

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

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A Q&A guide to venture capital law in the United Arab Emirates.

The Q&A gives a high level overview of the venture capital market; tax incentives; fund structures; fund formation and regulation; investor protection; founder and employee incentivisation and exits.

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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 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 are likely to construe VC more narrowly, as is the case in jurisdictions with an established 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 traditionally 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).
- Crowdfunding.

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 style funding.

Types of company

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 by 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 used in oil and gas and other energy projects.

Market trends

There has always been a small market for VC in the UAE, and the economic downturn 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 re-negotiate or cancel proposed investments by citing the economic climate and agreeing to new terms to facilitate the investment.

However, there has been an 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, as well as a launch pad for inbound investments into the UAE. 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. A number of UAE free zones (in particular the Dubai Silicon Oasis and the Dubai International Financial Centre (DIFC) in the Emirate of Dubai, and the Abu Dhabi Global Market (ADGM) and twofour54 in the Emirate of Abu Dhabi) provide seed funding, training, and/or strategic advice for entrepreneurs in the TMT sector. The Government of Dubai has also launched the "Dubai Future Accelerators" programme, aiming to encourage young entrepreneurs to address the

challenges facing the current age. Similarly, the DIFC has introduced the "FinTech Accelerator Programme", aimed at providing start-ups access to leading accelerator programmes, mentorship from leading financial institutions and insurance partners, along with a dedicated space to work alongside a community of like-minded individuals. In the Emirate of Abu Dhabi, the ADGM has introduced a licensing regime specifically catered towards tech start-ups that allows entrepreneurs to obtain an operational licence in the ADGM and access to a "Professional Services Support Programme" aimed at allowing entrepreneurs entry to a community of businesses, financial services and professional advisors. As the availability of funds for start-ups improves, there will be more opportunities for venture capitalists to invest in more mature businesses.

2. What recent reforms or proposals for reform affect venture capital in your jurisdiction?

Securities and Commodities Authority (SCA) Regulations

The UAE has embarked on an ambitious undertaking by introducing new business friendly mutual funds regulations to stimulate the UAE funds industry and provide the foundation for a more developed regional funds regime in the Gulf Cooperation Council (GCC).

SCA has recently issued the following new regulations governing the registration, licensing and promotion of investment funds in the UAE (Funds Regulations):

- Board Decision No. 9 of 2016.
- Board Decision No. 10 of 2016.
- Administrative Decision No. 49 of 2016.
- Administrative Decision No. 52 of 2016.
- Administrative Decision No. 1 of 2017.
- Administrative Decision No. 2 of 2017.
- Administrative Decision No. 3 of 2017.
- Board Decision No. 3 of 2017.

The Funds Regulations constitute the new UAE fund regime regarding onshore local funds and foreign funds that are marketed in the UAE (outside the two financial free zones). The Funds Regulations replace SCA Board of Directors Decision No. 37 of 2012 (2012 Regulations).

The Funds Regulations apply to all mutual funds and parties that are related to mutual funds. A mutual fund is defined as a financial pool engaged in the activity of accumulating investors' assets for the purpose of investment against the issue of fund units of equal value. SCA interprets this definition broadly.

A local mutual fund must be established by an eligible sponsor, which include:

- Companies licensed by SCA "in the area of securities" or to manage funds.

- Local or foreign banks licensed by the UAE Central Bank (Central Bank).
- UAE branches of foreign companies licensed by the International Organisation of Securities Commissions and that have a track record of at least five years.

The sponsor must contribute a minimum share capital of AED5 million and cannot own more than 30% of the fund's units.

The Funds Regulations provide for (or otherwise contemplate) the following types of funds:

- Public and private funds.
- Master/feeder funds and umbrella/sub-funds.
- Open-ended and close-ended funds.
- Speciality funds, including shari'a-compliant funds, venture capital funds, private equity funds, exchange traded funds (ETFs), and real estate investment trusts (REITS).

DIFC collective investment funds

The DIFC has made a series of changes to the regulations applicable to collective investment funds, to encourage the establishment of these funds in the free zone. The DIFC's funds regime is discussed more fully in [Question 7](#). The Emirate of Abu Dhabi has established the ADGM which has a funds regime that is very similar to that of the DIFC.

UAE passporting regime for "domestic funds"

In November 2018, SCA, the Dubai Financial Services Authority in the DIFC (DFSA) and the Financial Services Regulatory (FSRA) of the ADGM announced that they had reached agreement on facilitating the licensing of domestic funds by each authority for promotion across the UAE. This means that, in theory, a fund established in the DIFC, the ADGM or onshore in the UAE can (once the promoters satisfy the requirements of the passporting regime) be marketed in the other two participating jurisdictions. The DFSA and FSRA have published amendments to the relevant rules and regulations implementing the passporting regime. The SCA's regulations have not yet been published.

The Guidance to the DFSA's Fund Protocol Rules (FPR) explains that:

"The three UAE securities regulators: the SCA, the DFSA and the FSRA have agreed a "Protocol" regarding co-ordinated supervision of the marketing and selling of units of domestic funds within the UAE (State). The "Protocol" introduces a notification and registration process to enhance the monitoring and supervision of the financial services associated with the marketing and sale of units in domestic funds. The Protocol sets out a common regulatory framework which is to be implemented by each of the regulators. The Protocol is implemented in the DFSA Rulebook primarily through this module (FPR)."

The passporting regime applies to both private and public domestic funds. It does not apply to foreign funds promoted in the UAE. Foreign funds and other types of securities promoted in the UAE remain subject to the applicable rules of the jurisdiction in which they are promoted.

While still in its early stages, this development has the potential to bolster the UAE funds landscape and make the UAE substantially more attractive for fund managers.

Federal Law No. 2 of 2015 (Companies Law)

In 2015, the Federal National Council adopted the 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. This measure should improve enforceability of liens and promote lending in the UAE, including in the form of convertible debt that is common among VC investors.

Insolvency law

The UAE government has recently promulgated Federal Law No. 9 of 2016 on Bankruptcy (New Bankruptcy Law), which was published in the UAE Gazette on 29 September 2016, giving it an effective date of 29 December 2016. The New Bankruptcy Law signals a shift from benefiting creditors in the sense that they could previously force a party into insolvency irrespective of the sum owed, to providing more options for debtors to regain control over their solvency situation.

Tax regime

With a few exceptions, the UAE is generally a tax-free jurisdiction (see [Question 3](#)). However, from January 2018, the UAE has introduced a value added tax (VAT). Businesses will collect taxes on behalf of the government and file tax returns accordingly. Although the tax is collected at each stage of value addition, the primary tax burden falls on the end consumer as suppliers in intermediate stages can claim a refund.

Various statutory and administrative actions are being taken for the timely and effective implementation of VAT. Following the establishment of the Federal Tax Authority under Federal Law No. 13 of 2016, the Tax Procedures Law has been issued (Federal Law No. 7 of 2017). The Tax Procedures Law establishes the framework for federal tax administration in the UAE. Details will be added by executive regulations to supplement the Tax Procedures Law.

Tax incentive schemes

3. What tax incentive or other schemes exist to encourage investment in portfolio 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 currently imposed on businesses in the UAE.

VC funds can also be formed in the DIFC and/or the ADGM (see [Question 5](#)). Both the DIFC and the ADGM have a mandate to remain tax free for 50 years, and this mandate is renewable for an additional 50-year period.

Funding sources

4. How do venture capital funds typically obtain their 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. What legal structure(s) are most commonly used as vehicles for venture capital funds?

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

Three types of corporate entity can be used to establish a domestic fund in the DIFC:

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

Similar structures are available in the ADGM. 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*).

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

It is uncommon for VC funds to invest with other funds in the UAE. While it is not uncommon for sponsors to establish parallel or side-by-side funds in the UAE to co-invest with foreign funds, the process for the establishment of domestic funds that co-invest with other domestic funds is untested.

Investment objectives

7. 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 term 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. Investors in VC funds in the UAE negotiate a hurdle rate or preferred return of 5% to 10%, and expect a return of between 10% and 20%.

8. 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 5](#)). Accordingly, many VC funds established in the UAE invest in target companies through debt rather than equity.

Fund regulation and licensing

9. Do a private equity fund's promoter, principals and manager require authorisation or licences?

A VC 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 Central Bank and SCA are generally responsible for the regulatory oversight of financial activities in the UAE outside of the DIFC and the ADGM (where the DFSA or the FSRA (as applicable) carries out these functions). When examining the regulation of VC funds in the UAE, the laws and regulations applicable to the UAE, the DIFC, and the ADGM must be considered.

UAE funds (onshore)

SCA authorisation. Local funds offered in the UAE must comply with the SCA Regulations. In particular, the SCA Regulations require each local fund to obtain a licence issued by the SCA, and the fund must either be a UAE joint stock company, an LLC, or a UAE branch of a duly licensed foreign company. (See [Question 2](#) for further information concerning the Funds Regulations.)

Foreign funds. Onshore funds are uncommon in the UAE, as the legal and regulatory requirements imposed 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. 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 by the SCA to promote funds).

DIFC funds

Three types of corporate entity can be used to establish a domestic fund in the DIFC:

- 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.

Three types of fund can be established in the DIFC:

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

As public funds are open to retail investors, more extensive regulatory requirements to protect those 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 can only issue interests to a limited number of unitholders and cannot offer 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.

The ADGM also maintains a funds regime, which is very similar in structure to that maintained in the DIFC. The ADGM is a recently formed free zone and its funds regime is largely untested.

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 SCA, the DFSA and the FSRA (as may be relevant to the fund in question) (see [Question 10](#)), investors often seek information rights, which would require the fund manager to provide both:

- Periodic reports of the fund's activities.
- 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 lack of VC funds in the UAE, investment managers are generally granted significant powers over the fund.

Interests in portfolio companies and securities regulation

12. What form of interest do venture capital funds take in an investee company? Are there any restrictions on direct investment in a company's equity securities by foreign venture capital funds? What regulations govern the offer and sale of securities in venture capital transactions?

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 these institutions is usually in the form of loans or convertible loans, and the transactions are structured to ensure compliance with principles of shari'a. 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 [Question 16 to 18](#)). Taking an equity position in a portfolio company permits VC funds to maximise 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 economic 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, although certain regulatory (including publication) requirements 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 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 in turn determines the company's post-money valuation. Pricing of the investment round is done on a fully diluted basis, meaning that the investor takes 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, although foreign investors occasionally prepare their valuations in the currency of their country of origin.

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](#)), although the VC transaction documentation can be private (see [Question 12](#)).

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 [Question 18](#) and [Question 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 funds established in the DIFC, the ADGM and elsewhere outside the UAE, 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 or preference shares?

Venture capitalists (including VC funds) commonly request convertible preferred shares in return for their investments. The rights and protections usually associated with these shares (subject to restrictions in the law applicable to the investee company) are:

- 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) before 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, and 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 the 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/her 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 capital investors 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 1*).

However, if the fund does not have board representation, it is likely to 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 11*). Specifically, the shareholder can 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 or the company's organisational documents?

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. This 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, 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 5](#)), 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, although any such cost structure for locally licensed funds must be approved by SCA.

Portfolio company management

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.

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, which compel a defaulting founder 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](#)). These provisions are typically enforceable, although non-compete provisions are generally 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 these 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.

Many VC funds negotiate a right to force the sale of the company after a certain period, in which case the founders (or any other shareholders) 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 on 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 VC investments by way of an initial public offering (IPO), this is very uncommon.

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.

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Languages. English, Farsi

Publications

- Doing Business in the Middle East: Life After Oil, ACC Docket, June 2016.
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Languages. English, Urdu

Publications

- The Mergers & Acquisitions Review (UAE chapter), Law Business Research, 2018.

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