



ABU DHABI GLOBAL MARKET
سوق أبوظبي العالمي

DISCUSSION PAPER NO. 1 OF 2018

11 MARCH 2018

**PROPOSED REGULATORY
FRAMEWORK FOR OPERATORS OF
PRIVATE FINANCING PLATFORMS**

TABLE OF CONTENTS

Introduction.....	3
Proposed Regulatory framework	6
Background.....	6
A. Permitted activity.....	8
B. Risks Associated with PFP Transactions.....	9
C. Restrictions On Client Base.....	10
D. Client Assets.....	12
E. Capital Requirements.....	13
F. Risk Warning & Disclosure Statements.....	14
G. Due Diligence By PFP Operators.....	15
H. Restrictions On Marketing Communications.....	18
I. Management Of Potential Conflicts Of Interest.....	19
J. Exit Facility.....	20
K. Reporting Requirements.....	23
L. Complex Business Models.....	24
Implementation of the Proposed Regulatory Framework.....	25

INTRODUCTION

WHY ARE WE ISSUING THIS PAPER?

1. The Financial Services Regulatory Authority ("**FSRA**") of the Abu Dhabi Global Market ("**ADGM**") has issued this Discussion Paper to invite public feedback and comments on its proposed introduction of a regulatory framework that is tailored for operators of financing / funding platforms for non-public companies ("**Private Financing Platforms**").
2. Start-ups and small and medium enterprises ("**SMEs**") contribute significantly towards the UAE's economic growth. According to the UAE Ministry of Economy, the SME sector represents more than 94% of the total number of companies operating in the country and provides jobs for more than 86% of the private sector's workforce¹. Yet, SME financing makes up for only 4% of lending by UAE banks. According to the Arab Monetary Fund², while SMEs make up 80% of businesses in the region, only one in five has a loan or line of credit. The International Finance Corporation estimates the SME funding gap in MENA at US\$260 billion³.
3. Given the importance of start-ups and SMEs as key engines of economic growth and diversification in the region, it is important to develop alternative financing solutions to bridge the commercial funding gap and ease cash flow issues. Online Private Financing Platforms such as peer-to-peer lending, equity crowdfunding, invoice financing platforms and private investment / placement platforms that leverage data and technology can unlock new ways of raising money for small businesses from a qualified network of investors comprising professionals⁴ and potentially, individuals actively looking to diversify their portfolios.
4. Private Financing Platforms ("**PFPs**") can play an important role in the UAE and the region in developing the financing ecosystems for start-ups and SMEs

¹ <https://www.government.ae/en/information-and-services/business/crowdfunding/the-impact-of-smes-on-the-uae-economy>

² <https://www.thenational.ae/business/sme-lending-gap-in-region-must-be-filled-urges-amf-1.52640>

³ International Finance Corporation Report: "*Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises*" (August 2013, <https://openknowledge.worldbank.org/handle/10986/21728>)

⁴ These may include corporate ventures, private equity, venture capital, family offices, angel investors, accelerators / incubators, insurance firms, alternative asset managers, private banks and other wealth management service providers.

seeking to launch and grow their businesses, as well as spur innovation and enhance competitiveness in the SME sector. In addition to SMEs and start-ups, PFPs can serve a wide, private market landscape from very early stage to pre-IPO stage companies. As such, there are real socio-economic benefits in having a tailored regulatory regime that supports the development of PFPs.

5. The FSRA is proposing a risk-appropriate, calibrated regulatory framework for PFPs (the **“PFP Framework”**) that facilitates access by start-ups and SMEs to new alternate sources of funding, albeit primarily from Professional Clients, as an alternative to more traditional channels for financing, while applying the necessary regulatory safeguards to ensure they operate in a safe and sound manner for those clients. The term “clients” is used in this paper to denote the potential pool of lenders and investors which qualify to provide such funding, i.e. those on the buy-side of a PFP. Unless otherwise defined, capitalised terms referred to in this paper have the meanings attributed to such terms as contained in the Financial Services Markets Regulations 2015 (**“FSMR”**) and the Glossary (**“GLO”**).
6. FSRA would like to invite comments on the proposed introduction of the regulatory framework for PFPs. Our proposed regulatory framework will subsequently be effected through new regulations and rules, which FSRA will consult on after considering feedback and comments on this Discussion Paper.

WHO SHOULD READ THIS PAPER?

7. This Discussion Paper should be of particular interest to funding platform operators as well as investors, lenders, individuals and organisations active in the credit and investment sector, SME Issuers and borrowers, and their respective professional advisors.

HOW TO PROVIDE COMMENTS

8. 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 Discussion 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?

9. The deadline for providing comments on this proposal is **10 April 2018**. When we receive your comments, we will consider whether any modifications are required to the proposed regulatory framework. FSRA will then proceed to draft the relevant regulations, rules and guidelines (if applicable) for public consultation. You should not act on this proposal until the relevant regulations and rules are issued.

COMMENTS TO BE ADDRESSED TO:

Discussion Paper No. 1 of 2018
Financial Services Regulatory Authority
Abu Dhabi Global Market Square
Al Maryah Island
PO Box 111999
Abu Dhabi, UAE
Email: consultation@adgm.com

BACKGROUND

10. Given the business models of PFPs, the FSRA has received feedback that the current regulatory framework in ADGM might be better tailored to encourage PFP operators to play an active role in securing financing from qualified investors for start-up and SME businesses that might be offered on a PFP (“**PFP Prospects**”). In achieving the objective of facilitating such funding, the core undertakings that a PFP operator would undertake on behalf of the PFP Prospects and its network of clients might include the following.
- (i) Helping PFP Prospects better structure their business offerings to the investor community (“**PFP Transactions**”), thereby aiding them to secure subsequent funding rounds without the administrative burden⁵ of coordinating corporate actions involving many different clients.
 - (ii) Screening opportunities in PFP Transactions on behalf of its network of clients (see Section C, “Restrictions on client base”) who do not have the time and resources to do so, providing a degree of assurance to clients that PFP Prospects are of an acceptable quality.
 - In some instances a PFP operator may have a proprietary data-driven and technology-enabled due diligence process to screen investment opportunities, ensuring PFP Prospects meet certain criteria before they are made available to the client network. For instance, a PFP operator may decide that only deals with a lead, anchor investor may be offered on its platform, whereupon other suitable investors from its platform network are invited to join the investment round. A second example is the case of invoice financing which converts outstanding invoice receivables into immediate cash for an SME, the PFP operator may select PFP Prospects that conduct business with multinational corporations (“**MNCs**”) as the main credit risk lies with the payer, being the MNC.

⁵ Some platforms may operate a nominee structure, allowing PFP Prospects to interact with a single investor rather than many.

- (iii) As part of the business model, a PFP operator may also wish to help clients seeking to divest their investments in the PFP Prospect⁶ which is otherwise difficult due to the illiquid nature of the PFP Transactions.
11. We propose permitting two types of PFP Transaction to be offered in or from the ADGM, those being loan-based or investment-based crowdfunding⁷, where those activities might be undertaken on a single or distinct PFPs.
- (i) In terms of **loan-based** PFPs, the PFP operator would seek to connect several clients to a single borrower with the clients entering into separate credit agreements with that one borrower; the clients would lend money to the borrower in the expectation of a financial return in the form of interest payments and repayment of their capital over time.
- (ii) For **investment-based** PFPs, the PFP operator would seek to connect several clients to a single issuer with the clients investing directly or indirectly⁸ in securities issued by a single business; the clients would invest money in the expectation of dividend payments and a positive return on their investment over time.
12. Depending on its business model, a PFP operator would typically be required to hold a Financial Services Permission ("**FSP**") under the FSMR to undertake any one or more of these Regulated Activities⁹:
- (i) Advising on Investments or Credit;
- (ii) Arranging Credit (for loan-based PFPs)¹⁰;
- (iii) Arranging Deals in Investments (for investment-based PFPs).
13. In addition, any Offer of Securities to the Public within the ADGM through an investment-based PFP is required to be accompanied by a Prospectus under Section 61 of the FSMR, unless it qualifies as an Exempt Offer as set out in

⁶ For instance, there may be a change in the PFP Prospect's corporate strategic direction which the client does not agree with, or there may be an expected change in the client's financial situation.

⁷ There are other common types of crowdfunding such as donation-based and reward-based crowdfunding, which are not regulated as they do not involve offers of Specified Investments as defined under FSMR.

⁸ Typically through a Special Purpose Vehicle (SPV).

⁹ Although the PFP operator may also be conducting additional Regulated Activities under FSMR, e.g. Dealing in Investments, Providing Credit, etc.

¹⁰ The proposed PFP framework is not intended to cover institutional syndicated lending.

Chapter 4 of the Markets Rules (“**MKT**”)¹¹. It is our intention that any offers under the proposed framework must meet the conditions to qualify as an Exempt Offer.

14. In conclusion, given the objective of establishing and developing alternative sources of funding for start-ups, SMEs and private businesses, and in the light of the considerations above, the FSRA considers that there is merit to put in place a risk-appropriate, calibrated PFP Framework.
15. The following Sections A to K set out the characteristics of the proposed PFP Framework.

A. PERMITTED ACTIVITY

16. As mentioned previously, the services provided by a PFP operator could fall within the scope of some of the FSRA’s existing Regulated Activities. However, the FSRA is considering the introduction of a new Regulated Activity of “Operating a Private Financing Platform” that would solely capture loan-based and investment-based PFPs and fall within Category 4 for the purposes of prudential supervision.

ISSUES FOR CONSIDERATION

QUESTION 1:

THE FSRA SEEKS COMMENTS ON THE PROPOSAL TO CREATE A NEW REGULATED ACTIVITY SPECIFICALLY FOR PFPs OPERATORS.

¹¹ MKT Rule 4.3 sets out that a Person may make an Offer of Securities to the Public without a Prospectus where any one of the following conditions, amongst other conditions in that Rule, is met:

- a. an Offer is made to or directed at only Professional Clients other than natural Persons;
- b. an Offer is directed at fewer than 50 Persons in any 12 month period, excluding Professional Clients who are not natural Persons;
- c. where the consideration to be paid by a Person to acquire Securities is at least US\$100,000; or
- d. the Securities offered are denominated in amounts of at least US\$100,000.

B. RISKS ASSOCIATED WITH PFP TRANSACTIONS

17. Notwithstanding the benefits of a PFP Framework to the financing landscape for start-ups and SMEs, there are risks associated with PFP Transactions, including but not limited to the following.

- (i) Loss of capital: PFPs would attract mainly start-ups and SMEs that do not have an established track record, for which the observed failure rate is generally high. This poses high risks of capital loss to clients, particularly for those who may not be familiar with start-up or SME investing.
- (ii) Lack of liquidity: In the absence of a ready secondary market for PFP Transactions, clients face the risk of not being able to exit their PFP Transactions¹² or having to transfer them at a significant discount.
- (iii) Lack of information on PFP Prospects: There may not be sufficient information on the business proposals to be funded to enable clients to conduct proper due diligence and make fully informed investment decisions. Given that fundraising would be carried out through online platforms, clients may not have direct contact or recourse with the PFP Prospects. There is no assurance that the information provided by the PFP Prospects would be accurate or accessible and therefore that the projected valuations or returns to investors would materialise.
- (iv) Platform failure: Clients of a PFP may not be able to readily recover their assets in the event that a PFP operator that handles Client Assets fails and becomes insolvent. This may be further complicated in cross-border PFP Transactions, where they may be subject to the potentially conflicting laws and regulations of two jurisdictions. Clients who rely on the PFP operator to help seek recourse in relation to their PFP Transactions may be adversely affected.
- (v) Conflicts of interest of the PFP operator: The remuneration of a PFP operator is typically linked to the amount of funds raised so the interests

¹² For loan-based investments, the client cannot usually seek repayment of the loan on demand, as they might for a bank deposit account. The client must wait to be repaid under the terms of the loan, which may be a long term loan, or must assign his rights under a loan to another lender to exit the loan. For investment-based PFP Transactions, a Client must seek a willing buyer with the appropriate risk appetite to exit a position, which may be challenging given the high risks and subjective valuation of such investments.

of a PFP operator may be more aligned with those of the PFP Prospect than those of the client.

18. A key consideration for the FSRA in considering the regulatory approach for PFPs is to strike a balance between facilitating the establishment of PFPs in the AGDM to serve the UAE and the region, and ensuring that there are sufficient safeguards for clients. The proposed safeguards to mitigate the risks outlined above are considered and discussed in further detail in the following sections.

C. RESTRICTIONS ON CLIENT BASE

19. As a business model, PFP operators generally do not provide financial advisory services to clients. Under these circumstances, the onus is on clients to seek independent financial advice or to make their own evaluation of the risks associated with any potential loan or investment. Nonetheless, under Rule 3.4 of the Conduct of Business (“**COBS**”) Rulebook, before providing financial services to a client, an Authorised Person is required to have a reasonable basis to consider that the transaction is suitable for that particular client.
20. Notwithstanding the suitability requirements that would be applicable to PFP operators as Authorised Persons, the FSRA believes that Retail Clients¹³, in general, may not appreciate the high risks associated with PFP transactions even where comprehensive risk warnings are provided. Professional Clients, on the other hand, are more sophisticated and have more resources and capacity to make informed decisions on prospective loans or investments after factoring in consideration of the inherent risks. It is also likely that Professional Clients are better placed to assist start-ups and SMEs by contributing their expertise, experience and contact networks. Therefore, the FSRA proposes to restrict accessibility to PFPs under the PFP Framework to Professional Clients¹⁴.
21. The FSRA recognises, however, that there may be some Retail Clients who have sufficient expert knowledge about the businesses of the PFP Prospects

¹³ COBS Rule 2.3.

¹⁴ This may be imposed by means of a licence condition of the FSP granted to the PFP operator.

sourced by the PFP operator (e.g. through having worked in a similar industry sector). In this regard, and on an exceptional basis, the FSRA proposes to allow PFP operators to serve Retail Clients subject to the PFP operator putting in place proper policies and procedures to perform pre-qualification of Retail Clients, and having a reasonable basis to believe, through performing a client suitability test, that:

- (i) those qualified Retail Clients have the requisite knowledge and/or experience to invest in PFP Transactions; and
- (ii) particular PFP Transactions, as a group, are suitable for the Retail Clients in light of their investment objectives and risk tolerance.

22. Under these exceptional circumstances, i.e. where Retail Client participation is permitted, the FSRA may impose other risk-appropriate retail protections such as investment / lending limits and cooling-off periods prior to closing of the PFP Transaction, given the higher potential for conduct risks to exist with those clients and depending on the nature and scale of the PFP operator's business. The PFP operator would be required to conduct periodic reviews on the circumstances relating to its clients, for both Professional Clients and any Retail Clients, to ensure they remain qualified.

23. In addition, it is noted that an investment-based PFP Transaction offering securities to the public from ADGM would need to be accompanied by a Prospectus unless it qualifies as an Exempt Offer. In order to mitigate the specific risks associated with investment-based PFP Transactions, the FSRA proposes to only allow offers of PFP Transactions that comply with the Exempt Offer restrictions. It is expected that most PFP Prospects undertaking investment-based fundraising would seek to do so via an Exempt Offer as, for start-ups and SMEs, complying with the full Prospectus requirements for a generally small fundraising exercise from Professional Clients is usually not viable given the costs and resources involved in preparing a Prospectus. In light of the limited reach under an Exempt Offer, the FSRA is of the view that the restricted opening up of PFP activities to Retail Clients as mentioned above is risk-appropriate.

24. It is envisaged that any PFP Prospect would be a Body Corporate and would therefore qualify as a “Service-Based”¹⁵ Professional Client. All potential buy-side clients would have to be pre-screened and on-boarded before being allowed to access the platform to ensure that they meet the eligibility criteria to be classed as either “Deemed”¹⁶ or “Assessed”¹⁷ Professional Clients. In both cases, it would be a pre-requisite that all of these parties do not elect to be treated as a Retail Client unless the PFP operator’s FSP permits them to service such clients.
25. The FSRA notes that PFPs would be a relatively new form of financing for private businesses in the region, and this form of financing is at a nascent stage of development. The FSRA would continue to monitor market developments in considering the appropriateness of extending PFP participation to those Retail Clients with sufficient expertise should an innovative proposal for that category of clients come along. With this in mind, and more generally, it is proposed that the FSRA may waive requirements in the proposed PFP Framework on a case-by-case basis subject to the PFP operator having appropriate safeguards.

ISSUES FOR CONSIDERATION

QUESTION 2:

THE FSRA SEEKS COMMENTS ON ITS PROPOSED CLIENT RESTRICTIONS.

QUESTION 3:

THE FSRA SEEKS COMMENTS ON THE APPROPRIATE SAFEGUARDS THAT SHOULD BE INTRODUCED IF THE FSRA WERE TO EXTEND PFP PARTICIPATION TO RETAIL CLIENTS MORE BROADLY.

D. CLIENT ASSETS

26. As best practice, a PFP operator should not hold or control Client Assets and would be required to appoint a third party escrow agent or custodian.
27. However, the FSRA recognises that with advances in financial technology (“FinTech”) and distributed ledger technology (“DLT”), PFP operators may

¹⁵ COBS Rule 2.4.3.

¹⁶ COBS Rule 2.4.2

¹⁷ COBS Rule 2.4.4

better achieve escrow capabilities through smart contracts, and secured custody of Client Investments on the blockchain ledger. A PFP operator may therefore wish to hold or control Client Money, especially in the case where client funds are pledged before being transferred to the PFP Prospect, but an Authorised Person in prudential Category 4 is currently prohibited from doing so under COBS Rule 14.2.3(a). In order to facilitate this business model and apply appropriate safeguards, the FSRA may remove the prohibition on Category 4 firms that are PFP operators to enable them to hold or control Client Money. Re-calibrated capital requirements (see paragraph 28) and the Client Money provisions in COBS would also apply to such firms.

ISSUES FOR CONSIDERATION

QUESTION 4:

THE FSRA SEEKS COMMENTS ON THE PROPOSED CLIENT ASSET REQUIREMENTS FOR PFP OPERATORS.

QUESTION 5:

IN SOME INSTANCES WHERE A PFP OPERATOR INTENDS TO HOLD OR CONTROL CLIENT ASSETS, THE FSRA SEEKS COMMENTS ON WHAT ALTERNATIVE ARRANGEMENTS ENABLED BY FINTECH OR DLT MAY BE AVAILABLE TO ENSURE ADEQUATE SAFEGUARDING OF CLIENT ASSETS.

E. CAPITAL REQUIREMENTS

28. A PFP operator not holding or controlling Client Assets would be subject to Category 4 capital requirements under the Prudential Rulebook (“**PRU**”). As such, the PFP operator is subject to a Capital Requirement, being the higher of a Base Capital Requirement (“**BCR**”) of US\$10,000 or an Expenditure Based Capital Minimum (“**EBCM**”) computed as 6/52 of its Annual Audited Expenditure. If the PFP operator’s business involves holding or controlling Client Assets, the FSRA will have to calibrate the capital requirements accordingly.
29. As with other Category 4 firms, the PFP operator would be required to maintain professional indemnity insurance cover appropriate to the nature, size, and risk profile of its business as set out in PRU Rule 6.12.

ISSUES FOR CONSIDERATION

QUESTION 6:

THE FSRA SEEKS COMMENTS ON CAPITAL REQUIREMENTS FOR PFP OPERATORS UNDER THE PROPOSED PFP FRAMEWORK.

F. RISK WARNING & DISCLOSURE STATEMENTS

30. In order to ensure that all clients are aware of the risks associated with PFP Transactions, the FSRA would require a PFP operator to provide a written risk warning to each client and to obtain a signed acknowledgement (in written or electronic form) that they fully understand the risks involved, including potential losses that they might suffer through the poor performance or the failure of the PFP Prospect, before the client makes its first PFP Transaction on the platform. The risk warning is to be readily and prominently available on the platform and, as an absolute minimum, would be required to address the risks as set out in paragraph 17 of this paper.
31. Separately, a PFP operator would be required to provide appropriate information and disclosure to clients (e.g. in the client agreement) on how its platform model works, its remuneration model, its roles and obligations¹⁸, and the available recourse in the event of the failure of the PFP operator, in addition to the existing disclosure obligations in COBS¹⁹ and FSMR.
32. In the event that there is a material adverse change in the circumstances of the PFP Transaction or the related PFP Prospect defaults, the PFP operator would also be required to disclose to the relevant clients its arrangements for the return of the Client Assets.
33. The FSRA has considered requiring other specific disclosures such as information on expected and actual default rates of the PFP Transactions, but would not mandate such a requirement at this stage in light of the nascent

¹⁸ If the relationship between the Client and the PFP operator is non-advisory in nature, the PFP operator shall clearly disclose the fact and that the offer information presented for each PFP Transaction does not constitute personal advice or recommendation.

¹⁹ For instance, an Authorised Person is subject, as applicable, to disclosure requirements under COBS Rules 3.3.2 (client agreements) and 3.5.4 (conflicts of interest).

stage of the PFP industry in this region and that such information is unlikely to be currently available. However, as a PFP operator establishes an operating track record, such disclosure may foster better trust and confidence in PFPs as a viable alternative source of financing. The FSRA will continue to monitor industry development and review the need for such disclosure, and its form, as the market evolves and encourage appropriate disclosure in this area as best practice.

ISSUES FOR CONSIDERATION

QUESTION 7:

THE FSRA SEEKS COMMENTS ON THE RISK DISCLOSURE REQUIREMENT FOR PFP OPERATORS, AND WHETHER THERE ARE ANY OTHER SPECIFIC RISKS THAT SHOULD BE PRESCRIBED FOR DISCLOSURE UNDER THE PROPOSED PFP FRAMEWORK.

G. DUE DILIGENCE BY PFP OPERATORS

34. In view of the risks of PFP Transactions, given they involve start-ups and SMEs, the FSRA would require that a PFP operator undertakes appropriate and proportionate due diligence covering, as a minimum, the following areas before accepting any PFP Prospect onto its platform.
- (i) Fitness and propriety checks on the PFP Prospect, its management and key officers, including but not limited to, their integrity and honesty, competence and capability, and financial soundness.
 - (ii) Reasonable measures to reduce the opportunity for fraud to occur including, but not limited to, obtaining background and regulatory history checks on the PFP Prospect, its management and key officers, and having a reasonable basis for believing that the PFP Prospect is complying with applicable laws (e.g. governing laws on financial crime, financial services, etc.).
 - (iii) Reviewing the proposal from the PFP Prospect (the “**PFP Proposal**”) in relation to the PFP Transaction, to form a reasonable basis for believing that the PFP Proposal adequately sets out relevant information in a

clear, fair and not misleading manner for clients to make an informed decision including, but not limited to:

- general information about the PFP Prospect including details of its incorporation, commercial licence, directorships, major shareholders, beneficial holders;
- the business proposal and business model;
- financial information about the PFP Prospect;
- criteria by which the PFP Transaction would be regarded as being in default;
- a wind-down plan, including information on the return of Client Assets, in the event of business default/failure of the PFP Prospect;
- features, structures, and subscription classes of the PFP Transaction;
- basis of subscription class and allotment to each client;
- treatment, voting / contractual rights and claims of Clients of the PFP Transaction in any particular subscription class;
- pricing and valuation basis of the PFP Transaction;
- risks specific to the PFP Prospect and PFP Transaction;
- parties involved in the PFP Transaction and any conflicts of interest, including any financial or other interests that the PFP operator, its key officers, Employees and Associates have in the PFP Prospect or PFP Transaction;
- any roles and responsibilities that the PFP operator would or would not carry out on behalf of clients in any administrative / corporate actions;
- whether the PFP Prospect is seeking funding from other sources at the same time;
- intended use of funds;
- treatment of oversubscriptions and maximum amount accepted, if applicable;
- any cancellation rights;
- format / frequency of performance reporting to clients; and

- format / frequency of ongoing disclosure of applicable information in relation to the PFP Transaction and PFP Prospect.
- (iv) Ensure any material changes to the information disclosed to clients prior to closing of the PFP Transaction is updated and notified to clients.
35. A PFP operator would be required to maintain proper documentation of its due diligence process and the basis for accepting a PFP Transaction onto its platform, in order to facilitate supervisory oversight by the FSRA. The PFP operator is not required to publicly disclose actual due diligence reports, but is required to disclose and explain in a clear way the selection and acceptance criteria for PFP Transactions to be offered on its platform, and the due diligence approach under each criterion it chooses to use.
36. For example, in performing due diligence of a loan-based PFP Transaction, a PFP operator may assess the creditworthiness of a PFP Prospect including their ability to make repayments as they fall due; in this example, the PFP operator would be required to disclose and explain to potential lenders its approach to assessing creditworthiness of that PFP Prospect. Similarly, if the PFP operator relies on independent third party experts or specialist advisers to conduct the selection due diligence on a PFP Prospect²⁰, the PFP operator would have to disclose and explain the methodology adopted by the adviser on its platform.
37. An exception to the requirements in paragraph 34 would be permitted where a PFP operator wishes to gauge the interest from registered clients in a potential PFP proposal prior to publishing it. This private forum or message board must only publish general information about a potential PFP proposal which does not allow the related start-up or SME to be identified and must disclose that no or limited due diligence has been undertaken on that business. A PFP operator must monitor the forum or message board to remove any potentially misleading or fraudulent posts.
38. In addition to the above due diligence process, the PFP operator (as per any other Authorised Person) would be required to comply with all applicable regulatory requirements as set out in the Anti-Money Laundering and

²⁰ This may be the case to mitigate potential conflict of interest between the PFP operator and the PFP Prospect.

Sanctions Rules and Guidance (“**AML**”), and have systems and controls in place to mitigate the risk of financial crime that may arise from both the PFP Prospect and client side of a PFP Transaction.

ISSUES FOR CONSIDERATION

QUESTION 8:

THE FSRA SEEKS COMMENTS ON THE TRANSACTION DUE DILIGENCE REQUIREMENTS FOR PFP OPERATORS, AND WHETHER THERE ARE ANY OTHER SPECIFIC OBLIGATIONS THAT SHOULD BE PRESCRIBED TO ENHANCE CUSTOMER SAFEGUARDS AND CONFIDENCE UNDER THE PROPOSED PFP FRAMEWORK.

QUESTION 9:

THE FSRA SEEKS COMMENTS ON THE PRIVATE FORUM OR MESSAGE BOARD FACILITY AND WHETHER IT IS SUITABLE TO GAUGE PRIOR INTEREST IN A POTENTIAL PFP PROSPECT.

H. RESTRICTIONS ON MARKETING COMMUNICATIONS

39. As set out in Section C above, the FSRA would restrict the client base under the PFP Framework to Professional Clients, but retain the opportunity to extend the client base to Retail Clients should an innovative proposal appear and where, critically, those potential clients meet the client suitability test and appropriate retail controls are imposed.
40. As access to PFPs is to be available only to a restricted client base, mass solicitation, advertising or canvassing in relation to PFP Transactions would not be permitted. In order to ensure that PFP Transactions are limited in terms of scope and reach, the FSRA would require a PFP operator to restrict access to the details of PFP Transactions and PFP Prospects published on its platform to registered clients only. Clients would only be given access to the PFP if they meet the conditions set out by the PFP operator (e.g. Professional Clients or Retail Clients who have met the client suitability test), with access to the PFP Transactions only through clients logging onto the platform with their registered, controlled access details. Generally, we note that PFPs operate in this manner, and hence they should not have issues complying with this requirement.

41. The above restriction does not prohibit the PFP operator from promoting its platform to the general public. Such communications may include general information about a PFP operator, its business model and performance, as well as PFP Prospects accepted on its platform, but the communications must not include any information on specific offers in relation to a PFP Prospect or PFP Transaction.
42. As with all other Authorised Persons, a PFP operator is required to ensure any financial promotion and communication about the offerings on its platform and any Regulated Activities it undertakes is clear, fair and not misleading²¹.

ISSUES FOR CONSIDERATION

QUESTION 10:

THE FSRA SEEKS COMMENTS ON THE PROPOSED RESTRICTIONS ON MARKETING COMMUNICATIONS FOR PFP OPERATORS IN VIEW OF THE NATURE OF PRIVATE FINANCING, AND WHETHER THERE ARE OTHER PRACTICAL APPROACHES THAT MAY BETTER ACHIEVE THE REGULATORY INTENT UNDER THE PROPOSED PFP FRAMEWORK.

I. MANAGEMENT OF POTENTIAL CONFLICTS OF INTEREST

43. In order to manage any potential conflicts of interest that a PFP operator may have in promoting PFP Prospects and presenting the related PFP Transactions to its client base via its platform, the FSRA would prohibit PFP operators from carrying on the Regulated Activities of Managing a Collective Investment Fund and Managing Assets.
44. COBS Rule 3.5 specifies that “[A]n Authorised Person must take reasonable steps to ensure that actual conflicts of interest between itself and its Clients and between one Client and another Client are identified and then prevented or managed”; in the context of this Section the term “Clients” in this Rule should be taken to refer to both PFP Prospects and the clients on the buy-side

²¹ As per COBS Rule 3.2. For instance, when setting out the amount of funds to be raised, the PFP operator must distinguish between funds raised on the platform from clients not connected to the PFP Prospect and those raised by clients who are connected to the PFP Prospect, otherwise, this may lead clients to believe there is greater interest in the PFP Transaction from non-connected clients than is the case. The use of words that imply greater capital security than really exists (terms such as ‘guaranteed’, ‘protected’, ‘safe’ or ‘secure’) should be avoided.

of a PFP. In order to address any specific conflicts of interest that may arise in PFP activities the FSRA would impose the following requirements.

- (i) A PFP operator must clearly disclose the nature of all compensation and fees received from the PFP Prospect in connection with the PFP Transaction²².
- (ii) Where a PFP operator, its Associates or Employees may have a financial, or other, interest in the PFP Prospect²³ or participate in the PFP Transaction, the PFP operator must establish and maintain adequate policies and procedures to identify, address and manage any potential conflicts of interest arising from the proprietary or staff transactions. The PFP operator must clearly disclose any such interest in connection with a PFP Transaction.

ISSUES FOR CONSIDERATION

QUESTION 11:

THE FSRA SEEKS COMMENTS ON THE CONFLICT MANAGEMENT REQUIREMENTS FOR PFP OPERATORS, AND WHETHER THERE ARE ANY OTHER SPECIFIC DISCLOSURES OR PROHIBITIONS THAT SHOULD BE PRESCRIBED UNDER THE PROPOSED PFP FRAMEWORK.

J. EXIT FACILITY

45. As highlighted in paragraph 17, clients participating in PFP Transactions are exposed to liquidity risk, especially when seeking to exit their positions, given the nature of private capital markets. In order to help clients manage their liquidity risk in this case, a PFP operator may organise an incidental facility (termed the “**Exit Facility**”) to permit “seller clients” to exit their PFP Transactions, by allowing them to seek potential “buyer clients” to transfer their rights and obligations under their loan or investment agreements (via “**Transfer Transactions**”)²⁴.

²² This may be disclosed in a PFP Proposal document as per paragraph 34(iii) or within the platform itself.

²³ Including Board participation in an SPV structure.

²⁴ Such an Exit Facility could operate on a basis similar to an OTC ‘bulletin board’, where transactions are ultimately negotiated directly between the buyer and seller clients. The Exit Facility is not intended to operate as a trading venue (such as a Recognised Investment Exchange or Multilateral Trading Facility), and so may be considered an ‘incidental facility’ for a client to either exit from or to enter into a PFP Transaction.

46. The Exit Facility would not allow active trading by clients and would be solely an ancillary service alongside the core financing activity of the PFP. In order to ensure that proper business conduct is observed in the operation of such an Exit Facility, the FSRA would impose the following requirements.

- (i) Only existing, registered clients of the PFP operator would have access to and may participate in the Exit Facility, to ensure that it is not open to the public.
- (ii) The PFP operator must provide appropriate information and disclosure on how the Exit Facility operates.
- (iii) A PFP operator must provide a buyer client with any and all information that was originally published and provided to the seller client in relation to the PFP Proposal and any and all updates subsequently provided to the seller client as a result of any material change in the circumstances of the PFP Proposal.
- (iv) In the case of investment-based PFP Transactions subject to the Exit Facility, a PFP operator and the PFP Prospect must continue to comply with the conditions under the Exempt Offers regime. It is not intended for the PFP operator or the PFP Prospect to be able to bypass the Exempt Offers restriction through the use of the Exit Facility²⁵.
- (v) In order to safeguard against potential market abuse, as well as ensure that the Exit Facility is not used for active trading, the PFP operator must not deal in or facilitate trades as a market-maker, nor appoint a third-party market-maker. Further, the requirements in the COBS and General Rulebook (GEN) relating to communication, fraud and market conduct would apply to a PFP operator in relation to both loan- and investment-based financing.
- (vi) In order to address potential conflicts of interest, a PFP operator would be prohibited from advising and negotiating on behalf of any and all parties in relation to a Transfer Transaction.
- (vii) The PFP operator, its Associates or Employees who participate in a PFP Transaction and wish to transfer their rights to or obligations in a loan-

²⁵ For example, if the PFP operator is relying on the condition to have investments from fewer than fifty Persons in any twelve-month period to qualify for an Exempt Offer, it is not allowed to breach the exemption condition through the Exit Facility.

or investment-based asset on the Exit Facility must disclose their identities and interests to the buyer client.

47. For clients who might wish to reserve the opportunity to use the Exit Facility at some time in the future, a PFP operator may arrange for them to participate in an underlying PFP Transaction via a Special Purpose Vehicle (“SPV”) as “indirect” investors. The benefit of using an SPV is that it would allow a client holding shares or contractual rights in the SPV to transfer its holdings or rights to another investor, the buyer client in this case, without affecting the underlying PFP Transaction, which might otherwise be a very complex process²⁶.
48. While the use of an SPV structure facilitates the exit of a seller client from a PFP Transaction, it is often industry practice that the rights of a client in the position as an indirect investor or its entitlements in such a structure are not ranked *pari passu* with those of direct investors²⁷. Under those conditions, and in order for the PFP operator to establish an Exit Facility using an SPV structure, it usually requires the PFP operator to be nominated as a director of the SPV, where it may or may not have voting rights, in order to represent the indirect investors in relation to any administrative or corporate actions. The clients, as indirect investors through the SPV, do not get any voting rights and instead, would only get information rights. Consequently, in the event of multiple funding rounds, clients may not be able to avoid the dilution of the value of their shareholdings or subordination of their rights.
49. In order to ensure that clients in a PFP Transaction are aware of the risk that other investors may receive more rights, e.g. anti-dilution rights in the event of multiple funding rounds, the PFP operator would be required to disclose to clients details of the attributes of the subscription classes, as well as of the

²⁶ For example, the PFP Prospect may impose lock-in periods in the PFP Transaction that prohibit early exit, or require approval for any transfer of voting shares/contractual rights to ensure that only strategic, longer-term investors are on-boarded. Some PFP Prospects may also prefer an SPV nominee structure, which would allow them to interact with a single investor, i.e. the SPV, in respect of any administrative/corporate action, instead of many counterparties.

²⁷ A common structure involves the largest/lead investor being nominated as a director of the SPV that would represent the rest of the investors for corporate actions. Another structure is that all indirect investors (typically referred to as “followers”) do not get voting rights and instead, would only get information rights. Only lead investors who invested directly would get voting rights.

roles and responsibilities that the PFP operator would or would not carry out on behalf of clients in any administrative / corporate actions²⁸.

50. The FSRA would monitor the activities of such Exit Facilities as part of its supervisory process. Where the Exit Facility exhibits characteristics of a trading platform (including depth, liquidity and significant “turnover” being provided via the Exit Facility) the PFP operator may be subject to the relevant requirements under the Market Infrastructures Rules (“**MIR**”) or section 8 of COBS as applicable to Multilateral Trading Facilities (“**MTFs**”) or Organised Trading Facilities (“**OTFs**”)²⁹, depending on the business model that the Exit Facility most closely resembles. Importantly, the application of the Market Abuse provisions of FSMR Part 8 would also then apply.

ISSUES FOR CONSIDERATION

QUESTION 12:

THE FSRA SEEKS COMMENTS ON THE REQUIREMENTS WHERE PFP OPERATORS SEEK TO PROVIDE AN EXIT FACILITY, AND WHETHER THERE ARE ANY OTHER SPECIFIC SAFEGUARDS THAT SHOULD BE PUT IN PLACE UNDER THE PROPOSED PFP FRAMEWORK.

K. REPORTING REQUIREMENTS

51. As per the current requirement for Category 4 firms authorised by the FSRA, PFP operators would be required to comply with the financial reporting requirements under PRU and GEN.
52. Should the PFP operator be permitted to hold or control Client Money, it would be required to comply with the applicable client reporting provisions under COBS Rule 14.2.1 and auditor reporting provisions under COBS Rule 14.2.13 and GEN Rule 6.6. Unless otherwise agreed by a client, the PFP operator must provide the client with relevant information on transactions

²⁸ As outlined under paragraph 34(iii) above, i.e. “features, structures, and subscription classes of the PFP Transaction ... treatment, voting/contractual rights and claims of clients of the PFP Transaction in any particular subscription class”.

²⁹ OTFs can operate a trading venue in relation to non-equity type instruments, including Debentures.

or administrative / corporate actions executed on their behalf as set out in COBS Rule 6.10.

ISSUES FOR CONSIDERATION

QUESTION 13:

THE FSRA SEEKS COMMENTS ON THE ONGOING REPORTING REQUIREMENTS UNDER THE PROPOSED PFP FRAMEWORK, AND WHETHER THERE IS OTHER ESSENTIAL INFORMATION THAT SHOULD BE REPORTED TO CLIENTS OR THE FSRA.

L. COMPLEX BUSINESS MODELS

53. Given the state of start-up / SME financing in the ADGM, the UAE and the region, and the regulatory considerations set out in this paper, the proposed PFP Framework for ADGM would cater to the more common loan-based and investment-based PFPs, where the funding sought is intended to fund the business growth and/or cash flow needs of the PFP Prospect.
54. There are other PFPs with more complex / innovative business models, including those involving PFP Transactions that are pooled among different PFP Prospects and sold to multiple investors through the securitisation of SPVs or back-to-back loan agreements. Through such innovative structures there is also the potential for maturity transformation³⁰ of investments. The pooling of investments and thereby risks (among other factors) may mean that these platforms are undertaking other Regulated Activities, e.g. Managing a Collective Investment Fund, and hence would be subject to the appropriate requirements under the FSMR.
55. On balance, the FSRA is of the view that the proposed PFP Framework would be appropriately calibrated to foster the development of practical yet effective alternative financing channels, while protecting the interests of the community providing the funding, whether loan-based or investment-based.

³⁰ For instance, loan-based PFP Prospects may borrow on the usual terms, for loan periods of five years, but through securitization, clients may be allowed to take out their money after a thirty-day notice period; this could be deemed as deposit-taking, depending on the precise nature of the arrangement, and hence be considered a Regulated Activity.

Where potential applicants wish to establish PFPs with business models that fall outside the proposed PFP Framework, the FSRA would work with them on identifying the relevant Regulated Activities to be covered by the an FSP. The FSRA would continue to monitor market developments and refine our regulatory approach in future depending on how the PFP market evolves.

ISSUES FOR CONSIDERATION

QUESTION 14:

THE FSRA SEEKS COMMENTS ON WHETHER THE SCOPE OF THE PFP FRAMEWORK IS APPROPRIATE TAKING INTO ACCOUNT THE STATE OF THE INDUSTRY FOR START-UP / SME FINANCING IN THE UAE AND THE REGION.

IMPLEMENTATION OF THE PROPOSED REGULATORY FRAMEWORK

AMENDMENTS TO FSRA RULES & ISSUANCE OF GUIDANCE

56. In order to implement the PFP Framework, the FSRA is considering the introduction of a new Regulated Activity relevant to PFPs, as outlined in paragraph 16, and related definitions that would allow for a differentiated but suitable framework to apply to PFP operators. The relevant FSRA Rules will also be amended to implement the PFP Framework.
57. In addition, the FSRA will draft guidelines detailing the associated authorisation criteria and ongoing requirements that PFP operators would need to comply with.