

CONSULTATION PAPER
NO. 2 OF 2025

**REVIEW OF PRUDENTIAL FRAMEWORK
FOR LOWER-RISK FIRMS**

9 APRIL 2025



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Introduction

Why we are issuing this consultation 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 proposed amendments to the prudential framework applicable to Authorised Persons ("**firms**") in Category 3B, 3C and 4 under the FSRA's Prudential – Investment, Insurance Intermediation and Banking Rulebook ("**PRU**"), with the proposed amendments relating to capital requirements primarily affecting Category 4 firms.
2. The paper also seeks feedback to identify any other matters in relation to Categories 3B, 3C and 4 that have not been addressed in the current phase of the review and matters relevant to the prudential regime applicable to firms in Categories 2 and 3A, with a view to informing the next phase of the review of the relevant prudential requirements.
3. Capitalised terms contained in this consultation paper have the meanings attributed to them in the FSRA's Glossary Rulebook ("**GLO**") or in PRU, unless otherwise defined in this consultation paper.

Who should read this consultation paper

4. This Consultation Paper should be of particular interest to Authorised Persons in Categories 2, 3A, 3B, 3C and 4, potential applicants intending to conduct Regulated Activities that fall within these prudential categories, other Persons undertaking similar activities, and their respective professional advisors.

How to provide comments

5. 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 put 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

6. The deadline for providing comments on these proposals is 21 May 2025. When we receive your comments, we will consider whether any modifications to the proposals

are required. We will then proceed to enact the proposals in their final form. You should not act on the proposals described in this consultation paper until the final rules are issued and we will issue a notice on our website when that happens.

Comments to be addressed to:

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Background

1. The financial services sector in ADGM has grown significantly since PRU was first introduced in October 2015 and the FSRA considers that it is appropriate at this stage of ADGM's development to review its prudential framework to ensure that the requirements remain proportionate to the business models and risk profiles of its regulated firms.

Origin of the FSRA's prudential regulatory framework

2. The FSRA's prudential regulatory framework, detailed in PRU, is largely based on an earlier version of the EU prudential regulatory framework for banks and investment firms ("**CRR/CRD framework**"). In turn, the CRR/CRD framework was derived from successive iterations of the standards developed by the Basel Committee on Banking Supervision ("**BCBS**"), which were designed for well-diversified, internationally active banks and hence focussed on the risks associated with deposit taking and lending.
3. Regulators in other jurisdictions, including the EU, the UK and the DIFC, that have the origins of their prudential frameworks in the CRR/CRD framework/Basel standards have subsequently recognised that applying a prudential framework designed for such banks to other regulated firms may be disproportionate to the business model and risk profile of such firms, and have adjusted their prudential regimes accordingly.

ADGM-specific considerations

4. Since ADGM's inception, Category 3B, 3C and 4 firms have been considered to pose lower prudential risk than, for example, those taking deposits. In addition, the vast majority of Category 4 firms generally do not hold Client Assets or Insurance Money, which further reduces the extent and complexity of their risk profile.
5. In formulating the proposals outlined in this paper, the FSRA has been guided by its supervisory experience and has also considered regulatory developments in other jurisdictions, including the prudential regime for investment firms in the EU and the equivalent in the UK.
6. The proposals in section A of this paper represent the first phase of a holistic review of the prudential framework for all firms and focusses on certain prudential requirements applicable to Category 3B, 3C and 4 firms. Section B of this paper seeks feedback on any other matters in relation to Categories 3B, 3C and 4 that have not been addressed in the current phase and questions relevant to the prudential regime applicable to Category 2 and 3A firms, both with a view to informing the next phase of the FSRA's review of the relevant prudential requirements.

Section A: Proposed amendments to prudential requirements

Category 4 firms not holding Client Assets or Insurance Money

7. Currently, most Category 4 firms are subject to a Capital Requirement of the higher of the applicable Base Capital Requirement (“**BCR**”) or the relevant Expenditure Based Capital Minimum (“**EBCM**”). Consistent with other regulatory prudential regimes that impose an expenditure or overheads-based minimum capital requirement, the EBCM is intended to act as a “proxy” for the financial resources required to wind-down a firm’s business, if necessary, in an orderly manner and so reduce any negative effects of that wind-down on its Clients, and on the broader market. This is aligned with the FSRA’s statutory mandate of securing an appropriate degree of protection for the Clients of firms and the broader market.
8. However, as the majority of Category 4 firms are not permitted to hold Client Assets or Insurance Money, they will not typically have liabilities in relation to their Clients. Those Clients will generally be able to move their business to alternative providers relatively easily, and negative effects on the broader market will be negligible. This reduces the prudential risk profile of such firms and negates the need for a capital requirement based on winding-down.

Proposal

9. Therefore, given the very limited impact that failure of such Category 4 firms would have, it is proposed to remove the EBCM requirement for those Category 4 firms that do not hold Client Assets or Insurance Money (“**in-scope Category 4 firms**”), meaning that such firms would only be subject to the BCR. This proposal would not affect the EBCM for Category 4 firms that hold Client Assets or Insurance Money. Additionally, firms carrying on the Regulated Activity of Operating a Multilateral Trading Facility or an Organised Trading Facility are not affected by the proposal to remove the EBCM requirement.
10. As the BCR for most Category 4 firms is currently \$10,000, it is also proposed to increase the BCR for such firms to \$50,000. This proposal would not change the BCR currently applicable to firms Providing Third Party Services (\$50,000) or firms Operating a Private Financing Platform (\$150,000).
11. The proposed increase in the BCR is not intended to function as a wind-down capital requirement but rather is proposed as an appropriate minimum level of regulatory capital for in-scope Category 4 firms to hold in circumstances where the EBCM requirement would no longer apply. Beyond this minimum Capital Requirement,

firms would remain obliged under PRU 3.2.4(b) to have adequate financial resources to meet their liabilities as they fall due, including any non-client liabilities.

Impact on capital adequacy

12. Supervisory data indicates that the proposed removal of the EBCM requirement and increase to the BCR would combine to result in a significant decrease in Capital Requirement for most Category 4 firms, more appropriately reflecting the lower prudential risks inherent in them. Alongside this, as most Category 4 firms currently hold Capital Resources well in excess of their Capital Requirement, the FSRA consider that the proposed changes will not significantly impact their capital adequacy.

Liquid assets

13. As we are proposing to remove the EBCM for in-scope Category 4 firms, the requirement under the current PRU Rule 3.7.4 to hold liquid assets in excess of their EBCM would no longer apply to such firms. However, as the FSRA considers that such firms must continue to hold an appropriate portion of their balance sheet assets in liquid form, it is proposed that the liquid asset requirement for such firms would instead be in an amount that exceeds their BCR.

Question 1

Do you agree with the proposal to remove the EBCM for in-scope Category 4 firms and to increase the BCR for most Category 4 firms to \$50,000?

Question 2

Do you have any comments on the proposal to require Category 4 firms that would not be subject to the EBCM to hold liquid assets in excess of their BCR?

BCR for Providing Custody for a Fund

14. The FSRA has observed that the BCR of \$4 million for Providing Custody for a Fund is significantly higher than the BCR of \$250,000 applied to Providing Custody other than for a Fund and exceeds the BCR-equivalent in benchmarked jurisdictions. Other than where a firm is Providing Custody for a Public Fund, the FSRA considers that the risk profile associated with Providing Custody for a Fund and Providing Custody other than for a Fund is similar.

Proposal

15. It is therefore proposed to apply a BCR of \$250,000 to the Regulated Activity of Providing Custody, except where the firm is Providing Custody for a Public Fund. The

FSRA considers it appropriate to retain the higher BCR of \$4 million for a firm Providing Custody for a Public Fund, given that the Unitholders of such Funds are likely to include Retail Clients.

Question 3

Do you agree with the proposal to apply a BCR of \$250,000 to the Regulated Activity of Providing Custody for a Fund, other than a Public Fund?

Internal Risk Assessment Process requirement for Category 3B and 3C firms

16. Currently, Category 3B and 3C firms are required to prepare and submit an Internal Risk Assessment Process (“IRAP”) report to the FSRA on an annual basis and whenever there is a material change to their activities. The focus of an IRAP is on prudential risk and such firms have a low prudential risk profile, from a supervisory perspective, the FSRA no longer sees the practical value of receiving IRAP submissions from such firms.

Proposal

17. Therefore, it is proposed to remove the IRAP reporting requirement for Category 3B and 3C firms, thereby reducing the reporting burden on such firms. Where it considers it appropriate to do so, the FSRA may still use its supervisory powers to require such a firm to carry out an IRAP or to provide it with copies of the firm’s internal risk management reports and supporting documents and submit that material to it.

Conduct risk considerations

18. The FSRA does note, however, that firms in these prudential categories may pose elevated levels of conduct risk due to the nature of their ongoing interaction with their Clients and assets, and it will continue to consider how best to identify and mitigate such risk as part of its risk-based supervisory approach, whether through reporting or other means.

Question 4

Do you agree with the proposal to remove the IRAP reporting requirement for Category 3B and 3C firms?

Removing the requirement for professional indemnity insurance (PII) for Branches

19. Currently, all Category 3B, 3C and 4 firms, including Branches, are required to take out and maintain PII. PII is intended to address professional liability risk, i.e., liability

arising from negligent performance of duties for which a firm has legal responsibility, and which falls under the umbrella of operational risk.

Proposal

20. It is proposed that Branches should not be subject to the PII requirement, as they are not subject to specific prudential capital requirements under PRU and are reliant on their respective head offices for financial support.

Question 5

Do you agree with the proposal to remove the PII requirement for Branches of Category 3B, 3C and 4 firms?

Minimum standards for PII

21. The FSRA currently requires the PII cover taken out by a firm to be “*appropriate to the nature, size, complexity and risk profile of the Authorised Person's business*” and has outlined certain expectations in guidance relating to such cover, e.g., that it be taken out from a reputable and well-capitalised insurer. However, based on supervisory experience and benchmarking analysis, the FSRA considers that it would be appropriate to prescribe minimum standards for PII to ensure that it provides meaningful protection in respect of professional liability risk.

Proposal

22. Based on insights gained from experience and benchmarking, the following minimum standards are proposed:
- (i) the insurer must be a regulated insurance firm, which has an external credit assessment from an ECAI that maps to Credit Quality Grade 3 or better; and
 - (ii) the insurance policy must make provision for the following:
 - (a) continuous cover for claims arising from work carried out from the date on which the firm was authorised;
 - (b) appropriate cover in respect of legal defence costs; and
 - (c) cover in relation to claims for which the firm may be liable as a result of its conduct or the conduct of its Employees, the members of its Governing Body and its agents.
23. At this stage, the FSRA is not proposing to impose specific minimum coverage limits and restrictions on deductible amounts, given the range of Regulated Activities

included in Categories 3B, 3C and 4 and the differing risk profiles associated with such activities.

24. It is also proposed to revise the obligation outlined in PRU 6.12.2(b) where we currently require firms to provide the FSRA with a copy of the firm's PII cover on an annual basis. Instead, we propose to require the firm to submit to the FSRA a confirmation statement, approved by its Governing Body, which verifies that the PII cover meets the prescribed minimum standards.

Question 6

Do you have any comments on the minimum standards proposed for PII and the proposed change in the reporting obligation to the FSRA?

Miscellaneous amendments

Proposals

25. The FSRA also proposes a range of miscellaneous amendments to PRU including the following, alongside correcting typos and errata.
- BCR applicable to Authorised Fund Managers – amend PRU 3.3.2 to clarify that a BCR of \$150,000 or \$50,000 applies to an Authorised Person, where it is authorised to carry on only the Regulated Activity of Managing a Collective Investment Fund from the list of Regulated Activities under Category 3C.
 - Scope of application of Chapter 10 of PRU – amend it to clarify that the requirements outlined therein apply to Domestic Firms only and not to Branches, similarly amending App11.

Question 7

Do you have any comments on the miscellaneous amendments described above or those outlined in Appendix 1?

Section B: Discussion points

26. In the next phase of its review, the FSRA intends to consider any other matters in relation to Categories 3B, 3C and 4 that have not been addressed in the current phase, along with the prudential requirements applicable to Category 2 and 3A firms.

27. For Category 2 and 3A firms, the FSRA will consider whether differentiating the prudential requirements applicable to the Regulated Activities within each of these categories would be appropriate. In particular, while the Regulated Activities of Dealing in Investments as Agent and Dealing in Investments as Matched Principal are both currently included in Category 3A, the FSRA considers that the prudential risks associated with these Regulated Activities may differ to a meaningful degree.
28. Similarly, firms Dealing in Investments as Matched Principal are permitted to only hold incidental and temporary positions on their balance sheet where such positions result from a failure to match Clients' orders. As a result, such firms will not generally be subject to the same degree of prudential risk as firms Dealing in Investments as Principal on an unmatched basis but, other than the relevant BCR, they are subject in large part to the same prudential requirements.
29. Given these differences in risk profile, the FSRA welcomes comments on the key risks and considerations that should inform its approach to the prudential regulation of firms carrying on Regulated Activities within Categories 2 and 3A and whether it should continue to apply a Risk Capital Requirement to such firms and other requirements derived from the standards issued by the BCBS for large banks.

Question 8

Are there any other changes to the prudential requirements for Category 3B, 3C or 4 firms that the FSRA should consider as part of the next phase of its review?

Question 9

What are the key risks and considerations that should inform the FSRA's approach to prudential regulation of firms that are Dealing in Investments as Matched Principal? Should this Regulated Activity be further distinguished from Dealing in Investments as Principal on an unmatched basis from a prudential point of view?

Question 10

What are the key risks and considerations that should inform the FSRA's approach to prudential regulation of firms that are Dealing in Investments as Agent? Should firms carrying on this Regulated Activity be subject to a Risk Capital Requirement and other BCBS-derived requirements?

Appendices

The proposed legislative amendments are set out in the following document.

- **Appendix 1** - Prudential - Investment, Insurance Intermediation and Banking Rulebook (PRU)