable to those businesses based in western jurisdictions.

Why have laws and enforcement attitudes changed? Well, apart from the obvious reason that regulators benchmark each other and no regulator wants to be seen as undeveloped by their professional peers, there is a more fundamental reason. Regulators in the GCC countries were under pressure from their own national institutions and their own citizens to tighten up their rules and systems to offer protection of one type to their own consumers and of another type to their own locally regulated financial institutions.

Against this backdrop, international fund marketers blatantly ignoring local laws and engaging in fly-in-fly-out salesmanship was understandably seen as an insult by local financial regulators who came in for increasing domestic criticism within their own countries particularly due to the periodic occurrence of boiler-room scandals where local nationals were sold fake or worthless securities by what was probably in fact a relatively small number of outright fraudsters.

Why is this important?
The challenge is that many international asset managers and investment firms are unaware of this - displaying a herd of sheep mentality that still harks back to the time when the prevalent sentiment amongst international investment salespersons was ‘suitcase marketing into the Gulf - not be a problem – grey rules and no enforcement’.

A number of such behind-the-curve salespeople have been getting their employers into trouble recently. This may not have been intentional on the part of these marketers – often they either themselves conducted or their peers conducted fly-in-fly-out marketing, or other forms of cross-border activity, into Gulf States for so long that it is hard for them to now adjust to the fact that the rules of the game have changed.

But Gulf financial regulators lenience towards excuses of the “this was unintentional - please let us off this time” type, from the international firms employing such marketers, has run thin.

The penalties for getting it wrong
The penalties for an international asset manager or investment adviser (including, as we will see below, DIFC or other single GCC jurisdiction based firms) in marketing or selling their products or services in a GCC jurisdiction where they have no local licence, in contravention of laws and regulations in that jurisdiction will vary according to the GCC country concerned and according to the nature of the contravention.

But there should be no doubt the state enforcement penalties could include imprisonment and fines for salespersons caught undertaking illegal activities in the GCC country concerned, through unlimited fines for international firms responsible for such activities, through loss of licences if any in that country, and perhaps most importantly, potentially global damage to the most important asset of any firm in today’s marketplace - ie. damage to a firm’s international reputation. Knock-on effects for firms regulated in other jurisdictions can involve investigations and penalties being imposed by their home regulators.

In cases where an international asset manager or investment firm has any type of regulated presence in the GCC country concerned, or indeed if any other company in the same group or run by the same people has interests in the GCC country concerned, violations attributable to one group company could result in enforcement actions being directed against the group as a whole, with potential...
severe financial costs and reputational implications for the international firm.

**Different legal and court systems: a whole different category of risk and penalties**

There is a wholly different set of risks facing firms engaging in cross-border marketing of funds, securities and/or investment advisory services to potential customers located in GCC countries - and this is a second key risk area of which many international firms are, in this author’s experience, often simply unaware. This relates to vast differences in the nature of the legal and court systems in the GCC countries as compared to legal systems in other countries.

For international asset managers and investment firms located in or run by persons with a US, UK or Commonwealth background, there is the fact that all of the GCC countries have legal systems that are based on varying implementations of, interpolations between and variations upon, European Civil Law. Unlike English Law sourced Common Law (found in the UK, the US and most Commonwealth countries), Civil Law provides relatively many more opportunities for judges to override the plain language intention of the parties as specified in written contracts between those parties.

Thus, in certain circumstances, the judge can do this because his country’s Civil Law’s may provide binding statutory protections and judicial discretion provisions that override what parties have agreed in writing. This is particularly dangerous for international suppliers of financial instruments and advice to nationals of GCC countries since nationals of GCC countries often benefit from both explicit constitutional preferential treatment and de facto preferential treatment from judges in cases before local courts in the GCC.

In many cases in the GCC, foreign choices of law or jurisdiction will be routinely ignored by local courts if a local national is involved, local courts may assert jurisdiction and local law may apply even if another law and court jurisdiction was specified in any contract – and the matter may be dealt with and disposed of in the manner deemed most fitting by the local judge, who may or may not speak full English.

As the reader will by now readily understand, if an international firm or their salesmen has sold funds or investment advice to a local national and that investor then becomes dissatisfied with the performance of the securities or the advice then the local investor can go straight to their local court. Will their action against the international firm succeed?

Well, if the marketing or selling of the funds, securities or advice did not comply with the financial regulatory requirements of that country in the first place (and the judge is probably bringing in the regulator to take its own simultaneous enforcement action) then the defending salesperson and their firm are automatically on the back-foot from the start. There may not be any written or other record of exactly what went on between the salesperson and the investor before the product or the advice was sold. Accordingly the local national is in a position, whether honestly or dishonestly, to say that the promised returns were much, much higher than what actually materialised. So any such action brought by a local national against an international firm, in circumstances where the international firm’s marketing and sales to that investor were illegal in the first place, has a good chance of success.

Therefore, in such circumstances, due to its own failure at head office level, i.e. at senior management level, to make itself aware of the relevant GCC country’s current marketing and selling laws and regulations, the asset manager or adviser may now face not only financial regulatory enforcement action in that GCC country and perhaps in their own home country, with unpredictable financial and regulatory penalties in both places, definite reputational damage both locally and globally – but it may also face financial judgements against it in the GCC court forcing it to recompense the local investor(s) to profit level that the investor(s) allege was promised in the sales pitch for the funds, securities or in the investment advice.

**Another misunderstanding best avoided**

No discussion of the marketing of funds and portfolio investment services in the Gulf would be complete without mentioning a further class of particularly persistent and increasingly incorrect misunderstandings: that there are particular jurisdictions in the Gulf where if a licence is obtained then that licence can be deployed as a valid licence for marketing throughout the rest of the Gulf – this is a completely erroneous notion.

Readers would be astonished if they knew the number of times this author has been approached by international clients who needed to be rapidly disabused of the notion that the GCC is a ‘passing’ zone like the European Union, where a licence gained in one member jurisdiction can be used to undertake business in any other member jurisdiction. This is not the case. A licence issued in a particular GCC country to carry on financial services, whether it be securities marketing and sales, investment advice, or even a completely different type of financial services such as insurance marketing and sales, is of no use whatsoever in any other GCC country.

In the UAE, where the DIFC is located in part of Dubai, the situation is that there in fact two completely different and separate licensing jurisdictions for financial services within the UAE: the DIFC and the rest of the UAE. The DIFC is a small (approximately 100 acres) financial services free zone that is geographically onshore but legally offshore. Its financial regulation and laws are constitutionally carved out of and separate from the rest of the UAE - the important exception to this being the Federal Penal Code (criminal law) that applies throughout the UAE including the DIFC.

So let this author put readers in the picture. A financial services firm licence from the financial regulator in the DIFC, namely the Western-modelling Dubai Financial Services Authority (DFSA) is, in legal and regulatory terms, is no more valid in the rest of Dubai outside the DIFC, or in Abu Dhabi or anywhere else in the DIFC than would be a London or New York licence.

**What can be done to reduce or avoid these types of risks in cross-border marketing and sales?**

From working closely with local counsel in each and every country in the GCC, namely the UAE, Saudi Arabia, Bahrain, Qatar, Kuwait and Oman, this author can categorically state that the market practices referred to in the 2007 article cited above – which were not advisable even then (including for reasons that are outside of the purely regulatory system as are discussed elsewhere in this article) – are now outright inadvisable in each and every GCC country. The laws in each of these countries are very different from each other and the financial services regulatory and enforcement systems in each are at different (fast moving) stages of development.

So responsible and/or risk averse fund managers and others wishing to sell funds and other securities into the GCC states need to find out what are the rules and acceptable practices for cross-border marketing and sales into these countries. However, only a limited number of lawyers have an overview of the rules in all the GCC countries since this comes from deep involvement in this area and liaison with local counsel in each jurisdiction.

**Fools rush in where angels fear to tread, or look before you leap**

By obtaining guidance from lawyers who have familiarity with the financial regulations and enforcement rules are in all of the GCC countries, international asset managers and investment firms and investment advisors can get an early idea of which GCC countries where which they wish to target potential investors pose what marketing and selling problems and risks and what may be the techniques to reduce these risks to acceptable levels.
The right solution for internationally based firms targeting investors globally is highly unlikely to be applying for a licence in all the GCC countries where it wishes to target investors (though a licence in one jurisdiction may be well worth it just for the marketing advantages of showing a commitment to the region).

Rather, in most cases the solution will be, where possible, to find mechanisms that the international firm can use to give itself some credible claim that it has tried to follow practices that are legal and acceptable for each specific type of marketing and sales in each particular GCC country. In relation to marketing, for example, certain, but definitely not all GCC countries will treat more favourably marketing that can, using various techniques, be characterised as having taken place at the instigation of the local investor. In relation to sales, for example, in certain, but it must be stressed not all, GCC countries there is a relatively useful degree of protection from regulatory risk that can be obtained by ensuring that any transactions are at least technically consummated outside of the jurisdiction.

Final considerations for cross-border financial services into the GCC countries
Legally unregulated private placements do not exist as a concept in most GCC countries. Most GCC countries do not have any categories of sophisticated investors to whom marketing or sales of financial instruments or advice can be directed. Most GCC countries have the same rules for sales and marketing to their sovereign wealth funds as to their individual citizens. Lowering risk in these jurisdictions is possible if the right steps are taken. However, prior legal consultation is essential before marketing or selling any funds, securities or investment advice on a cross-border basis into any GCC country.