MFA

10 May, 2024

Via Electronic Submission: https://survey.dfsa.ae/f/135742/3124/

Dubai Financial Services Authority
Level 13, West Wing, The Gate, DIFC
Postal Address:
PO Box 75850, Dubai, UAE

Re: Call for Evidence re: Private Credit Funds

Dear Sir or Madam:

MFA[1] submits these comments to the Dubai Financial Services Authority ("**DFSA**") in response to the DFSA's request for comments on the above-referenced Call for Evidence ("**Call for Evidence**"),[2] with a focus on the aspects of Call for Evidence applicable to alternative asset management funds,[3] a growing number of which are focused on private credit strategies. We have set out our responses to the relevant questions in the Call for Evidence in the Annex hereto.

MFA welcomes the thoughtful consideration of the DFSA in re-imagining the future regulation of credit funds and the related Consultation, which would permit Dubai-based managers to manage external

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1 Managed Funds Association (MFA), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member fund managers, including traditional hedge funds, credit funds, and crossover funds, that collectively manage over $3.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

2 *See* Dubai Financial Services Authority, Call for Evidence – Credit Funds (Mar. 2024), available at https://dfsaen.thomsonreuters.com/sites/default/files/net_file_store/Call_for_Evidence_Credit_Funds.pdf ("**Call for Evidence**").

3 The global alternative asset management industry, including hedge funds, credit funds, and crossover funds, has assets under management of $4 trillion (Q4 2022). The industry serves thousands of public and private pension funds, charitable endowments, foundations, sovereign governments, and other global institutional investors by providing portfolio diversification and risk-adjusted returns to help meet their funding obligations and return targets.

funds that are domiciled in jurisdictions other than Dubai.[4] Credit funds have deployed significant capital investment into U.S. markets, especially over the last 15 years, which has led to its robust economic recovery since the great financial crisis. The UK and EU markets are also increasingly enhancing the regulatory framework to allow for greater private capital investment. MFA member firms include the largest and most sophisticated private credit fund managers in the world, and we welcome the opportunity to serve as a resource to the DFSA Staff as it continues to evaluate the appropriate regulatory oversight of private credit funds.[5] MFA views the Call for Evidence in recognition of the growing importance of Dubai to MFA member firms and broadly, MFA agrees with the goals of DFSA seeking to reconsider the regulatory oversight of credit funds in Dubai.

The actions of one regulatory authority can in fact impact other jurisdictions, and as such MFA welcomes the healthy dialogue initiated by the DFSA in its Call for Evidence. Today institutional alternative asset managers offering credit strategies operate globally in the US, EU, UK, and increasingly, Dubai. They provide important sources of capital, particularly to small and medium-sized enterprises. Given their investors and deployment of capital across global jurisdictions, private credit funds often have to comply with the most burdensome common requirement amongst jurisdictions or attempt to offer a fund only in that jurisdiction that would operate in parallel to other funds with the same strategy that are offered in other jurisdictions. Regulatory inconsistencies that drive alternative investment fund organisational structures can dilute or eliminate economies of scale the manager has sought to achieve.

Executive Summary

MFA appreciates the efforts of the DFSA in publishing the Call for Evidence as a means of continuing and focusing the dialogue with the investment funds industry and related stakeholders regarding the future of credit fund regulation in Dubai and the region more broadly. Appropriate risk management is a cornerstone of the alternative investment fund industry, and MFA welcomes the ongoing dialogue of the DFSA in this key area.

A top-level response to the specific questions posed by the Call for Evidence, in the order presented, are as follows:

1. MFA does not believe it appropriate to separately regulate credit funds as a specialist class of funds with specific requirements applicable only to them. Investors in alternative asset funds traditionally

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[4] Dubai Financial Services Authority, Consultation Paper No. 158 (Mar. 19, 2024), available at https://dfsaen.thomsonreuters.com/sites/default/files/net_file_store/CP_158_Credit_Funds%2C_Public_Property_Funds_%26_REITs.pdf.

[5] MFA has developed a series of brief "primers" on private credit and related issues such as syndicated loans and collateralized loan obligations (avail. at https://www.mfaalts.org/issue/alternative-credit/).

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are sophisticated, institutional investors more than capable of assessing the credit, liquidity, interest rate, and related risks that accompany this long-term investment.

2. With our recommendation that credit funds are not specifically called out for particularised regulation, alternative asset managers generally should be permitted to invest in private credit assets, subject to general requirements regarding the naming of the fund and its strategy, and how it is marketed to investors.

3. MFA supports additional flexibility in the types of private credit investments permitted for funds pursuing private credit strategies, including international trade finance instruments such as letters of credit and financial guarantees. Private credit funds also should be permitted to acquire interests in loans that were originated elsewhere, in addition to originating loans themselves.

4. MFA supports eliminating the 10% leverage limit for private credit funds given the robust risk management practices at alternative investment funds and, importantly, the counterparties through which they trade.

5. MFA is of the view that there is a role for open-ended credit funds but notes the importance of liquidity management.

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MFA appreciates the opportunity to provide these comments to the DFSA in response to the Call for Evidence. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact the undersigned (jhan@mfaalts.org) or Jeff Himstreet (jhimstreet@mfaalts.org).

Sincerely yours,

Jennifer W. Han

Executive Vice President
Chief Counsel & Global Head of Regulatory Affairs

ANNEX

Question 1.1 ***Should private credit funds be treated as a separate class of funds, attracting specific requirements?***

MFA Response:

MFA does not believe it is necessary to treat private credit funds as a separate class of funds. In the US, EU, and other developed markets, alternative investment funds are regulated based on the manner in which the fund is offered and sold, and the investors permitted to invest in the fund, rather than a particular strategy. Singling out private credit funds for additional layers of regulation is counterproductive to encouraging responsible, sustained growth of this asset class and, given the institutional nature of private credit investors, unnecessary. The private credit fund market is largely limited to professional clients that are capable of evaluating a fund's use of leverage, its investment objectives, and liquidity terms.

We note that in the US, alternative asset vehicles specialising in credit have experienced considerable growth. Alternative asset managers, through private credit funds, have provided steady, long-term capital, including through direct loans to grow businesses and help support middle-market companies and the US economy generally. We note this increased participation of the private sector in the broader economy is in line with the UAE's "We the UAE 2031" Vision[6] which seeks to double UAE GDP and lead in proactively legislating for new economic sectors (like non-bank lending).

The expansion of private credit in the US is due at least partly to the flexible US regulatory structure that exists for funds that are offered and sold to institutional investors through non-public offerings. US private credit markets, respectfully, would not have experienced this sustained and considerable growth had credit funds been specifically and distinctly regulated when it comes to the types of private credit offered, limitations on leverage, and regulatory constraints that currently exist in Dubai and other countries.

Question 1.2 ***If so, should specific requirements applicable to credit funds depend on the type of clients (e.g., professional or retail) or any other criteria?***

MFA Response:

As noted in our response to Question 1.1, MFA recommends against treating private credit funds as a separate category of fund. Professional clients investing in private credit funds are sophisticated, institutional investors, such as pensions, sovereign investment funds, foundations, endowments, and insurance companies. Private credit fund managers provide detailed disclosure to professional investors and employ rigorous risk management controls. Professional investors also are exceedingly sophisticated in terms of the information they require in evaluating whether to invest. We agree with the considerations in

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[6] *See generally*, https://u.ae/en/about-the-uae/strategies-initiatives-and-awards/strategies-plans-and-visions/innovation-and-future-shaping/we-the-uae-2031-vision.

the Call for Evidence that "distinguish the type of requirements applicable to credit funds depending on the types of investors such funds are offered to (e.g., the UK's Long Term Asset Fund (LTAF))."[7]

Question 1.3 Should retail clients be allowed to invest in credit funds?

MFA Response:

We note that in the US, retail clients can invest in publicly offered funds that are regulated under the US Investment Company Act of 1940 (the "**1940 Act**") as business development companies. The 1940 Act requirements for business development companies impose detailed disclosure and diversification requirements, the offerings are registered with the US Securities and Exchange Commission, and the fund is subject to prescriptive liquidity requirements that managers are obligated to meet.

We also note that retail clients can invest in credit funds in the EU and in the UK. These have grown further in popularity and interest by the introduction of the European Long-Term Investment Fund ("**ELTIF**") in the EU and the Long-Term Asset Fund ("**LTAF**") in the UK.

Question 2.1. What are your views on how the investment objective should be calibrated to provide sufficient flexibility?

MFA Response:

MFA supports a liberalisation of the existing, rigid requirement that a credit fund has an investment objective to invest at least 90% of fund assets in credit assets, including loans. Credit fund investors would benefit from being able to diversify by acquiring non-loan assets such as fixed income securities or other assets that would cause the fund to own a lower percentage of traditional credit assets. Holding additional, more liquid fixed income assets can also aid in meeting redemptions. In addition, as the Call for Evidence notes, there is increasing popularity of so-called multi-strategy funds, where the fund may invest in several different strategies. These strategies often include a "sleeve" of private credit assets and MFA suggests that the future state of private credit fund regulation recognise and allow for multi-strategy funds to include a private credit sleeve, so long as it is marketed in a manner that is not misleading and accurately discloses its investment strategies.

With respect to products offered to retail investors, MFA believes it may be appropriate, consistent with principles of full and fair disclosure, for there to be a stated percentage of credit assets owned before a fund can market itself as a credit fund. We note that in the US, the 1940 Act requires that if a fund uses a name suggesting investment in certain securities, or countries or geographic regions, the fund must adopt a policy to invest at least 80% of fund assets in those investments, securities, or countries.[8] We do not

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[7] Call for Evidence, *supra* note 2.

[8] *See* Investment Company Act Rule 35d-1 (17 CFR 270.35d-1).

believe that such a requirement is necessary, nor appropriate, for private credit funds that are only available to professional or institutional investors.

Question 2.3. ***Should the regime differentiate between acquisition of loan portfolios generated by other credit providers and origination of loans where the fund acts as a sole or primary lender? Why/why not?***

MFA Response:

MFA recommends that the DFSA take efforts to create a regulatory regime for alternative investment funds investing in private credit assets that will remain flexible and adaptable as these markets continue to evolve and grow. The private credit markets today have a limited secondary market for loans that are originated by one party and sold – most private credit funds currently originate the loans and hold them until maturity. It is not unrealistic to anticipate the development of a secondary market for private credit loans as institutional investors reallocate their alternative investment fund investments and increase or decrease their alternative investment fund exposure. For this reason, MFA recommends that the future state of the DFSA's private credit fund regulation accommodate both loans that are originated with the alternative investment fund and loan portfolios generated by other credit providers. Consistent with its fiduciary obligations, the alternative investment fund manager should disclose to investors the types of private credit investments held in the fund, whether they were originated by the fund or elsewhere, and the criteria used for determining the private credit investments held in the fund.

Question 3.1. ***Do you think that Credit Funds should be permitted to engage in international trade finance instruments, including letters of credit and financial guarantees?***

MFA Response:

Yes. MFA suggests that the operational capabilities of cross-border finance activities have developed considerably since the initial adoption of CIR Rule 13.12.4 and notes several large institutional firms have developed expertise in cross-border finance activities. Where firms have developed the expertise, systems, and operational capability to offer letters of credit and other financial guarantees or non-loan financing, they should be permitted to do so in Dubai as they are in the US and other jurisdictions.

Question 4.1. ***What are your views on the current permitted level of leverage for Credit Funds?***

MFA Response:

MFA's view is that the DFSA's current rules regarding credit fund leverage should be reconsidered in light of leverage restrictions in other jurisdictions and the strong risk management practice employed by alternative asset managers. The current rules require that credit fund leverage cannot exceed 10% of the net asset value of the fund, presumably to prevent excessive leverage at a private credit fund adversely impacting one or more financial institutions providing credit to the fund. Given the limited risk posed by private credit funds, discussed below, the current 10% leverage limit should be revisited. The 10% limit may

create severe challenges for a firm to fully hedge a private credit fund portfolio against interest rate, credit, and currency risks.

Private credit funds have been shown to pose modest counterparty risk partly because of the limited use of leverage and strong risk management controls. Margin and collateral requirements serve to limit the amount of leverage that an alternative credit fund can incur, and dealers can increase or adjust requirements to manage leverage and other risks as trading, credit, or market conditions warrant. As a general matter, relationships with counterparties are an appropriate area of focus when considering leverage limits and the potential for transmission of risk throughout the system. Adequate risk management by both the alternative investment fund and the counterparty can and does mitigate the possibility of losses resulting from risk transmission. The risk mitigation reforms enacted globally after the global financial crisis have done much to reduce transmission of risk throughout the system, with an emphasis on clearing derivatives transactions, prompt reporting of them to regulators, and requiring minimum margin amounts for uncleared transactions.

In the US, considering the US alternative investment funds market, the US Government Accountability Office ("**GAO**") concluded that leverage lending had not contributed to bank (or other financial entity) distress,[9] which suggests that banks are effectively managing exposure leverages to borrowers through collateral and other margin requirements, thus serving to mitigate counterparty exposure risk. The GAO study is relevant to the Call for Evidence as many private credit funds organised in Dubai trade through US-based banks. In the US, as it relates to private credit funds for example, the US Federal Reserve has stated that "financial stability vulnerabilities posed by private credit funds appear to be limited."[10] We agree, and have long advocated that alternative investment fund activities are best suited to market and investor protection regulation by functional regulators, rather than bank-like supervision and regulation.

Question 4.2. ***If you consider that the current level is too low, what would a more appropriate limit be and why?***

MFA Response:

MFA does not support a prescribed "limit" of permissible leverage in funds. As noted above, counterparties to alternative investment funds manage their own risks and limit credit risk through margin and collateral requirements. These requirements also create an economic disincentive for the investor to incur excessive risk. For funds that use leverage, it is important not to conflate a fund's use of leverage

[9] *See* GOV'T ACCOUNTABILITY OFFICE, FINANCIAL STABILITY: AGENCIES HAVE NOT FOUND LEVERAGED LENDING TO SIGNIFICANTLY THREATEN STABILITY BUT REMAIN CAUTIOUS AMID PANDEMIC, 34-35 (2020).

[10] FEDERAL RESERVE, FINANCIAL STABILITY REPORT 47 (2023) (Additionally, "most private credit funds use little leverage and have low redemption risks, making it unlikely that these funds would amplify market stress through asset sales.") ("**Financial Stability Report**").

across the financial system as a whole, or even with risk levels proposed by an organisation that manages a fund that uses leverage. Because asset classes each have distinct risk exposures, leverage metrics based on a single aggregate number across asset classes do not provide a meaningful basis on which to assess the risks associated with an investment fund's use of leverage and are likely to mislead regulatory authorities reviewing the data. The review of misleading data could result in regulatory authorities attempting to solve a non-existent problem, leading it to potentially miss areas of systemic risk that exist in the financial ecosystem in areas other than investment funds. Leverage measurements must be assessed on an asset class by asset class basis, rather than as a single aggregated number. Furthermore, it is critical that regulatory authorities consider the *purpose* of leverage: a bona fide hedging transaction mitigates risk (both the fund and systemically), whereas other derivatives trades may not.

Across the fund industry globally, alternative investment funds are relatively limited users of leverage. The US Federal Reserve for example stated with respect to private credit that "[m]ost private credit funds use little leverage and have low redemption risks, making it unlikely that these funds would amplify market stress through asset sales."[11] Private credit funds are more commonly holders of long positions in debt investments that are acquired through capital invested by investors, and leveraged positions are often times derivative positions to hedge against currency or interest rate risks. Therefore, it is far more common that the investors are bearers of counterparty exposure risk rather than transmitters of risk to the counterparties.

Question 5.1. Should credit funds be permitted to operate through open-ended structures?

MFA Response:

MFA is of the view that with the right controls and circumstances, it may be appropriate for credit funds to operate through open-ended structures (i.e., US business development companies, as discussed in our response to Question 1.3).

Alternative investment funds do not offer daily redemption to investors, and as such have not been susceptible to mass redemptions in times of stress. Alternative investment fund documents govern investor liquidity standards for investors. Alternative investment funds' investors are typically large, sophisticated institutional investors such as foundations, endowments, and pension funds – and they understand the redemption limitations on the fund and often have multi-generational investment horizons. We did not see mass redemptions from alternative investment funds during times of stress, largely because the sophisticated alternative investment fund investors knew and appreciated the redemption limitations to which they agreed, and the alternative investment funds enforced fairly the redemption terms agreed to by investors.

The less-liquid the portfolio holdings, the longer the contractual limits on redemptions tend to be. Private credit funds, for example, often have multi-year lock-up periods to reflect the less-liquid nature of

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[11] *See id.*

the underlying investments. Private credit funds often hold direct loans, for example, through maturity as there is no developed secondary market for these bespoke, individually negotiated loans. Frequent redemptions simply would not work in a private credit fund as they may with an alternative investment fund investing in large-cap, liquid equity securities.

Question 5.2. What redemption terms would be typical for such funds? What liquidity management tools would be appropriate for such open-ended structures?

MFA Response:

MFA notes that open-ended private credit funds are being offered with increasing frequency in the US as business development companies (as we discuss in our response to Question 1.3 pertaining to retail funds). Fund liquidity generally is calibrated through redemption periods that correspond to the liquidity of the underlying portfolio assets. Redemption rights in traditional private credit funds traditionally are limited, with redemptions often-times unavailable for several years after investment.

Question 5.3. Should we consider accommodating evergreen funds and why?

MFA Response:

MFA supports accommodating evergreen funds. In the US and elsewhere, firms have demonstrated that they can manage liquidity risk through limited and clearly disclosed redemption periods, requirements that redeeming investors provide adequate notice, and limiting investor access to those sophisticated investors that understand the limitations on liquidity. We discuss our views on liquidity management above in our response to Question 5.1.