The DFSA regulatory environment
The Dubai Financial Services Authority (DFSA) is the independent integrated regulatory authority of the Dubai International Financial Centre (DIFC) created by Dubai Law No 9 of 2004. The DFSA supervises financial institutions authorised to conduct financial services in or from the DIFC, and oversees the provision of certain ancillary services to DFSA authorised firms such as auditing, accounting, and legal services. The DFSA is empowered by the DIFC Regulatory Law, Law No 1 of 2004 to make rules and regulations and also enforce these regulatory requirements.

The supervisory philosophy of the DFSA is to be a ‘risk-based’ regulator which means that the DFSA will focus on the risks within DFSA authorised firms, and the impact of those risks on the centre, to clients and the potential impact on the DFSA’s ability and resources required to meet the DFSA’s regulatory objectives as stipulated in the DIFC Regulatory Law (See Figure 3).

Figure 3: Impact of the risk profile of an Authorised Firm on the DFSA Regulatory Objectives

Regulatory Objectives:

- Foster and maintain fairness, transparency and efficiency in the financial services industry in the DIFC;
- Foster and maintain confidence in the financial services industry in the DIFC;
- Foster and maintain the financial stability of the financial services industry in the DIFC, including reduction of systemic risk;
- Prevent, detect and restrain conduct that causes or may cause damage to the reputation of the DIFC or the financial services industry in the DIFC, through appropriate means including the imposition of sanctions;
- Protect direct and indirect users of the financial services industry in the DIFC;
- Promote public understanding of the regulation of the financial services industry in the DIFC; and
- Pursue any other objectives as the Ruler may from time to time set under DIFC Law.
The DFSA’s ‘risk-based’ philosophy is a continuous process for the identification, assessment, prioritisation, and mitigation of risks which arise within authorised firms. The DFSA has a range of regulatory tools available to monitor such risks, including risk assessment visits, theme reviews, desk-based reviews, including review and analysis of prudential returns, auditor reports, and Shari’a reports, to name a few. As a risk-based regulator, the DFSA focuses on the risks which the authorised firm poses regardless of whether it is an Islamic (including an Islamic window) or conventional firm.

In the context of Islamic finance, the DFSA is a Shari’a systems regulator – not a Shari’a regulator. It does not regulate finite points of Shari’a, but the systems put in place to ensure compliance with Shari’a.

In the context of the supervisory cycle, the same regulatory model of supervision applies to all regulated firms. The emphasis of focus may change to reflect the product range, but the overall supervisory philosophy of review and monitoring remains the same across all DFSA authorised firms (See Figure 4).

Figure 4: Example of a regulatory cycle for institutions offering financial services and products in accordance with Shari’a.
DFSA operating environment for the conduct of Islamic finance

The DFSA will consider applications from authorised firms as well as new applicants to offer Islamic financial business in or from the DIFC. To understand how this works, it is important to understand the overall licensing process which is summarised below. For further details, the AUT module of the DFSA rulebook should be consulted.

1. Selection of financial services

Applicants intending to offer financial services as defined by the DFSA in or from the DIFC require authorisation by the DFSA. The applicant’s business plan should detail what activities are to be offered and how these relate to the financial services as defined in the GEN module of the DFSA rulebook.

In the context of Islamic finance, the applicant will need to explain, as part of its business plan, what Islamic structures or contracts are to be used and map these structures and contracts into the financial services definitions of the DFSA.

2. Financial Services

Applicants intending to offer the following financial services in or from the DIFC must be authorised by the DFSA (See Figure 5).

Figure 5: Financial Services Table for Authorised Firms

<table>
<thead>
<tr>
<th>Financial Services</th>
<th>Operating a Collective Investment Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accepting Deposits</td>
<td>Operating Custody</td>
</tr>
<tr>
<td>Providing Credit</td>
<td>Arranging Custody</td>
</tr>
<tr>
<td>Dealing in Investments as Agent</td>
<td>Effecting Contracts of Insurance</td>
</tr>
<tr>
<td>Dealing in Investments as Principal</td>
<td>Carrying Out Contracts of Insurance</td>
</tr>
<tr>
<td>Arranging Credit or Deals in Investments</td>
<td>Insurance Intermediation</td>
</tr>
<tr>
<td>Managing Assets</td>
<td>Insurance Management</td>
</tr>
<tr>
<td>Advising on Financial Products or Credit</td>
<td>Operating an Alternative Trading System</td>
</tr>
<tr>
<td>Managing a Profit Sharing Investment Account</td>
<td>Providing Fund Administration</td>
</tr>
<tr>
<td>Providing Trust Services</td>
<td>Operating a Clearing House</td>
</tr>
<tr>
<td>Acting as a Trustee of a Fund</td>
<td></td>
</tr>
<tr>
<td>Operating an Exchange</td>
<td></td>
</tr>
</tbody>
</table>
3. In or from concept
When considering which activities an applicant intends to offer, the requirement to be authorised applies where the financial services are to be offered by a DFSA authorised firm in the DIFC or from the DIFC.

4. Authorisation process
The Authorisation Department of the DFSA will assess all applications for authorisation to ensure that the proposed business has a clear strategy, is managed effectively and prudently, and intends to operate in compliance with the DIFC laws and DFSA regulations. The Authorisation Department, will, among other things, consider the collective suitability, fitness and properness of those involved in the business.

The same authorisation approach applies to both Islamic and conventional firms. Once satisfied, the DFSA will authorise the applicant to offer financial services in or from the DIFC.

5. Single licence structure
Once approved, the DFSA will issue a single licence which lists the financial services that the firm can offer in or from the DIFC. The DFSA does not issue licences by category, although there is a common reference to the prudential category which the authorised financial services lead to (See Figure 6).

*Figure 6: Explanation of the Single Licence process and categorisation of Authorised Firms*
6. Prudential categories

The financial services shown below are those that determine which prudential category is applicable to the firm – ie, where the applicant identifies a range of financial services to offer in or from the DIFC, if the selection includes one of the financial services below, that will determine the prudential category for the firm (the determinant).

Figure 7: Prudential Categories as set out in the PIB Module of the DFSA Rulebook

<table>
<thead>
<tr>
<th>Prudential Category 1</th>
<th>Prudential Category 2</th>
<th>Prudential Category 3</th>
<th>Prudential Category 4</th>
<th>Prudential Category 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accepting Deposits</td>
<td>Dealing in Investments as Principal except where this is done on a Matched Principal basis</td>
<td>Dealing in Investments as Principal on a Matched Principal basis</td>
<td>Arranging Credit or Deals in Investments</td>
<td>Wholly Islamic Financial Institution AND which Manages a Profit Sharing Investment account</td>
</tr>
<tr>
<td>Providing Credit</td>
<td>Operating a Collective Investment Fund</td>
<td>Advising on Financial Products or Credit</td>
<td>Arranging Custody</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Managing Assets</td>
<td></td>
<td>Insurance Intermediation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Providing Custody</td>
<td></td>
<td>Insurance Management</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Providing Trust Services</td>
<td></td>
<td>Operating an Alternative Trading System</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Acting as Trustee of a Fund</td>
<td></td>
<td>Providing Fund Administration</td>
<td></td>
</tr>
</tbody>
</table>

DFSA Authorised Firms endorsed to operate as either a Wholly Islamic Financial Institution or Islamic Window can fall into these Prudential Categories.

N.B Effecting and Carrying out Contracts for Insurance, including Takaful is set out in the Prudential Insurance Business Module, PIN.
Where the firm is to offer one or more of the determinant financial services, the highest prudential category applies, for example an applicant intending to provide credit, deal as principal, and arrange custody will be a prudential Category 1 firm. Where the firm is to be a wholly Islamic financial institution (not an Islamic window) and also manages a profit-sharing investment account (PSIA) other than as a collective investment vehicle, for example where it mobilizes funds through PSIA’s it will be subject to prudential Category 5.

Where a wholly Islamic financial institution intends to provide other financial services, other than manage a profit-sharing investment account, such as ‘deal as principal’, then the appropriate prudential category will apply. In this example it will be a prudential Category 2 firm. A firm which is an Islamic window will be subject to prudential Category 1-4 according to the selected financial services (See Figure 7 previous page).

7. Benefits of a single licence
A single licence has many advantages, most significantly where additional financial services are to be added at a later stage. In such a case, a ‘change in scope of licence’ application using DFSA form SUP 4 can be submitted to the DFSA and additional financial services can be added to the existing licence, subject to regulatory approval. This model provides flexibility and ease of processing for both the DFSA and authorised firms.

8. Islamic finance endorsement
In the context of Islamic finance, the DFSA does not issue Islamic finance or Islamic banking licences, but will issue an endorsement across the financial services licence to indicate that the firm is to operate either as a wholly Islamic financial institution or as an Islamic window. Again, this provides the necessary degree of flexibility. For example, where additional Islamic contracts or structures are to be proposed at a later stage, a ‘change in scope of licence’ application can be submitted to add the equivalent financial service which relates to the Islamic contract or structure.

9. Holding out
In accordance with the DIFC Law Regulating Islamic Financial Business, a financial institution cannot ‘hold itself out’ as conducting Islamic financial business unless it is endorsed to operate as either a wholly Islamic financial institution or an Islamic window. The concept of ‘holding out’ has two functions. Firstly, financial institutions that want actively to
market themselves as offering financial services in accordance with Shari’a – i.e., Islamic Finance – must be duly endorsed and have the requisite Shari’a oversight systems in place. The second function is that those financial institutions that offer financial services in accordance with Shari’a without intending to – such as mutual funds, ethical finance, and certain conventional products which meet the principles for Shari’a and Halal by default – are not required to seek an endorsement where the financial institution has no intention of holding itself out to the market as offering financial services in compliance with Shari’a. This ensures that the regime only applies to the correct financial institutions.

When a financial institution is proposing to offer Islamic finance in or from the DIFC, they must first consider if they are intending to ‘hold themselves out’ to the market that they are providing Shari’a-compliant financial services. For example, advisors who advise on financial structures which are Shari’a-compliant may not necessarily need to be endorsed if they provide a purely advisory role in the same manner as they would provide for a conventional product – i.e., with no specific additional service being provided as a result of the Shari’a nature of the product.

In the context of the DFSA’s operating environment, financial institutions that ‘hold themselves out’ as offering Shari’a-compliant finance must seek an endorsement from the DFSA.

10. Identification of appropriate financial services
Financial institutions that intend to offer Islamic products in or from the DIFC must select the appropriate financial service as defined by the DFSA which equates to the proposed Islamic product. To do this, the underlying purpose, effect, and risk profile of the Islamic product needs to be understood so as to select the most relevant DFSA financial service.

11. Types of Islamic firm in the DIFC
The DFSA defines two types of financial institution which can be endorsed to offer financial services in accordance with Shari’a – a wholly Islamic firm, and an Islamic window. A wholly Islamic firm is one whose entire business operations are undertaken in accordance with Shari’a, as stated in its constitutional documents. An Islamic window is a conventional financial institution which also offers Shari’a compliant financial products and services as well as conventional financial products and services.
Seeking an ‘endorsement to operate’ either as a wholly Islamic financial institution or as an Islamic window

Figure 8: The following 7 Steps summarise the process to be considered when planning to offer Islamic Finance in or from the DIFC.

STEP 1

Holding Yourself Out as Offering Financial Services in accordance with Shari’a

Is the Firm ‘Holding itself out’ as offering Financial Services in accordance with Shari’a? If No, then you do not require an endorsement under the DIFC Law Regulating Islamic Financial Business and the DFSA Rules. If Yes, then the Steps detailed below must be followed.

STEP 2

Identification of Financial Services to be offered in accordance with Shari’a

If the Firm is intending to hold itself out to potential clients as a provider of financial services which comply with Shari’a, the financial services prescribed in the GEN Module of the DFSA Rulebook, which relate to the Islamic contracts or structure which you intend to offer should be identified.

STEP 3

Appoint 3 scholars to a Shari’a Supervisory Board (SSB)

The Firm must identify and appoint 3 scholars to form a Shari’a Supervisory Board and undertake due diligence on the Scholars including:
• Assessing the fitness and properness of each scholar.
• Assessing the competence, qualifications and experience of each scholar.
• Assessment of any conflicts of interest as a result of the proposed appointment.
• Confirmation that the Scholar is not a director or controller of the Authorised Firm

STEP 4

Implement a Shari’a System to ensure compliance with Shari’a

Develop a written Islamic Financial Business policy setting out the process for initial and ongoing Shari’a Compliance including:
• Identification of the scholars and the recruitment and dismissal process.
• Process for seeking fatwa’s.
• Process for monitoring transactions against issued fatwa’s.
• Process for ongoing internal Shari’a compliance reviews in accordance with AAOIFI GSIFI.
• Process for seeking external Shari’a compliance reviews from the Scholars in accordance with AAOIFI GSIFI.
• The specific controls in respect of Profit Sharing Investment Account
• In the case of Islamic Windows, the process for segregating the Islamic Finance business from the conventional business
Figure 9: Summary of the 3 core considerations for seeking an Islamic endorsement to operate as a Wholly Islamic Financial Institution or an Islamic Window

**STEP 5**

**Risk Management**

Wholly Islamic Firms and Islamic Windows must have adequate risk management systems in place to manage the risk arising from the Shari’a compliant business, including Shari’a Non-compliance risk and prudential risks. Appropriate Shari’a compliant risk mitigants, such as Hamish Jiddayah, Arboun, 3rd Party guarantees, should be considered.

**STEP 6**

**Disclosures**

Wholly Islamic Firms and Islamic Windows must ensure that the relevant regulatory disclosures are made in all communications to actual and potential customers, including details of the SSB which is providing Shari’a oversight over the products to which any marketing relates. Additionally, Islamic Windows must make the disclosures required by AAOIFI FAS 18.

**STEP 7**

**Accounting**

Wholly Islamic Financial Institutions must adopt AAOIFI. Islamic Windows must adopt IFRS as supplemented by AAOIFI FAS 18. In the context of Islamic Funds, AAOIFI FAS will also apply to the Islamic Fund.
Operating a DIFC Islamic fund

The DFSA has implemented a regime for the oversight of collective investment funds (CIF). The DFSA categorises these into two types: DIFC domestic funds (established in the DIFC under the laws of the DIFC); or foreign funds (established in a jurisdiction other than the DIFC).

In the context of DIFC domestic Islamic funds, an authorised firm must, as a minimum, be authorised to ‘operate a collective investment fund’. The operator will be responsible for the fund’s overall operations and is required to ensure that any delegation arrangements with fund administrators, custodians, or managers are undertaken following careful due diligence. In the context of Islamic finance, the operator must also implement the Shari’a system to ensure sufficient Shari’a oversight of the fund. The same process described in Steps 3-7 in Figure 8 above applies.

*Figure 10: Operating a DIFC Domestic Islamic Fund*

It is common for the Shari’a scholars to form a three-member Shari’a Supervisory Board (SSB) to issue fatwa’s. In the case of funds, the SSB may issue broad investment guidelines pertaining to the fund with ongoing Shari’a-compliance monitoring undertaken by the financial institution.
Islamic Funds are usually required to comply with industry and financial filters. The industry filters are in place to ensure that prohibited stocks, ie those that are ‘Haram’ are not included in the investments. Financial filters are in place to ensure that certain thresholds are maintained, for example common financial filters will prohibit investments to be made in companies that have certain financial positions, including but not limited to certain debt to equity ratio’s and certain interest income thresholds.

Other fund structures may track Islamic indexes, such as the Dow Jones Islamic Index, or FTSE Islamic Index. Such indices are also subject to approval by a SSB.

**Shari’a-compliant REITs**

In the context of Shari’a compliant funds, REITs are becoming increasingly popular fund structures that can be offered in accordance with Shari’a. Shari’a-compliant REITs are essentially listed collective investment schemes where funds from investors are pooled and invested in a portfolio of Shari’a-compliant real estate assets, or real estate related assets. These assets are usually leased out to a third party (commonly under an Ijara structure) and rentals from the leased assets form the income of the REIT which can be distributed to Unitholders.

Recent Shari’a-compliant REIT structures have used Ijara as the basis of the investment. The typical Ijara REIT structure is set out in Figure 11 below.

*Figure 11: Summary of an Ijara based REIT*
**Shari’a-compliant REITs under the DFSA regulatory regime**

The DFSA CIR module permits REITs to be established and offered in or from the DIFC. Although there is no specific DFSA module for Shari’a-compliant REITs, the regime does permit REIT structures, and also permits Shari’a-compliant funds to be established and offered in or from the DIFC. An example of a REIT established in the DIFC could have the characteristics set out in Figure 12 below.

*Figure 12: An example of a DFSA REIT structure incorporating a Shari’a System (Author’s view only)*

Diagram:

- **The Operator of the DIFC Domestic Public REIT will appoint an oversight panel to oversee the operation of the fund.**
- **The primary objective of the Fund is investment in income generating Real Property with distribution of at least 80% of the audited annual income to Unitholders.**
- **Ijara based REIT Fund property may be leased out to 3rd parties under an Ijara structure. The rental income can be distributed to Unitholders of the DIFC Shari’a compliant REIT.**
- **Operator has overall responsibility for the Fund including establishing the DIFC Domestic Fund.**
- **Operator must implement the Shari’a systems, as depicted in Figure 10 above, where the Fund is to be Shari’a compliant, including appointing the Shari’a Supervisory Board to provide Shari’a oversight to the Shari’a compliant REIT. The Shari’a system, for initial and ongoing Shari’a oversight must adhere to the internal Islamic Financial Business Policy which is implemented by the Operator.**
- **The Fund must be structured as a Public Property Fund and the legal vehicle must either be an Investment Company; or Investment Trust.**
Where REITs are to be offered as Shari’a-compliant, a Shari’a system, as described in steps 3-7 in Figure 8 and Figure 10 must also be put in place.

The DFSA CIR module could be used to permit Shari’a-compliant REITs to invest in real property that can subsequently be leased out under an Ijara structure using the rental income as the returns which are distributed to Unitholders.

The DFSA CIR Module also permits REITs to invest in property under development, provided that the contract value of the property under development does not exceed 30 per cent of the net asset value of the fund property and that the REIT will hold the developed property upon completion.

**Marketing DIFC Islamic funds and foreign Islamic funds**

All funds to be marketed in or from the DIFC must be marketed by a DFSA authorised firm, which must at least be appropriately authorised.

1. **Marketing DIFC Domestic Islamic funds**

In respect of DIFC domestic Islamic funds, units of such funds can also be marketed into Malaysia with minimal regulatory intervention. DIFC domestic Islamic fund units can be offered into Malaysia via an approved distributing agent under the Mutual Recognition arrangement between the DFSA and Securities Commission Malaysia. The prospectus must make a number of clear statements pertaining to the fund and provide clear information about the Shari’a oversight arrangements, including details of the SSB, and confirmation that the Shari’a oversight satisfies the requirements imposed by the respective regulatory regime.

2. **Marketing foreign Islamic funds**

In relation to the marketing of foreign funds (those not domiciled in the DIFC), DFSA authorised firms can market and offer units in such foreign funds where they are either ‘designated funds from recognised jurisdictions’, or which satisfy the requirements relating to the marketing of non-designated funds. The information below summarises the requirements in the DFSA rulebook which should be consulted for full details.
Option 1: Marketing Foreign Designated Islamic Funds

1. Is it a Designated Fund located in a Recognised Jurisdiction, [DFSA Recognised Jurisdiction Notices are available from the DFSA website]

2. Is the Fund approved or authorised by the Recognised Jurisdiction’s Financial Services Regulator

3. Does the Fund satisfy the requirements in that jurisdiction for the offer of those Units to retail customers by means of a public offering

The Foreign Fund can be marketed to Qualified Investors in or from the DIFC provided that the relevant DFSA Regulatory disclosures including relevant Shari’a oversight disclosures are made.
Option 2: Marketing of Foreign Non-Designated Islamic Funds

Where the Fund does not meet the requirements to be a Designated Fund it can be marketed as a Non-Designated Fund if one or more of the following tests is satisfied.

- Both the Custodian of the Fund meets 1 of the 4 eligibility tests in COB 6.9.5 (4) and the investment manager of the Fund meets 1 of the 3 tests in COB 6.9.5 (5).

- Both the custody and investment management activities of the Fund are performed by a person that meets the eligibility requirements in COB 6.9.5 (6).

- The Fund has been rated or graded at least ‘Investment Grade’ by Moody’s, Fitch or Standard & Poor’s, or by any other international rating agency recognised by the DFSA.

Specific additional requirements exist for specialist funds such as property funds which are not described in Figure above. The summaries are equally applicable to conventional funds.

**Legal Framework in the DIFC**

Although subject to the UAE’s criminal laws, including anti-money laundering and counter-terrorist financing laws, the DIFC is subject to its own legal system based on common law, influenced by the UK legal system. A full set of laws have been developed to operate in the Centre, some of which are administered by the DFSA, others administered by the DIFCA.
These laws, particularly those pertaining to the legal vehicles which are permitted in the Centre are equally applicable to Islamic Finance. The DIFC was one of the first jurisdictions in the Gulf to introduce specific Trust Laws which were internationally recognised by the prestigious Society of Trust and Estate Practitioners (STEP) body.

<table>
<thead>
<tr>
<th>DIFC Laws administered by the DFSA</th>
<th>DIFC Laws administered by DIFCA</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Regulatory Law</td>
<td>• Strata Title Law</td>
</tr>
<tr>
<td>• Markets Law</td>
<td>• Real Property Law</td>
</tr>
<tr>
<td>• Law Regulating Islamic</td>
<td>• Data Protection Law</td>
</tr>
<tr>
<td>Financial Business</td>
<td>• Limited Partnership Law</td>
</tr>
<tr>
<td>• Trust Law</td>
<td>• Companies Law</td>
</tr>
<tr>
<td>• Investment Trust Law</td>
<td>• Personal Property Law</td>
</tr>
<tr>
<td>• Collective Investment Law</td>
<td>• Law Relating to the</td>
</tr>
<tr>
<td></td>
<td>Application of DIFC</td>
</tr>
<tr>
<td></td>
<td>Laws(Amended and Restated)</td>
</tr>
<tr>
<td>• Employment Law</td>
<td>• Law of Obligations</td>
</tr>
<tr>
<td>• Law of Obligations</td>
<td>• Implied Terms in Contract and</td>
</tr>
<tr>
<td>• Implied Terms in Contract and</td>
<td>Unfair Terms</td>
</tr>
<tr>
<td>Unfair Terms</td>
<td>• Law of Damages and Remedies</td>
</tr>
<tr>
<td>• Law of Damages and Remedies</td>
<td>• Law of Security</td>
</tr>
<tr>
<td>• Law of Security</td>
<td>• Law on the Application of Civil</td>
</tr>
<tr>
<td>• Law on the Application of Civil</td>
<td>and Commercial Laws</td>
</tr>
<tr>
<td>and Commercial Laws</td>
<td>• Law on Application of DIFC</td>
</tr>
<tr>
<td>• Law on Application of DIFC</td>
<td>Laws</td>
</tr>
<tr>
<td>Laws</td>
<td>• Limited Liability Partnership</td>
</tr>
<tr>
<td>• Limited Liability Partnership</td>
<td>Law</td>
</tr>
<tr>
<td>Law</td>
<td>• Contract Law</td>
</tr>
<tr>
<td>• Contract Law</td>
<td>• Insolvency Law</td>
</tr>
<tr>
<td>• Insolvency Law</td>
<td>• Arbitration Law</td>
</tr>
<tr>
<td>• Arbitration Law</td>
<td>• Court Law</td>
</tr>
<tr>
<td>• Court Law</td>
<td>• General Partnership Law</td>
</tr>
<tr>
<td>• General Partnership Law</td>
<td></td>
</tr>
</tbody>
</table>