

**FINANCIAL SERVICES REGULATORY AUTHORITY**  
**سلطة تنظيم الخدمات المالية**

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## **Supplementary Guidance – Regulatory Framework for Fund Managers of Venture Capital Funds**

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## 1. INTRODUCTION

- 1.1 This Guidance is issued under section 15(2) of the Financial Services and Markets Regulations 2015 (“**FSMR**”). It should be read in conjunction with FSMR, the relevant Rulebooks of the Financial Services Regulatory Authority (“**the Regulator**”) and the Guidance & Policies Manual of the Regulator.
- 1.2 The Guidance is relevant to an applicant for a Financial Services Permission (“**FSP**”) to carry on the Regulated Activity of Managing a Collective Investment Fund, as defined in FSRA Fund Rules (“**FUNDS**”), where the Fund Manager operates a Venture Capital (“**VC**”) Fund. This Guidance does not apply to Fund Managers of VC Funds (“**VC Managers**”) that undertake the management of other types of funds other than VC Funds.
- 1.3 The Guidance sets out the Regulator’s approach to an application for an FSP to operate under the framework outlined here for VC Managers (the “**VC Manager Framework**”), in addition to the existing requirements in relation to the Threshold Conditions as set out in the FSMR and GEN Rules.
- 1.4 In particular, this Guidance includes the eligibility and authorisation criteria that applicants must satisfy to be authorised as VC Managers, the ongoing regulatory requirements, and the types of restrictions that the Regulator may impose on a VC Manager’s activities.
- 1.5 This Guidance is not an exhaustive source of the Regulator’s policy on the exercise of its statutory powers and discretions. In discharging its regulatory mandate, the Regulator may impose other, specific conditions to address any additional risks posed by the proposed activities of the VC Manager.
- 1.6 The Regulator is not bound by the requirements set out in this Guidance and may modify this Guidance at its discretion where appropriate.
- 1.7 Unless otherwise defined or the context otherwise requires, the terms contained in this Guidance have the same meanings as defined in FSMR and the Glossary (GLO).

## 2. OBJECTIVES OF THE VC MANAGER FRAMEWORK

- 2.1 VC Funds are investment funds that seek private equity stakes in start-ups or young, small or medium enterprises (whether companies or partnerships, collectively “**Early Stage entities**”) which typically offer products that are innovative and possess strong growth potential, such as those at the cutting-edge of technology.
- 2.2 VC Managers typically raise funds for a VC Fund from sophisticated and financially well-resourced investors, and invest those funds into Early Stage entities.
- 2.3 VC Funds can play an important role in Abu Dhabi and the wider UAE in nurturing start-up ecosystems by providing funding and mentorship to Early Stage entities seeking to launch and grow their businesses. As such, there are economic and other benefits for a tailored regulatory regime to anchor the activities of VC Managers in Abu Dhabi.

2.4 VC Funds exhibit the following characteristics that result in them presenting a different structure and risk profile compared to non-VC Funds.

- (a) Risk profile. VC Funds typically invest in small, minority equity positions in small ventures that are not traded on public markets. They typically utilize little or no leverage when acquiring their investments, which tend to be far smaller than investments made by private equity funds. VC Funds are also closed-ended, and do not in practice permit investors to make ongoing subscriptions or redemptions at their discretion once the funds have completed the subscription period<sup>1</sup>, thereby reducing liquidity risk. As such, VC Managers and the VC Funds they manage generally pose lower systemic and contagion risks, and should therefore give rise to fewer market impact concerns in the event of their failure.
- (b) Clients. Although investments in VC Funds are risky in nature, investors in VC Funds are generally Professional Clients and possess high levels of financial sophistication and financial resources. Those investors anticipate that many of the Early Stage entities the VC Fund invests in will fail: however, they also expect that at least a few investments will generate significant returns and make the entire fund profitable overall. In addition, VC Managers typically invest their own financial resources in the VC Fund alongside their investors, as they earn money primarily from their own investments rather than management / advisory fees. This ensures that a VC Manager has interests aligned with those of its investors<sup>2</sup>. Therefore, VC Managers should generally present fewer concerns in relation to investor protection and conduct risks arising from any potential for conflicts of interest.
- (c) Regulatory Capital. Unlike traditional Fund Managers, the capital of VC Managers is largely invested in Early Stage entities. As a VC Manager does not necessarily operate on steady streams of revenue earned from management / advisory fees, the ongoing financial health of the VC Manager is very much dependent on the valuation of its illiquid investments which can only be realized on divestment. Consequently, it may not be meaningful to impose the standard capital requirements on a VC Manager, as long as it has the ability to meet its liabilities as they fall due. In addition, given that most successful VC Managers are serial entrepreneurs who have accumulated their financial

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<sup>1</sup> Redemptions by investors are generally only done at the end of the life of a VC Fund. VC Funds usually have a limited term of seven to ten years, with the first three to five years being the investment period during which the fund seeks and invests in a number of Early Stage entities. The remaining years of the fund's life are the divestment period, where the VC Manager will direct the fund to attempt to realize or exit all investments before the fund is finally liquidated and any resulting profits distributed.

<sup>2</sup> Commonly, the VC Manager will work closely with Early Stage entities to support their development work, and may provide marketing and research resources and/or take seats on the board of directors.

resources through successful exits, the track record and experience of the principal(s) in a VC Manager is equally important in assessing the ongoing viability of that VC Manager than is the case for traditional fund managers.

- (d) Governance and controls. The nature of VC Fund investments is such that traditional internal governance and control structures may not be appropriate or relevant for a VC Manager. An example can be seen in the requirement for traditional fund managers to have an independent valuation function for the fund; as most early-stage fund investments may not be generating revenues or may not yet be profitable, the investment decisions of a VC Manager hinge very much on the qualitative assessment and expert judgment of the individual manager, rather than conventional financial models. Valuation of early-stage investments is typically subjective, and is to a large extent determined by investor appetite during the actual funding rounds of the Early Stage entities. As periodic valuation of a VC Fund's assets based upon traditional cash flow or balance sheet models cannot take into consideration the unique, speculative nature of the fund's investments, the benefit of imposing conventional control structures on a VC Manager is generally not proportionate compared to the cost of doing so.

- 2.5 In light of these considerations, FSRA has created a proportionate, risk-based regulatory framework for VC Managers that streamlines their regulatory requirements, while applying the necessary regulatory safeguards to ensure they operate in a safe and sound manner. The authorisation criteria and ongoing regulatory requirements under this framework are set out in the next section.

### **3. AUTHORISATION CRITERIA AND ONGOING REQUIREMENTS**

#### **Eligibility Criteria**

- 3.1 To qualify for authorisation under the VC Manager Framework, an applicant will need to demonstrate that each VC Fund it manages satisfies all of the following criteria<sup>3</sup>:
- (a) the fund invests directly in equity share capital of businesses which are at an early stage of development and not listed on any exchange;
  - (b) the fund is closed-ended;
  - (c) the fund is offered only by way of private placement to Professional Clients (as defined in GLO);

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<sup>3</sup> The criteria reflect the nature of VC investments and should ensure that a VC Fund will generally present low systemic and conduct risks.

- (d) the fund limits total subscriptions to an amount not exceeding US\$100 million, or a higher amount approved by the Regulator; and
- (e) the fund is a Domestic Fund<sup>4</sup> that is either an Exempt Fund or Qualified Investor Fund.

### **Authorisation Requirements**

3.2 When applying for an FSP the VC Manager will be subject to the following, streamlined evaluation criteria, bearing in mind the considerations set out in section 2 of this Guidance.

- (a) Approved Persons. A VC Manager must appoint a Senior Executive Officer (“**SEO**”) and, additionally, a Licensed Director (for a Body Corporate) or a Licensed Partner (for a Partnership). Of the two Approved Persons, the SEO should possess a minimum of ten years’ relevant and demonstrable experience and the Licensed Director or Licensed Partner a minimum of five years’ relevant experience in either:
  - i. operating a VC or private equity fund; or
  - ii. in-depth industry experience and expertise within the target sectors that the VC Manager intends to focus on investing in<sup>5</sup>.

As per the current requirement for Authorised Persons, the SEO of a VC Manager must be resident in the UAE.

- (b) Recognised Persons. It will not be mandatory for a VC Manager to appoint a Finance Officer under Rule 5.5.1 of GEN, although the VC Manager should demonstrate that it has the relevant expertise (whether in-house or outsourced) on hand to prepare and oversee its financial accounts. A VC Manager must, however, appoint a Compliance Officer and a Money Laundering Reporting Officer who are independent of the front office investment function, but both functions may be carried out by the same individual, be done in-house or outsourced, and need not be dedicated to, or independent of, other control functions. The SEO and Directors / Partners of the VC Manager ultimately remain responsible for all compliance matters of the firm.

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<sup>4</sup> Domiciling the VC Fund in ADGM will facilitate the effective regulatory oversight of the VC Manager and its activities by the FSRA, in light of the streamlined regulatory requirements for VC Managers as set out in paragraph 3.2 of the Guidance.

<sup>5</sup> This recognizes that VC Managers tend to have entrepreneurial backgrounds with specialist sector knowledge.

- (c) Control Functions. The Regulator will not require a VC Manager to meet the following governance and control requirements.

Requirement	Rule(s)	Note
Internal audit function	GEN 3.3.13	A VC Manager is not required to appoint an internal auditor under GEN Rule 3.1.1(5).
Independent custodian	FUNDS 12.3.7(1)(b) and 12.3.3(4)	A VC Manager does not have to appoint a separate custodian where it can demonstrate to the Regulator that either (i) an adequate and effective alternative safekeeping mechanism exists or (ii) where it would not be practical or proportionate to do so.
Independent valuation	FUNDS 12.3.10	A VC Manager may choose not to establish an independent valuation function, but must demonstrate, to the satisfaction of the Regulator, that there is functional and hierarchical separation and independence between the risk management and the portfolio management functions.
Independent fund administrator	FUNDS 12.3.7(1)(a)	A VC Manager may choose not to appoint an independent fund administrator given the relatively illiquid nature of a VC Fund, arising from its closed-ended nature (with no ongoing subscriptions or redemptions).

A VC Manager will have to disclose to its clients that it is not mandatory for it to comply with the above control requirements. However, investors in the fund may still negotiate the inclusion of these safeguards as part of their contractual agreements with the VC Manager.

- (d) Capital Requirements. A VC Manager will not be required to maintain the Base Capital Requirement or the Expenditure Based Capital Minimum on an on-going basis as set out in Chapter 3 of Regulator’s Prudential Rules (“PRU”) for investment business. The VC Manager will, however, have to disclose to its clients that it is exempted from those capital requirements. Additionally, the VC Manager will still be required to:

- i. submit audited financial statements and audit reports annually (as applicable) pursuant to Rule 6.6 of FSRA’s General Rulebook (“GEN”);
- ii. demonstrate the ability to meet its liabilities as they fall due and to have adequate financial resources to manage its affairs prudently and soundly, pursuant to GEN Rules 2.2.4 and 5.2.8; and

- iii. ensure that the VC Funds it managers are subject to annual audit requirements pursuant to FUNDS Chapter 16.
- (e) Professional Indemnity Insurance [“PII”]. As set out in Rule 6.12 of PRU, a VC Manager shall maintain PII cover appropriate to the nature, size and risk profile of its business.

## APPENDIX A: SUMMARY OF REQUIREMENTS FOR CONTROLLED FUNCTIONS (“KEY OFFICERS”)

The minimum evaluation criteria in respect of the competency of the Key Officers and compliance arrangements of the VC Manager are summarised in the table below.

Evaluation Criteria	
<p><b>(a) Number of Approved Persons:</b></p> <p><i>Approved Persons (as set out in GEN 5.3) will include the Licensed Directors, Licensed Partners and Senior Executive Officer [“SEO”] of the VC Manager. Nominee directors such as legal advisers or corporate secretaries will not count towards meeting this requirement.</i></p> <p><b>Of these Approved Persons:</b></p> <p>(i) <b>Minimum years of individual relevant experience<sup>6</sup></b></p> <p>(ii) <b>Number</b> resident in the U.A.E.</p>	<p>At least 2<sup>7</sup></p> <p>10 years (for the SEO) 5 years (for others)</p> <p>At least 1 (which should include the SEO)</p>
<p><b>(b) Number of employees / professionals conducting the regulated activities residing in the U.A.E:</b></p> <p><i>Such employees / professionals may include the Approved Persons and Recognised Persons (as set out in GEN 5.4) of the VC Manager.</i></p>	<p>At least 2</p>
<p><b>(c) Compliance Function</b></p> <p>The VC Manager may, depending on the scale, nature and complexity of its operations:</p> <p>(i) Have a compliance function with staff who are suitably qualified and independent from the front office;</p>	

<sup>6</sup> The relevance of an individual’s experience should be assessed in the context of the role that the individual will perform in the VC Manager. For example, relevant experience may include specialist industry sector experience (e.g. green technology and infrastructure, financial technology, etc.). Directors/Partners, SEO and Senior Managers should have managerial experience or experience in a supervisory capacity as part of their relevant experience.

<sup>7</sup> For a VC Manager that is deemed as high impact or systemically important, the Regulator may require the VC Manager to have more than two Directors.

<b>Evaluation Criteria</b>	
(ii)	rely on compliance oversight and support from an independent compliance team at its holding company or related entity; or
(iii)	engage an external service provider to support its compliance arrangements. The Manager should ensure that the service provider is competent and familiar with the regulatory requirements for Managers in ADGM. The service provider should be able to provide meaningful onsite presence at the Manager.