



ABU DHABI GLOBAL MARKET
سوق أبوظبي العالمي

CONSULTATION PAPER
NO. 8 OF 2022

**PROPOSED REGULATORY
FRAMEWORK FOR PRIVATE
CREDIT FUNDS**

12 DECEMBER 2022

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Introduction

Why we are issuing this paper

1. The Financial Services Regulatory Authority ("**FSRA**") of Abu Dhabi Global Market ("**ADGM**") has issued this consultation paper to invite public feedback and comments on its proposed introduction of a specific regulatory framework, the "Private Credit Fund Framework", that would enable Funds and their respective Fund Managers to originate and invest in Credit. Defined terms contained in this consultation paper have the meanings attributed to them in the FSRA's Glossary Rulebook ("**GLO**"), unless otherwise defined in this paper.
2. In presenting the proposals outlined below, the FSRA is responding to interest from existing Fund Managers and potential Applicants seeking to establish such Funds that will raise investment for the purpose of investing in Credit, whether through the origination of, or participation in, Credit Facilities or the purchase of Credit-related instruments.

Who should read this paper

3. This Consultation Paper should be of particular interest to Fund Managers, potential Applicants seeking to operate as Fund Managers within ADGM, as well as investors, individuals and organisations active in the funds industry, and their respective professional advisors.

How to provide comments

4. All comments should be made in writing and sent to the mail address or email address specified below. If sending your comments by email, please use the Consultation Paper number in the subject line. If relevant, please identify the organisation you represent in providing your comments. The FSRA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making any comments. Comments supported by reasoning and evidence will be given more weight by the FSRA.

What happens next

5. The deadline for providing comments on these proposals is 27 January 2023. When we receive your comments, we will consider whether any modifications are required to the proposed Private Credit Fund Framework. The Board and the FSRA will then proceed to enact the proposed Private Credit Fund Framework. You should not act on these proposals until the relevant regulations and rules are issued. The FSRA will issue a notice on the ADGM website when this happens.

Comments to be addressed to:

Consultation Paper No. 8 of 2022
Financial Services Regulatory Authority
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ADGM Square
Al Maryah Island
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Background

1. The FSRA adopts a risk-based approach to regulation and supervision of the entities that it authorises, taking into account the nature, size and complexity of their business activities. Currently, the FSRA has in place a proportionate regulatory framework for ADGM-based fund managers, having regard to the size of the funds they manage and the sophistication of the clients they serve. An example of this is that fund managers that manage funds targeting Professional Clients are therefore subject to less stringent regulatory requirements compared to managers of Public Funds.
2. Credit funds are Funds with investment strategies which seek to earn returns from lending or Credit related investments, either through the origination of, or participation in, loans to borrowers, the purchase of existing loans from third party Lenders, the purchase of instruments creating or acknowledging indebtedness, or a combination of the foregoing. The popularity of such investment strategies has grown with the opportunity to invest in loans on terms which may be comparably attractive when compared to other asset classes, and are driven in part by difficulties faced by smaller, growth-stage companies that fall below lending thresholds for traditional bank financing.
3. The global private credit market has grown in the last ten years from an estimated US\$300 billion to almost US\$900 billion, with Funds sitting on approximately US\$300 billion of further commitments¹. Asset managers² are increasingly turning their focus to the private credit market as it is seen as an asset class that is growing.

International context and benchmarking

4. In 2016, the European Securities and Markets Authority (“**ESMA**”)³ issued an opinion on the use of Alternative Investment Funds to originate loans and called for a common European framework for such Funds, considering the different frameworks in place in several member states. The key proposals from ESMA, as reflected in the changes proposed to the Alternative Investment Fund Managers Directive (“**AIFMD**”), have been considered by the FSRA in developing the Private Credit Fund Framework.
5. Credit funds in jurisdictions such as Ireland, Germany, Spain, Malta and Italy operate within established regulatory frameworks that impose investment and operating restrictions to address risks. Such Funds are typically closed-ended or have limited redemption rights and a fixed term.

¹ <https://enterprise-sharing.ft.com/redeem/5812e295-225b-4577-93c9-c4a110adc144>

² <https://enterprise-sharing.ft.com/redeem/40a99b25-b86c-4f6e-8321-cae9c6e8330f>

³ https://www.esma.europa.eu/sites/default/files/library/2016-596_opinion_on_loan_origination.pdf

Potential for systemic risk

6. The growth of the size and importance of credit funds and other non-bank sources of Credit has been identified by the Financial Stability Board and others as a potential source of risk to the greater economy, as reliance upon such non-traditional sources of liquidity grows. Unlike banks, credit funds are not required to hold surplus capital to withstand economic shocks and are subject to the demands of Unitholders, who may individually seek to exit their investment, or collectively may decide to wind up the Fund. Such an exit may adversely impact borrowers which rely upon credit funds as sources of capital, with potential adverse consequences for the economy as a whole
7. The FSRA believes that credit funds that might be based in ADGM in the near term will not constitute a significant proportion of the overall amount of lending in either the State or the region. The FSRA is therefore proposing a risk-proportionate, 'wait and see' approach to the imposition of constraints that are found in some jurisdictions with a larger, more developed credit funds industry.

Proposed Private Credit Fund Framework

8. Within the credit fund industry in benchmarked jurisdictions, a variety of strategies are employed to locate suitable investment opportunities as well as address risk. Sources of investments, beyond origination, may include participation in syndicated lending, co-investment alongside institutional Lenders as well as the purchase of instruments creating or acknowledging indebtedness such as trade receivables. Measures used to address risk include the use of security over the assets of the debtor or other credit enhancement measures such as guarantees, as well as the assessment of creditworthiness and the appropriate pricing of the Credit Facility being offered or instrument purchased.

Investor base and maximum term

9. Given the inherent risks and limited liquidity of credit funds, it is the FSRA's view that such Funds are unsuitable for investment by Retail Clients, and should be operated as either a Qualified Investor Fund or Exempt Fund, referred to as a 'Private Credit Fund' for the purposes of this consultation paper.
10. The Private Credit Fund Framework does not currently specify a maximum term on the duration of a Private Credit Fund; the FSRA is of the view that, given the closed-ended nature of the Fund, investor appetite will dictate the maximum term for which potential Unitholders may be willing to invest.

Permitted investments

11. Private Credit Funds will be required to restrict their investments to Credit Facilities which include loans which the Fund may originate, purchase or participate in as well as Specified Investments which create or acknowledge

indebtedness. Private Credit Funds will be permitted to invest in equity securities of entities or groups to which it has extended Credit and may hold non-Credit related Financial Instruments for treasury, cash management and hedging purposes.

12. Private Credit Funds will also be required to adhere to specific operating restrictions, addressing conflicts of interest, concentration risk, disclosure, reporting, stress testing and leverage. Specific requirements include:
- a. a requirement that a Private Credit Fund be closed-ended;
 - b. a requirement that the Fund Manager must be located within ADGM;
 - c. a prohibition upon lending to certain types of borrowers, including Natural Persons, other Funds, Related Persons, other Lenders, Financial Institutions and Persons intending to use proceeds of the Credit Facility for speculative investment purposes;
 - d. concentration risk investment restrictions which require the Fund to diversity its exposures across multiple borrowers, while retaining flexibility that gives the Fund sufficient time to expand its loan portfolio to achieve the desired level of diversification;
 - e. a requirement to document the Fund's risk appetite statement and credit risk monitoring methods and disclose the same to potential Unitholders; and
 - f. the adoption of a pricing methodology relating to Credit and systems and controls necessary to monitor the Fund's existing Credit Facilities, including policies relating to the renewal and refinancing of Credit Facilities.

Question 1

Should a Private Credit Fund be permitted to operate as a hybrid or 'mezzanine'-type Fund, which may make equity investments in the businesses to which it extends Credit?

Stress testing

13. The Private Credit Fund Framework compels a Fund Manager of a Private Credit Fund to employ comprehensive and robust stress testing methods which consider principal market risk factors at a minimum on a monthly basis, such as changes in interest rate, FX rates and credit spreads, and apply multifactor stress testing considering severe economic events at minimum on a quarterly basis. The results of such stress testing are to be shared with the Governing Body of the manager of the Private Credit Fund at least quarterly.

Question 2

Do you agree with the proposed approach to stress testing? Is the frequency of stress testing and reporting sufficient? The FSRA seeks comments concerning other additional stress testing scenarios which should be contemplated.

Leverage

14. Whilst the FUND Rules do not currently limit the amount of financing a Fund marketed to Professional Clients may employ to meet its objectives, amongst benchmarked jurisdictions limits on leverage have been imposed upon Private Credit Funds to contain the potential contagion effect of borrower default. The FSRA, after considering the levels of restrictions imposed in benchmarked jurisdictions, is of the view that a limit upon leverage is warranted. The Private Credit Fund Framework proposes to limit the use of leverage by the Fund to 100% of Net Asset Value (NAV), i.e. imposing a cap of 50% loan to value of the Fund's portfolio.

Question 3

Do you agree with the proposed limit upon leverage which may be used by a Private Credit Fund?

Private Credit Funds within the FSRA's regulatory framework

15. Given the significant systems and controls required to operate a Private Credit Fund, the FSRA is of the view that a Private Credit Fund is unsuitable to qualify as a Venture Capital Fund.
16. Subject to specific exceptions, the FSRA currently requires ADGM-based lending businesses and the persons who exercise rights under a Credit Facility on their behalf to possess a Financial Service Permission ("**FSP**") enabling the firm to engage in Providing Credit. The FSRA's view is that it would be impracticable to impose these FSP requirements (and associated organisational and prudential requirements) upon Private Credit Funds and their respective Fund Managers. The FSRA therefore proposes that Private Credit Funds and their Fund Managers be exempted from the requirement to hold a FSP, or satisfy a specified Base Capital Requirement, to carry on the Regulated Activities of Providing Credit or Arranging Credit.
17. Similarly, the FSRA considers the current fee and capital requirements to be appropriate for managers of Private Credit Funds.
18. As with all Funds, a Fund Manager of a Private Credit Funds must perform Customer Due Diligence ("**CDD**") in respect of both the Unitholders of the Fund as well as the counterparties which enter into transactions with the Fund, in order to satisfy its obligations according to the AML Rulebook. In the case of a Private Credit Fund, a Fund Manager must perform CDD in relation to all borrowers and

prospective borrowers which seek to obtain Credit from the Fund, or sell debt instruments to the Fund.

Summary

19. The FSRA is proposing a proportionate, risk-appropriate regulatory framework enabling Fund Managers in ADGM to manage Funds which may invest in Credit Facilities, whether originated by the Fund or acquired from third parties, that balances the desire to respond to industry demand with necessary regulatory safeguards to ensure that such Funds operate in a safe and sound manner.

Proposed amendments to FSMR and FSRA Rulebooks

20. In order to implement the Private Credit Fund Framework, the FSRA proposes to introduce amendments to FSMR to enable Private Credit Funds and their managers to offer and arrange Credit, respectively, without imposing additional FSP requirements.
21. Proposed amendments to FUNDS and GLO would include the definition of a Private Credit Fund and establish the operating and investment restrictions set out above in a new Chapter 13A. A number of additional consequential amendments would be required across several Rulebooks. The proposed FSMR amendments are set out in **Annex A** to this paper, while the proposed amendments to the Rulebooks are contained in **Appendices 1 to 4**.
22. Additionally, the FSRA is proposing to provide guidance (see **Attachment 1**) to Fund Managers operating a Private Credit Fund, which will also cover their ongoing regulatory requirements after the granting of a Financial Services Permission.

Question 4

Do you have any additional comments on the draft legislative amendments to implement the Private Credit Funds Framework?

The detailed, proposed legislative amendments and proposed guidance are set out as follows.

- **Annex A:** Financial Services and Markets Regulations 2015 (FSMR)
- **Appendix 1:** Funds Rules (FUNDS)
- **Appendix 2:** Glossary (GLO)
- **Appendix 3:** Islamic Finance Rules (IFR)
- **Appendix 4:** Markets Rules (MKT)
- **Attachment 1:** Supplementary Guidance concerning Private Credit Funds