

Venture capital investment in United Arab Emirates: market and regulatory overview

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MARKET OVERVIEW

1. What are the main characteristics of the venture capital market in your jurisdiction?

Venture capital and private equity

Venture capital (VC) is a growing industry in the United Arab Emirates (UAE). As the VC market is not yet fully developed, the definition of VC is often construed broadly in the UAE and includes:

- Angel investments.
- Traditional VC funding.
- Crowdfunding.
- Small-market private equity investments.

VC funding is generally made available to entrepreneurs in the seed capital, start-up, and growth phases of the target company. As liquidity improves and VC becomes a more consistent funding option, entrepreneurs and investors will likely construe VC more narrowly, as is the case in jurisdictions with a longer history of VC financing.

Private equity (PE) investments in the UAE can overlap with what are traditionally considered to be VC investments, particularly in the case of small- and medium-sized enterprises (SMEs) and in the growth phase of the target company. However, PE investments differ markedly from VC investments in the UAE in a number of ways. While PE funding is available for expansion projects for SMEs, it is more commonly used to finance infrastructure and development in mature companies. In addition, PE investments pool funding from different sources than those available in the VC market and are used for more capital-intensive industries (see *below*).

Sources of funding

The most common sources of funding for early stage companies in the UAE are:

- Personal finance.
- Funding from family and friends.
- Angel investment (often from high net-worth individuals).
- VC funds.
- Funding from strategic investors.
- Bank finance (to a lesser extent).

By contrast, funding for PE investments can be derived from banks, companies, pension funds, insurance companies, and government institutions (particularly in Dubai and Abu Dhabi). It is also common for sophisticated high net-worth individuals, wealthy local family businesses, and sovereign funds to provide PE funding.

Types of company

As noted above, VC investments are made in a broad range of enterprises in the UAE (including start-ups and growth phase SMEs) and are also sought at the seed capital stage. As with most jurisdictions, VC firms tend to invest heavily in companies in the technology-media-telecommunications (TMT) sector. However, given the reluctance of banks to provide financing to start-ups, VC is also sought by businesses in a number of other industries, including food and beverage, retail, education, and healthcare.

By contrast, PE investment is generally used in larger enterprises that are in their growth or development phases. In addition, while PE is a common source of funding in the TMT sector, it is also heavily used in oil and gas projects and other energy companies.

Market trends

There has always been a small market for VC in the UAE, and the economic downturn has led to a severe decline in the level of VC activity as investors became more cautious. Consequently, during that decline it was common to see parties attempting to renegotiate or cancel proposed investments by citing the economic climate as a *force majeure* event and agreeing to new terms to facilitate the investment.

However, there has been a recent increase in VC activity in the UAE, particularly in the Emirate of Dubai as it commonly serves as a regional hub for expansion into other countries in the Middle East, North Africa and South Asia. While investors are still taking a measured approach (and in many cases providing funding only to more proven growth-stage companies), VC firms are more readily providing seed capital financing and commercial assistance (including incubator services) for entrepreneurs and start-up companies. Government entities have also ramped up their efforts to assist early stage ventures. Two free zones (in particular Dubai Silicon Oasis in the Emirate of Dubai and twofour54 in the Emirate of Abu Dhabi) provide seed funding, training, and strategic advice for entrepreneurs in the TMT sector. As the availability of funds for start-ups improves, there will be more opportunities for venture capitalists to invest in more mature businesses.

2. Are there any recent or proposed regulatory changes affecting the venture capital industry?

Draft SCA Regulations

The regulation of local funds and promotion of foreign funds in the UAE must comply with the Resolution No. 37 of 2012 Concerning Regulations of Investment Funds (SCA Regulations), which have imposed significant restrictions on a fund's ability to market its units (see *Question 7*). Consequently, many venture capitalists prefer to establish foreign funds and offer units only to UAE investors who engage the fund independently (that is, without marketing by the fund in the jurisdiction) in order to avoid the purview of local authorities (see *Question 10*).

The Securities and Commodities Authority (SCA) is currently contemplating a significant overhaul of its funds regime. The SCA Regulations govern the registration, licensing, management and administration of foreign and domestic mutual funds in the UAE (see *Question 10*). SCA is currently in the process of finalising the amended SCA Regulations, along with supplements and guidelines. These are intended to bring the funds regime in line with comparable jurisdictions to further promote the establishment of local funds and registration and marketing of foreign funds in the UAE. The draft rules will, among other things:

- Ease investment restrictions imposed on fund managers and sponsors.
- Distinguish between professional and retail investors.

SCA is contemplating enacting guidelines to the SCA Regulations, as well as three mutual fund supplements, which will provide additional rules that are applicable only to exchange traded funds, private equity funds, and real estate investment trusts. SCA intends to implement the new regulations in 2016.

DIFC Collective Investment Funds

The Dubai International Financial Centre (DIFC), a financial free zone established in the Emirate of Dubai, has made a series of changes to the regulations applicable to collective investment funds in order to encourage the establishment of such funds in the free zone. The DIFC's funds regime is discussed more fully in *Question 7*.

Companies Law

In 2015, the Federal National Council adopted Federal Law No. 2 of 2015 (Companies Law), which has made a number of changes to the existing federal companies law. The Companies Law expressly allows a shareholder to pledge its shares in a limited liability company to another shareholder or a third party and establishes the requirements to effect the pledge. While the procedure related to such pledge is still being finalised, this measure should improve enforceability of liens and promote lending in the UAE, including in the form of convertible debt that is common amongst VC investors.

Draft Insolvency Law

The legal framework governing insolvency in the UAE is primarily set out in the UAE Commercial Code, and it has remained essentially unchanged since this law was passed in 1993. The insolvency regime is still largely untested in practice, as debtors and creditors tend to avoid lengthy court proceedings and opt instead for commercially agreed solutions outside of the courts.

The UAE government has been developing an entirely new insolvency law for the UAE, which is likely to replace the existing legislation as and when it comes into force. The new legislation is expected to substantially overhaul the current regime and to create a specialised tribunal to oversee insolvency proceedings, which should improve lender confidence and encourage debt financing in the UAE. The draft Insolvency Law has yet to be released publicly, and the expectation is that the legislation will not be finalised and put into effect for at least another one or two years (if not longer).

Proposed tax regime

With few exceptions, the UAE is generally a tax-free jurisdiction (see *Question 3*). However, in December 2015, the undersecretary of the UAE Ministry of Finance revealed that the GCC states have agreed on key issues for implementing a value added tax (VAT) in the region. Initial reports suggest that rates in the region may initially be around 3% to 5% and that healthcare, education and certain food items would be exempt from the tax. The UAE tax law is currently being prepared, and a draft has been sent to the Technical Committee for Legislation at the UAE Ministry of Justice. The VAT is expected to be introduced in the UAE and across the GCC in 2018.

Also, the International Monetary Fund (IMF) has been advising the UAE government regarding further tax initiatives. In particular, the

IMF has suggested that the UAE impose an excise duty on the sale of automobiles and broaden the applicability of the corporate income tax (while reducing the percentage payable by each individual payor). The proposed tax regime may serve to discourage VC investment in the UAE.

TAX INCENTIVE SCHEMES

3. What tax incentive or other schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

With the exception of foreign banks and oil producing companies, no income tax is imposed on businesses in the UAE.

VC funds can be formed in the DIFC (see *Question 7*). The DIFC has a mandate to remain tax free for 50 years (from its establishment in 2004), and this mandate is renewable for an additional 50-year period.

FUNDING SOURCES

4. From what sources do venture capital funds typically receive funding?

VC fund subscribers include:

- High net-worth individuals.
- Wealthy local family businesses.
- Institutional investors, such as pension funds, endowments, insurance companies and banks.

FUND STRUCTURING

5. Can the structure of the venture capital fund affect how investments are made?

All companies established onshore in the UAE (including investee companies and VC funds) are prohibited from having multiple classes of shares (see *Question 7*). Accordingly, many VC funds established in the UAE invest in target companies through debt rather than equity.

6. Do venture capital funds typically invest with other funds?

It is uncommon for VC funds to invest with other funds in the UAE. The restrictions imposed by the SCA Regulations (see *Question 7*) provide that an applicant must obtain waivers from local authorities to establish a domestic fund to act as a feeder fund that invests in an underlying fund or act as a vehicle to invest in markets outside the UAE. The approval process for such waivers remains generally untested, as the SCA Regulations are relatively new and will change soon (see *Question 2*).

7. What legal structure(s) are most commonly used as vehicles for venture capital funds?

VC funds may be established onshore in the UAE, as well as in the DIFC. Onshore foreign funds are uncommon in the UAE, as the legal and regulatory requirements imposed by the Central Bank and SCA are onerous (see *Question 10*).

The three types of corporate entities that can be used to establish a domestic fund in the DIFC are:

- Investment companies.
- Investment trusts.
- Investment partnerships.

While trust structures are predominantly used for property funds, investment partnerships are more commonly used for private equity and VC funds.

Also, VC funds established as offshore limited partnerships and exempted companies are commonly used to invest in UAE companies (see *Question 12*).

INVESTMENT OBJECTIVES

8. What are the most common investment objectives of venture capital funds?

It is common for VC funds in the UAE to be industry-specific, although there are a number of funds that have broad investment objectives. The of VC funds is commonly eight to ten years with possible extensions at the investment manager's discretion, which serve to align the investment term with anticipated liquidity events of the underlying investments. The expected return for a VC fund in the UAE can range from 12% to 20%.

FUND REGULATION AND LICENSING

9. Do a venture capital fund's promoter, manager and principals require licences?

A venture capital fund's promoter, manager and principals require licences. See *Question 10*.

10. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

The UAE Central Bank (Central Bank) and the Emirates Securities and Commodities Authority (SCA) are generally responsible for the regulatory oversight of financial activities in the UAE outside of the DIFC, where the Dubai Financial Services Authority (DFSA) carries out such functions. When examining the regulation of VC funds in the UAE, the laws and regulations applicable to both the UAE and the DIFC must be considered.

UAE funds (onshore)

Central Bank authorisation. Federal Law No. 10 of 1980 (Banking Law) is the primary legislation giving the Central Bank the authority to regulate financial services in the UAE. The Banking Law provides for the licensing and regulation by the Central Bank of a wide variety of financial institutions, including those seeking a licence to establish a VC fund.

Each of the entity structures that are permitted to establish an onshore fund requires a UAE national to hold at least 51% of its shares. However, finance companies, commercial banks, and investment banks (the most common entities through which funds are established) must have a minimum UAE national shareholding of 60%.

Once an entity becomes licensed, it is eligible to market its investment funds (including any VC funds) in the UAE, provided that it complies with the SCA Regulations (see *below*). The Central Bank requires investment funds to have a prospectus, which must include:

- The objective of the fund.
- Its investment policies.

- The means by which its assets will be valued.
- The manner in which the fund will be managed.

The Central Bank imposes no general restrictions on investments or leverage, but may require certain conditions to be met at the time of registration or authorisation.

SCA authorisation. Local funds offered in the UAE must comply with the SCA Resolutions. In particular, the SCA Regulations require each local fund to obtain a licence issued by SCA, and the fund must either be a UAE joint stock company or a UAE branch of a duly licensed foreign company. The regulations also require the sponsor of a local fund to contribute at least 3% (but not more than 49%) of the capital in order to align the interests of the fund's promoters with those of the other investors.

While the SCA Regulations specify the type of entity that can act as the sponsor of a local fund, it does not prescribe a particular entity form for the fund itself. A local fund must also have a minimum capital of AED30 million. Some of these restrictions are likely to change with the proposed amendments to the SCA Regulations (see *Question 2*).

The SCA Regulations include several restrictions for a local fund, including:

- Minimum requirements for the fund offering documents (which must be in Arabic) and the investment policy.
- Specific investment ratios on certain assets.
- A restriction on pledging funds to repay liabilities.

Foreign funds. Onshore funds are uncommon in the UAE, as the legal and regulatory requirements imposed by the Central Bank and SCA are onerous. In addition, the Companies Law prohibits companies outside of the UAE's free zones from issuing different classes of shares. This restricts the ability of VC funds to create suitable entities. Therefore, VC funds are generally established in the DIFC or through a foreign registered entity, such as a partnership established in the Cayman Islands, the British Virgin Islands or Delaware (if the fund is seeking US investors).

Foreign funds must be registered with the Central Bank and must comply with the SCA Regulations. Specifically, a foreign fund seeking to market its units in the UAE must:

- Obtain SCA approval to promote its units in a public offering.
- Be licensed to promote public offerings in its home country.
- Be subject to the control of a supervisory authority similar to the SCA.

Foreign funds may also be promoted in private offerings within the UAE after obtaining SCA approval, provided that the fund is marketed by a local promoter (which must be a bank licensed by the Central Bank, an investment company licensed by the Central Bank, or a company licensed to promote funds by the SCA).

DIFC funds

The three types of corporate entities that can be used to establish a domestic fund in the DIFC are:

- Investment companies.
- Investment trusts.
- Investment partnerships.

While trust structures are predominantly used for property funds, investment partnerships are more commonly used for private equity and VC funds. An investment partnership is a limited partnership that is registered in the DIFC and comprised of a general partner and limited partners. The general partner must be authorised by the DFSA to act as the fund manager. Similar rules are applicable to DIFC investment companies.

The two types of funds that can be established in the DIFC are:

- Public funds.
- Exempt funds.
- Qualified investor funds (QIFs).

As public funds are open to retail investors, more extensive regulatory requirements to protect such investors apply to these funds. Exempt funds are only open to professional clients who must make a minimum subscription of US\$50,000, and investors of QIFs must subscribe for units having a value of at least US\$500,000. Also, exempt funds and QIFs may only issue interests to a limited number of unitholders and cannot be offered to the public, as distribution is only allowed through private placement. Most private equity and VC funds are structured as exempt funds.

DIFC funds can be marketed within the DIFC and outside of the UAE (subject to applicable local laws). To market a DIFC fund onshore in the UAE, the fund must comply with the SCA Regulations.

11. How is the relationship between investor and fund governed? What protections do investors in the fund typically seek?

In addition to the fund requirements imposed by the Central Bank, SCA, and DFSA (see *Question 10*), investors often seek information rights, which would require the fund manager to provide periodic reports of the fund's activities and notice of any material changes to the fund (such as the appointment and removal of board members) or laws applicable to the fund. Investors in the fund can also seek inspection rights and in certain cases, the right to remove the manager if certain financial metrics are not met. Finally, some investors will push for restrictions to the amount of cross-funding and follow-on funding that the manager can invest from its other funds.

However, given the dearth of VC funds in the UAE, investment managers are generally granted significant powers over the fund.

INTERESTS IN INVESTEE COMPANIES

12. What form of interest do venture capital funds take in an investee company?

Forms of interest

Debt financing by VC funds established in the UAE is much less common than equity financing, although Islamic banking institutions often provide debt and equity funding. Debt financing from such institutions is usually in the form of loans or convertible loans, and the transactions are structured to ensure compliance with Sharia law. In addition, conventional banks in the UAE are not permitted to take equity. The advantages of debt funding (particularly emergency funding) include the ability to negotiate a high rate of interest on the debt and priority of repayment of the debt over equity investments in the event of liquidation.

However, offshore VC funds investing in the UAE typically take some equity in a portfolio company (see *Questions 16, 17 and 18*). Taking an equity position in a portfolio company permits VC funds to obtain the maximum return on the investment on an exit. Conversely, equity investments also pose a risk of financial loss if the portfolio company goes into liquidation. VC funds therefore also generally invest through convertible debt to hedge this risk, particularly when providing bridge financing between major equity rounds.

Restrictions on direct investment

Foreign investors cannot hold more than a 49% stake in UAE companies (outside of the free zones) (see *Question 10*). Foreign VC funds commonly invest in an offshore holding company that owns the maximum legal interest and full beneficial interest in the local target company.

Securities regulation

Public filings are required for an offer of securities of a locally licensed fund or a registered foreign fund (see *Question 10*). There are no public filings required for investments in local companies, though certain regulatory (including publication) requirements may apply.

VALUING AND INVESTIGATING INVESTEE COMPANIES

13. How do venture capital funds value an investee company?

Valuation of investee companies for VC financing is inherently difficult given the lack of available information and operating history, and early stage ventures have difficulty obtaining bank financing in the UAE for this reason. Accordingly, VC funds typically have industry professionals who are skilled at making long-term projections and evaluating the company's business plan. The VC fund may also develop its own forecast of the investee company's financials (rather than relying on that company's own forecast), which will be based on comparable enterprises, industry standard ratios, and exit valuations.

The valuation of the investee company will necessarily change as it procures additional financing. For each round of financing, the angel investors and venture capitalists will conduct pre-money valuations to determine the amount of equity to acquire in exchange for the proposed funding for the entrepreneur or start-up which will in turn determine the company's post-money valuation. Pricing of the investment round will be done on a fully diluted basis, meaning that the investor will take into account the current (and, in some cases, proposed) securities that are convertible into common stock (for example, options and warrants).

Valuations are typically made in UAE dirhams or US dollars, though foreign investors occasionally prepare their valuations in the currency of their country of incorporation.

14. What investigations do venture capital funds carry out on potential investee companies?

VC funds typically perform thorough financial and legal due diligence to evaluate a potential investment opportunity. The diligence review is intended to identify and mitigate the key risks associated with the investment.

The initial due diligence is intended to screen business opportunities given the life of the fund and uses predetermined criteria to identify which opportunities to focus on as possible investments. The screening process typically eliminates opportunities that do not fit the fund's mandate or investment objectives. In addition, some venture capitalists only review opportunities that have been referred from a trusted source or involve an entrepreneur that has had previous success.

Once an opportunity clears the screening process, the VC fund investigates the potential investee company to determine whether the deal is viable. Venture capitalists generally review the company's:

- Management team.
- Market potential.

- Product or service.
- Business model.
- Financial projections.

Some VC funds also produce their own financial models to evaluate the potential target (see *Question 13*).

Following the financial due diligence, the VC fund arranges for a legal due diligence review of the investee company, which (among other things) ensures that the proposed investment structure is viable.

LEGAL DOCUMENTATION

15. What are the principal legal documents used in a venture capital transaction?

The principal legal documents used in a VC investment are the term sheet, share purchase agreement, and shareholders' agreement, which include (or are supplemented by) an investor rights agreement, voting agreement and right of first refusal and co-sale agreement. The investor may also require the target company and its founders to sign an indemnification agreement and non-disclosure agreement and procure a legal opinion from the investee company's lawyers. The funding documentation for a public licensed or registered fund must be made publicly available (see *Question 10*), though the VC transaction documentation can be private (see *Question 13*).

PROTECTION OF THE FUND AS INVESTOR

Contractual protections

16. What form of contractual protection does an investor receive on its investment in a company?

Investors generally seek management and shareholder rights, see *Questions 18* and *19*.

The investment documentation also generally addresses any statutory pre-emption rights that are applicable to the entity structure of the investee company.

Forms of equity interest

17. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

VC funds typically take equity in a portfolio company. Many established VC funds seek to acquire a large minority stake (or if necessary, a majority stake) that enables it to control the investee company while still incentivising the founders. In the case of DIFC and foreign funds, the equity is often in the form of convertible preferred stock, while local funds commonly acquire common stock (to the extent that they do not provide debt).

Preferred shares

18. What rights does a fund have in its capacity as a holder of preferred shares?

Venture capitalists (including VC funds) commonly request convertible preferred shares in return for their investments. The rights and protections normally associated with such shares are as follows:

- A liquidation preference that entitles the preferred shareholder to receive a certain fixed amount (expressed as a multiple of the shareholder's original purchase price, plus any declared and

unpaid dividends) before any assets are distributed to the common shareholders in a liquidation.

- A dividend preference that entitles the holder to a dividend (which may be non-cumulative and discretionary or cumulative) prior to any dividend being paid to the common shareholders.
- Redemption rights that enable the investor to compel the company to purchase its shares on or after a certain date (and in some cases at a premium over the initial purchase price of the shares).
- Anti-dilution rights that protect an investor from dilution resulting from subsequent share issuances at a lower price than the investor originally paid by adjusting the conversion price applicable to the investor's preferred shares.
- Voting rights that generally allow the preferred shareholders to:
 - vote with common shareholders (as though the shares had been fully converted);
 - elect one or more of the company's directors;
 - approve certain types of corporate actions (for example, amendments to constitutional documents, proposed mergers, issuance of a new series of preferred shares).
- A pre-emption right that enables the preferred shareholders to participate in any future issuance of securities by the company (up to its percentage shareholding as of the date of the issuance).
- A right of first refusal that enables a preferred shareholder to purchase shares that another shareholder wishes to transfer (up to the preferred shareholder's percentage shareholding as of the date of the transfer notice) on the same terms offered to a third party.
- Co-sale/tag-along rights that permit the preferred shareholders to participate in a sale of shares by the founders or a majority of shareholders.
- Drag-along rights, that prevent minority shareholders from objecting to a sale or liquidation of the company that has been approved by a majority of the preferred shareholders.
- Vesting of founder's shares, that discourages founders from leaving the company by giving the company the right (which lapses with time) to repurchase some or all of a founder's unvested shares in the event that the founder terminates his employment.

Management control

19. What rights are commonly used to give a fund a level of management control over the activities of an investee company?

In addition to voting rights (see *Question 18*), venture capitalists (including VC funds) often seek representation on the target company's board of directors as a condition of the investment. Venture capitalists in the UAE typically prefer to take an active role in the management of early stage companies (see *Question 7*).

However, if the fund does not have board representation, it will likely be entitled to consult with and advise the company's management team on significant business issues (such as proposed annual operating plans and budgets).

In addition, investors typically have inspection and information rights (see *Question 17*). Specifically, the shareholder may examine the books and records of the company and inspect its facilities, and the company will be required to provide the shareholder with periodic financial reports.

Share transfer restrictions

20. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

Many VC investments include a lock-up period in the investment documentation to restrict the redemption or sale of shares. Depending on the nature of the investment, a typical lock-up period for an investment in the UAE can range from six months to two years. This type of restriction is more common for shareholders that also participate in the company's operations (for example, founders and strategic investors).

The transfer of shares may be subject to a right of first refusal, co-sale/drag-along and/or tag-along rights. See *Question 18*.

21. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company?

Investors taking a minority interest in the target company typically seek tag-along rights that, in the event of a proposed sale of the shares held by certain shareholders would compel the selling shareholders to sell the minority shares on the same terms and conditions applicable to their shares. In many cases, this right would be triggered if a majority shareholder (or group of shareholders holding a majority of the outstanding shares) initiated a sale. However, investors may seek the tag-along right in any proposed sale involving a founder, which may involve a certain shareholding threshold for the offer (for example, 20%).

VC investors with a majority interest in the investee company generally resist this protection when the investor believes that a partial exit (such as sale of the investor's shares) may be the only viable liquidity event.

All shareholders (including minority shareholders) will attempt to negotiate a right of first refusal over any proposed share transfers, which would enable each remaining shareholder to purchase a pro rata portion of the offered shares on the same terms and conditions that have been agreed by the selling shareholder and potential buyer. Such right may only be available to larger investors (for example, to investors holding 5% or more of the target company's shares).

Minority shareholders will also benefit from higher voting thresholds for reserved matters (see *Question 18*).

Pre-emption rights

22. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Investors typically seek anti-dilution rights in respect of its shares in the investee company, in addition to a pre-emption right over any new share issuances in order to enable it to maintain its shareholding in the company (see *Question 18*).

Many investee companies are subject to statutory pre-emption rights, which are applicable to all limited liability companies in the UAE. The limited liability company is the most common entity structure for target companies in the UAE.

Consents

23. What consents are required to approve the investment documentation?

In addition to the approvals that may be required from the government and regulatory agencies (see *Question 7*), the parties to a typical VC investment may need to obtain the consent of third parties (such as an existing lender or lessor) or, in the case of a VC fund, an investment committee to proceed with the proposed transaction. A limited number of corporate actions (such as the amendment of the memorandum and articles of association) require a super majority vote of shareholders holding 75% of the outstanding shares.

COSTS

24. Who covers the costs of the venture capital funds?

The costs associated with establishing the fund are directly borne by the fund (and therefore the investors). The fund also pays an annual management fee to its investment manager to cover the expenses arising from the fund's ordinary operations. It is uncommon for reimbursable costs to be capped, as investment managers are typically given significant leeway in their operation of a fund, though any such cost structure for locally licensed funds must be approved by SCA.

FOUNDER AND EMPLOYEE INCENTIVISATION

25. In what ways are founders and employees incentivised? What are the resulting tax considerations?

Incentives

Management incentives are commonly granted through the issue of shares or a higher participation in the company's profits, and employee share option schemes may also be implemented. In particular, an investor can stagger the vesting of a founder's shares (typically, over a four year period with a one-year cliff) to encourage the founder to continue his employment with the company, and subsequent investors may wish to extend the vesting period.

As the VC industry is still growing in the UAE, many of the more complex forms of incentive scheme have yet to become part of the VC landscape.

Venture capitalists prefer to invest in target companies while acquiring a large minority stake in order to align the interests of the founders and the financiers (see *Question 12*).

Tax

See *Question 3*.

26. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture?

Many investors seek to impose bad leaver provisions on the founders of the venture, whereby a defaulting founder would be compelled to sell his or her shares at a (sometimes significant) discount. In addition, investors often impose lock-up periods on the transfer of founders' shares (see *Question 20*) and seek to extend the vesting period for founders' shares in subsequent financings (see *Question 25*). Such provisions are typically enforceable, though non-compete provisions will generally be enforced in the UAE if the duration (up to one year) and scope of application are reasonable.

EXIT STRATEGIES

27. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

It is common for a VC fund to invoke a put option in the event of an unsuccessful investment (that is, a redemption right). In such cases, the investor has the right to have its shares redeemed at a predetermined exercise price (which often includes a premium over the acquisition price) by the company if certain financial thresholds concerning the company's revenue or net profits have not been met.

However, in many cases the company will have insufficient assets to pay for the share redemption, in which case the VC fund will likely either hold the investment with a view to obtaining a better return in the long term or facilitating a distressed sale in the market.

The transaction documentation may also include deferred payment clauses. This mechanism is used to reduce the purchase price of the shares or avoid making further investments where the company is not achieving certain financial milestones. The disadvantage of such clauses is that they inhibit the company's operations, as less capital will be made available for investment.

Many VC funds will negotiate a right to force the sale of the company after a certain period, in which case the founders (or any other shareholders) would have no right to vote on the exit transaction. This right enables the fund to wind-up its investment in the company in accordance with the fund's investment term. However, a forced sale is unlikely to yield the maximum value for the company, and subsequent investors are unlikely to agree to such a restriction, which will hinder the company's ability to secure future financing. It may also be feasible for an investor to compel an exit above a certain valuation or upon achieving a minimum threshold of returns for preferred shareholders.

28. What forms of exit are typically used to realise a venture capital fund's investment in a successful company? What are the relative advantages and disadvantages of each?

The most likely liquidity events for successful companies in the UAE are in the form of trade sales and secondary buyouts. While some investors have exited venture capital investments by way of an initial public offering (IPO), this is very uncommon in the UAE.

Trade sales are generally on better terms than secondary buyouts and have higher valuations (and therefore yield greater returns for the VC fund). While not as lucrative as trade sales, secondary buyouts generally provide liquidity to companies that have already realised significant gains from prior investments.

An IPO affords the company increased access to capital and potentially provides greater net worth to the shareholders. However, an IPO also results in significant expenses to effect the exit and exposes the company to volatile market conditions.

29. How can this exit strategy be built into the investment?

The investment documentation must contemplate all anticipated exit strategies. In particular, the term sheet should describe the rights and obligations applicable in the event of a sale or listing of the company, and the share purchase agreement and shareholders' agreement (or equivalent investment documentation) should specify the rights associated with each class of shares. The parties should also discuss and record the proposed timetable and mechanisms for a liquidity event and any additional rights that may be triggered (for example, a change in the conversion price of preferred shares by type of exit transaction and waiver of approval rights for an exit that meets a minimum valuation threshold).

From the VC fund's perspective, it is also useful to have management rights in the company, as the management team that is in place once an exit becomes possible will be responsible for the securing and negotiating the terms of the exit.

ONLINE RESOURCES

W www.centralbank.ae

This is the UAE Central Bank's official website, which includes an English translation of the Banking Law that is applicable in the UAE.

W www.sca.gov.ae

This is the SCA's official website, which includes an English translation of the SCA Regulations applicable in the UAE.

W <http://ejjustice.gov.ae>

This is UAE Ministry of Justice's official website, which includes an English translation of the Companies Law.

W www.dfsa.ae

This is the DFSA's official website, which includes the Collective Investment Rules applicable in the DIFC (and is produced only in English).

Practical Law Contributor profiles



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Publications

- *Making Monetary Sense: [The How-To] Understand Your VC Term Sheet (co-author), Entrepreneur Middle East, February 2015.*
- *IPO You Start-Up, Start Up (Arabian Business), April 2014.*
- *Venture Capital Fund: A-How-to-Guide, Start Up (Arabian Business), February 2014.*
- *Balancing Founder Control and Venture Capital Money, Start Up (Arabian Business), November 2013.*

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Publications.

- *Mind the Gap: A guide to bridge financing in the Middle East, Arabian Business, March 2016.*
- *Acquisition Finance 2016 – United Arab Emirates, Getting the Deal Through.*
- *Making Monetary Sense: [The How-To] Understand Your VC Term Sheet (co-author), Entrepreneur Middle East, February 2015.*