CONSULTATION PAPER NO.127

MISCELLANEOUS CHANGES

8 AUGUST 2019

PREFACE

Why are we issuing this Consultation Paper (CP)?

1. This Consultation Paper (CP) seeks public comment on the DFSA's proposals to make a number of amendments to the DFSA's policy framework, as expressed through its Rules and the Regulatory Law (DIFC Law No. 1 of 2004, "the Law"). The DFSA has collected a small number of miscellaneous amendments to the DFSA Rulebook; each of the two items in this paper is a discrete topic.

Who should read this CP?

2. The proposals on Suitability will be of interest to Persons who:

   (a) advise on financial products or contracts of insurance;

   (b) manage assets on a discretionary basis;

   (c) propose to conduct the services referred to above; or

   (d) use, or propose to use, the services referred to above.

3. The proposals on the DFSA's reserves may be of interest to a wide range of stakeholders.

Terminology

4. In this CP, defined terms have the initial letter of the word capitalised, or of each word in a phrase. Definitions are set out in the Glossary Module (GLO). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

What are the next steps?

5. Please send any comments online by clicking here. You will need to identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments. The deadline for providing comments on this consultation is **10 September 2019**.

6. Following public consultation, we will proceed to make the relevant changes – amended as appropriate to reflect points raised in consultation - to the DFSA Rulebook. The proposed changes to the Law will be submitted to His Highness the President of the DIFC for his consent that the changes should be passed, for assent, to His Highness the Ruler. You should not act on the proposals until the relevant changes are made. We shall issue a notice on our website telling you when this happens.

Structure of this CP

Part I Suitability
Part II DFSA's financial reserve
Appendix 1 – Draft amendments to COB;
Appendix 2 – Draft amendments to the Regulatory Law; and
Appendix 3 – Questions in this consultation paper.

Part I Suitability

The current suitability requirements

7. There are three suitability related requirements in the DFSA Rulebook:

   (a) the overarching requirement in Principle 8 (Suitability) of the Principles for Authorised Firms that a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for customers, who are entitled to rely on its judgment;[1]

   (b) the suitability assessment that a firm[2] must carry out under COB to have a reasonable basis for making a recommendation of a financial product or financial service to, or executing a discretionary transaction relating to an Investment for, a Client; and[3]

   (c) the suitability assessment that an Insurer or Insurance Intermediary must carry out under COB when recommending a General Insurance product to a Retail Client.[4]

8. We do not propose any changes to the overarching principle referred to in paragraph 7(a). Under it, every firm will continue to have the obligation to ensure the suitability of the advice they give to, or a discretionary decision they make for and on behalf of, a customer in circumstances where the customer is entitled to rely on the firm's judgement. This is a broad requirement and may apply in situations where the firm gives advice of a general nature (as opposed to giving a recommendation, which is also a sub-set of advice) to a customer where the customer is reasonably likely to rely on the firm's advice.

Need for change

9. Through our supervisory process, we have identified some practices adopted by firms that are inconsistent with the intended effect of the suitability assessment.[5] These include firms that often:

   (a) include vague or generic language in the notice to warn a Professional Client that the firm will not undertake, or will undertake to a limited extent only, the suitability assessment for recommendations given to, or discretionary portfolio transactions undertaken for, the Client; and

   (b) do not draw the attention of Professional Clients sufficiently to the effect of the warning given to them by:

      (i) burying the warning amidst other information included in the Client Agreement; and

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1 See GEN Rule 4.2.8.
2 These are firms which are authorised under their licences to advise on financial products (defined as Investments, Deposits, Profit Sharing Investment Accounts and rights under a contract of long-term insurance) and on credit facilities.
3 See COB Rule 3.4.2, which also applies to firms making recommendations relating to long-term contracts of insurance.
4 See COB Rule 7.8.2.
5 It is mandatory for a firm to undertake a full suitability assessment when making recommendations to, or executing discretionary transactions for, Retail Clients. The flexibility that a firm has, to undertake a partial or no suitability assessment is available only in relation to recommendations and discretionary transactions for Professional Clients.

(ii) not requiring a separate signature indicating the Client's consent for a limited, or no, suitability assessment.

10. We are concerned that Professional Clients may be consenting to a firm not undertaking any suitability assessment at all, or undertaking a limited suitability assessment, without fully appreciating the consequences of not having the benefit of a suitability assessment. This defeats the intended purpose of the warning, which is to enable a Professional Client to make a well-informed and considered decision when agreeing to give away the right to have a proper suitability assessment.

International best practice relating to suitability assessment

11. We have benchmarked our suitability regime against:

(a) the standards set by the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS);[6] and

(b) the practices adopted in EU jurisdictions, based on MiFID.[7]

12. The IOSCO principles recognise that the suitability requirements may be less stringent, or inapplicable, through waiver or otherwise, with regard to non–retail customers.[8] Similarly, the IAIS principles recognise that regulators have the discretion to specify the particular types of insurance products or customers for whom advice is not required. Examples given are 'simple to understand' products, or products sold to customer groups who usually have expert knowledge of the type of products, thereby allowing flexibility in applying the requirements based on a qualified or professional customer qualification.

13. Under MiFID, the suitability assessment applies to all clients whether retail or professional. However, a firm may make a suitability assessment based on limited information relating to a professional client. For instance, when a firm provides investment advice or portfolio management services to a professional client, the firm is entitled to assume that:

(a) the client has the necessary level of experience and knowledge, and therefore is not required to obtain information on these aspects; and

(b) the client is able to financially bear any related investment risks consistent with the investment objectives of the client, and therefore, it is not generally required to obtain information on the financial situation of the client.

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6 Being able to meet the standards set by IOSCO, IAIS and the Basel Committee on Banking Supervision is important for the DFSA regime to be assessed favourably under the Financial Sector Assessment Programme (FSAP) undertaken by the International Monetary Fund and the World Bank.

7 The DFSA's current suitability requirements are based on MiFID I (the Markets in Financial Instruments Directive (2004)). We have considered whether any changes are needed given the more recent changes in MiFID II (Markets in Financial Instruments Directive (2014)).

8 See the IOSCO Final Report on "Suitability Requirements with Respect to the Distribution of Complex Financial Products – January 2013". That Report states that '*The regulatory system should require intermediaries to comply with suitability requirements, calibrated to the complexity and riskiness of the product and service and the level of sophistication of the customer.*'

Proposals – Investment firms

The extent of the suitability assessment

14. Under the current suitability regime, a firm can limit the extent to which it will consider suitability when making a recommendation to, or undertaking a transaction on a discretionary basis for or on behalf of, a Professional Client, if, prior to carrying on that activity, the firm has given a written warning to the Client clearly stating either that the firm:

    (a) will not consider suitability (a full waiver of suitability); or

    (b) will consider suitability only to the extent specified in the notice (a partial waiver of suitability),

    and the Client has agreed to it.

15. Before addressing the shortcomings identified in paragraphs 9 and 10 relating to the effectiveness of the warnings given to Professional Clients who fully or partially waive the benefit of a suitability assessment, we considered the threshold issues of:

    (a) whether the current flexibility available for Professional Clients to waive either fully or partially the suitability assessment in itself is warranted; and

    (b) to the extent it is, whether such flexibility should only be limited to 'deemed' Professional Clients, and not to 'assessed' or 'service-based' Professional Clients.

16. We do not propose to remove the current flexibility for Professional Clients to waive partially the suitability assessment (i.e. an assessment limited to specific parameters). Such a partial waiver can be beneficial for Professional Clients who wish to obtain limited advice, or discretionary services under limited or broad mandates. However, we do not consider it appropriate that firms should be able to make recommendations about financial products, or execute discretionary Transactions (as opposed to Execution-Only Transactions) for Professional Clients, without any suitability assessment at all for the reasons set out below:

    (a) first, the Suitability Principle referred to in paragraph 8 will continue to apply to a firm, requiring the firm to ensure the suitability of their advice (recommendations being a type of advice) and discretionary decisions, as Clients would rely on the suitability of such advice or decisions; and

    (b) second, a recommendation or discretionary decision for a Client, in our view, could not be considered to be founded on a reasonable basis, unless it is based on some considerations (although this may be limited), relating to the Client's needs and objectives, financial circumstances and objectives, including risk tolerance, as identified or known to the firm – but, not without any suitability assessment at all.[9]

17. Therefore, we propose to remove the flexibility currently available for a full waiver of the suitability assessment for Professional Clients, but retain the flexibility for partial waivers.

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[9] We also found that, in a 2018 thematic review undertaken by IOSCO of the suitability assessment for complex financial products, the DFSA is the only jurisdiction (out of 25 jurisdictions responded, including US, UK, Singapore, South Africa and Hong Kong) which allows a complete waiver of the suitability assessment for Professional Clients.

See the proposed amendment to COB Rule 3.4.2(a) at Appendix 1.

18. We also considered whether it is appropriate to draw a distinction between different classes of Professional Clients, in particular, between 'assessed' and 'deemed' Professional Clients. If we drew such a distinction:

    (a) only 'deemed' Professional Clients would be able to make a partial waiver of the suitability assessment; and

    (b) a full suitability assessment would become mandatory for 'assessed' Professional Clients.[10]

    As 'deemed' Professional Clients are considered to have greater expertise to understand risks associated with investments, and sufficient resources to absorb any losses that may result from bad or inappropriate investments, than 'assessed Professional Clients, such a distinction may seem warranted.

19. However, we do not consider it appropriate to draw such a distinction for the following reasons:

    (a) the suitability requirements are not intended to apply to 'deemed' Professional Clients where they become Market Counterparties following the procedure for classifying Market Counterparties (see COB 2.3.9(1) & (3));

    (b) due to due diligence requirements applicable to certain categories of institutional clients 'deemed' as professional (e.g. pension funds and insurers), they may choose not to be classified as a Market Counterparty, instead wishing to rely on recommendations or discretionary decisions made by regulated firms;

    (c) some categories of 'deemed' Professional Clients, such as municipalities and local governments, may have portfolios of investments which are particularly sensitive to certain types of investments (for example, complex financial products such as collateralised debt instruments which have hidden risks or volatility), and hence their interest would be better served if they have the ability to obtain a suitability assessment limited to specific parameters when investing in such products; and

    (d) drawing a distinction between different classes of Professional Clients is administratively cumbersome for both firms and the DFSA as the regulator.

20. For the reasons set out in paragraph 19, we propose not to draw a distinction between different types of Professional Clients in applying the suitability assessment requirements. As a result, all Professional Clients would have, under our proposals, the benefit of either a full suitability assessment, or a suitability assessment limited to specific parameters, as discussed further below.

21. We found that the current exemption, in COB 3.4.1(a), from the suitability requirements for Market Counterparties in COB 3.3.1(a) may have an unintended limited effect, because it applies to "a Transaction with a Market Counterparty". We propose to amend that provision so that the exemption applies to firms when they carry on financial services

[10] 'Service-based' Professional Clients, (i.e. the third category of Professional Clients), are classified as professional in reference to specific types of Financial Services provided to them, viz. Providing Credit, Advising on or Arranging Credit, Advising on Financial Products' and Arranging Deals in Investments. With regard to the provision of other types of Financial Services, a firm needs to assess them. They could only be classified as professional following an assessment.

"with, or for, a Market Counterparty". See draft COB Rule 3.4.1(a) at Appendix 1.

Issues for consideration

Q1. Do you agree with our proposal to remove the ability for a firm not to undertake a suitability assessment at all for any type of Professional Client? If not, why not?

Q2. Do you have any concerns relating to our proposals not to draw a distinction between different types of Professional Clients? If so, what are they and how should they be addressed?

Scope of a limited suitability assessment

22. There are two pre-requisites that must be met for a firm to be able to limit the extent to which it will carry out the suitability assessment for a Professional Client, which are:

    (a) the firm must give a written notice to the Professional Client clearly stating that it will consider suitability only to the extent specified in the notice; and

    (b) the Professional Client must give express consent, after a proper opportunity to consider the warning, by signing that notice.

23. Where a firm undertakes a limited suitability assessment, this should be for the benefit of the relevant Professional Client, rather than for the firm to have a less extensive or quicker process when making recommendations or carrying out discretionary transactions for such Clients. Generally, the basis for limiting the suitability assessment should focus on considerations relevant to the needs and objectives of a particular Professional Client, including the Client's level of sophistication and ability to absorb risks, rather than be driven mainly by the firm to suit their needs, for example, by any product limitations they have.

24. However, our proposals do not prohibit firms from being able to offer recommendations or undertake discretionary transactions based on a limited range of products. In such a case, those products can be recommended, or transactions relating to them executed, only if they are found, following a proper suitability assessment of the Client's needs and circumstances, to be suitable for the relevant Client, and the necessary warnings are given to the Client about the limited product range. It is a logical conclusion of a limited product range and a proper suitability assessment that, for some clients, the firm will not be able to make a recommendation.

25. As we propose to retain the current flexibility for a firm to provide recommendations or undertake discretionary transactions based on a limited suitability assessment, to provide greater clarity about the limited scope of a suitability assessment, we propose to amend current Guidance to reflect the position noted above. See draft Guidance under COB Rule 3.4.2 at Appendix 1.

Issue for consideration

Q3. Do you agree with our proposals? If not, why not?

Giving written warnings

26. The DFSA has, as noted in paragraph 10, concerns regarding the effectiveness of the

warnings that are given to Professional Clients. We propose to provide further Guidance on the procedures relating to warnings, so that Professional Clients are given appropriate and effective warnings of the consequences of the firm undertaking a limited suitability assessment, before the firm makes a recommendation or executes a transaction on a discretionary basis. However, there is no requirement for the firm to issue a new warning before each recommendation, or indeed before each discretionary transaction undertaken for a client.

27. We propose to clarify in Guidance that a firm, before making recommendations or executing discretionary transactions on a limited suitability assessment, should under the procedures currently set out in COB Rule 3.4.2(2):

(a) give to the relevant Professional Client a warning:

(i) as a separate stand-alone communication given to that Client (so that it is not included as part of the Client Agreement or other documents issued to the Client); and

(ii) in good time before any recommendation is made to, or any discretionary transactions are undertaken for, that Client;

(b) include in the warning, in clear terms, the extent to which the suitability assessment will be limited – for example, to suit any specific investment objectives, needs or circumstances of the particular Client, or any type or range of financial products from which the firm would select when making a recommendation or undertaking a discretionary transaction;

(c) provide for the Client's acknowledgement of their receipt, and understanding, of the warning given to them, and their express consent to the limited suitability assessment being undertaken; and

(d) consider the need to provide a fresh warning, for example, if the type of financial products to be recommended, or to be invested in on a discretionary basis, were to differ from the type of financial products covered in the initial warning.

See the draft Guidance to COB Rule 3.4.2 at Appendix 1.

Issues for consideration

Q4. Do you have any concerns relating to the proposals on warnings? If so, what are they, and how should they be addressed?

Q5. Are there other matters that should be included in warnings? If so, what are they, and why should they be included?

The information that a firm should obtain and consider when making a limited suitability assessment

28. Information relating to the Client (whether retail or professional) is a critical part of a firm being able to form a reasonable basis for making any recommendation to, or executing any discretionary transactions for, a particular Client. Under the current requirements, to make an appropriate assessment, a firm needs to have information about the particular Client's needs, objectives, and financial situation, including risk tolerance, and the knowledge, experience and understanding of the risks involved, as relevant.

29. Our supervisory experience has shown that firms conducting suitability assessments have varying degrees of information relating to clients and procedures for assessing suitability. Many firms ask what the desired approach to assessing suitability is and what the DFSA's expectations are. This might be due to lack of clarity regarding the suitability-relevant information a firm needs to obtain from Clients and the procedures for validating and updating such information.

30. Based on IOSCO guidance, and similar material from other regulators,[11] we propose to set out Guidance on the DFSA's expectations. The Guidance will discuss the information that a firm should obtain and consider as part of its suitability assessment to form a reasonable basis for any recommendation given to, or any discretionary transaction executed for and on behalf of, Clients, along the lines set out in the paragraphs below.

31. For the purposes of the suitability assessment, the information which a firm needs to have, or to obtain, includes, with regard to:

    (a) *the Client's needs and objectives* - matters such as the length of time for which the Client wishes to hold the type of financial product and, in some cases, the age and stage of life of an individual Client;

    (b) *the Client's financial situation* - matters such as the Client's assets, liabilities (including tax), income and expenses, and general capacity to withstand losses arising from investing in financial products; and

    (c) *the Client's knowledge and experience* - the nature, volume and frequency of the Client's previous investments, and the level of familiarity with relevant financial products and financial services. If the Client is an individual, their occupation or profession, former professional experience, and level of financial education.

32. We also propose to provide Guidance that, when recommending a financial product to a Client, or executing a discretionary transaction, the firm should consider the overall effect of its recommendation on the Client's investment portfolio. See the draft Guidance after COB Rule 3.4.2 at Appendix 1.

Issues for consideration

Q6. Do you agree with the proposed Guidance relating to information that a firm should obtain, and consider, when making a limited suitability assessment? If not, why not?

Q7. Is there other information that a firm should obtain, and consider, when making a limited suitability assessment? If so, what is that information, and why is it necessary?

Q8. Are there other matters that should be included in the Guidance? If so, what are they, and why should they be included?

Firms conducting Insurance or Insurance Intermediation Business

Suitability assessments for recommendations relating to contracts of insurance

[11] Guidance issued by Hong Kong Securities and Futures Commission.

Long-Term Contracts of Insurance

33. Under the current regime, the suitability requirement that applies to a firm conducting Investment Business also applies to an Insurer, or Insurance Intermediary, who conducts business with Retail Clients in respect of Direct Long-Term Contracts of Insurance because they have an investment component, which makes them comparable to other investment products. All the proposals discussed in relation to Investment Business are relevant to Insurers and Insurance Intermediaries making recommendations to Retail Clients relating to Long-Term Contracts of Insurance.

Contracts of General Insurance

34. All Contracts of Insurance, other than Long-Term Insurance, are General Insurance contracts. Under the current requirements, an Insurer or Insurance Intermediary must not make a recommendation to a Retail Client to enter into a contract of General Insurance unless the firm has:

    (a) taken reasonable steps to ensure that the recommended contract of General Insurance is suitable for the Client, in light of the Client's demands and needs; and

    (b) obtained from the Client such information as is necessary to identify the circumstances and objectives of the Client.

35. If an Insurer or Insurance Intermediary recommends a contract of General Insurance to a Retail Client that does not fully meet the Client's requirements, the firm:

    (a) must clearly explain to the Client, at the point of making the recommendation, that the contract does not fully meet the Client's requirements and the differences in the contract recommended; and

    (b) should take into consideration the knowledge the Client has in relation to the particular type of insurance, when deciding the level of explanation that needs to be given to the Client.

36. If an Insurance Intermediary is instructed by a Client to obtain a Contract of Insurance contrary to any advice given by the intermediary, the firm must obtain written confirmation of the Client's instructions before obtaining insurance as per the Client's instructions.

37. While the above requirements and procedures are clear, we believe Insurers and Insurance Intermediaries would benefit from having further guidance relating to how they should meet their suitability related requirements, along the lines set out below:

    (a) simple and easy to understand insurance products do not generally require extensive suitability assessment in terms of a Client's demands and needs. In other cases, the information which a firm should obtain about a Client's demands and objectives before recommending to a Client a General Insurance product includes:

        (i) details relating to the purpose for which the Client seeks to obtain cover (e.g., what risks the Client wishes to cover);

        (ii) the Client's circumstances, including financial, to assess the type of exclusions and level of excess that the Client wishes to accept or that is suitable for the particular Client; and

(iii) any other matters as would be relevant to the particular type of insurance product involved, and the Client's needs and objectives; and

(b) when a firm recommends a contract of General Insurance to a Client that does not meet all the Client's requirements, the notice of explanation which the firm needs to give to the Client should include sufficient information:

(i) for the Client to understand easily the differences between what is proposed and what the Client wishes to obtain;

(ii) about the advantages and disadvantages of the proposed cover; and

(iii) about any financial or other risks the Client may be exposed to, due to the proposed policy not fully meeting the Client's requirements.

See draft Guidance under COB Rules 7.8.2 and 7.8.3 at Appendix 1.

Issues for consideration

Q9. Do you agree with the proposed Guidance? If not, why not?

Q10. Are there other issues that Guidance should cover? What are they, and why should they be included?

Transitional arrangements

Impact of the proposals on existing arrangements

38. Although the proposals are not intended to have any retrospective effect, firms would need to consider what impact they have on existing arrangements with their Clients. For example:

(a) if a firm has an existing arrangement with a Professional Client not to undertake any suitability assessment for recommendations given to, or discretionary transactions to be undertaken for, that Client, the firm will not be able to rely on that arrangement going forward; and

(b) if a warning notice already given to a Professional Client for a limited suitability assessment does not meet the current requirements in Rule 3.4.2(2), as clarified by the proposed Guidance, the firm would need to reissue new warnings if recommendations are to be made, or discretionary transactions are to be undertaken, for those Clients after the changes come in to effect.

Issues for consideration

Q11. Are there any practical difficulties which a firm may face with the proposed changes? If so, what are they, and how should they be addressed?

Q12. Should the proposed changes come into effect on 1 January 2020? If not, why not?

Part II DFSA's financial reserve

The current position

39. The DFSA is funded, as most stakeholders will know, by a combination of funding from the Government of Dubai and fees paid by regulated entities, and others, who are licensed, registered, or otherwise regulated, by the DFSA.

40. It is common practice amongst regulatory bodies[12] to build up, over time, a regulatory reserve so that the organisation can fund its activities if there is – for whatever reason – a breakdown in the normal methods of funding, or an unexpected need for expenditure, such as to fund a litigation matter.

41. We have looked at the position in a number of other jurisdictions, and have noted that it is becoming more common to set out – in the statute that governs the activities of the regulatory body – the maximum extent of reserves that can be allowed, and the treatment of any surplus funds in excess of that maximum. For example, our research has shown that:

    (a) the UAE Central Bank is allowed to establish a General Reserve Account and can hold in that account up to four times its paid-up capital;

    (b) the UAE Insurance Authority is expected to maintain reserves equal to twice its annual budget; and

    (c) the Capital Markets Authority in Saudi Arabia also is expected to maintain a reserve equal to twice its previously reported annual expenditure.

42. The statute governing the operations of the DFSA, namely the Regulatory Law (DIFC Law No. 1 of 2004) does not set out any specific limit on the amount of regulatory reserve that the DFSA can hold.

43. We propose, therefore, putting forward an amendment to the Law so that the DFSA can hold a regulatory reserve of up to two times its annual budget, with any surplus funds above this maximum limit to be remitted to the Government of Dubai.

Issues for consideration

Q13. Do you have any comments on the proposed change to the Law regarding the DFSA's reserves? If so, what are they?

[12] This tends to be the case for non-central bank regulatory bodies. Central banks are, usually, in a different situation when it comes to the financing of regulatory activities.

Appendix 3: Questions in this Consultation Paper

Q1. Do you agree with our proposal to remove the ability for a firm not to undertake a suitability assessment at all for a Professional Client? If not, why not?

Q2. Do you have any concerns relating to our proposals not to draw a distinction between different types of Professional Clients? If so, what are they, and how should they be addressed?

Q3. Do you agree with our proposals? If not, why not?

Q4. Do you have any concerns relating to the proposals on warnings? If so, what are they, and how should they be addressed?

Q5. Are there other matters that should be included in warnings? If so, what are they, and why should they be included?

Q6. Do you agree with the proposed Guidance relating to information that a firm should obtain, and consider, when making a limited suitability assessment? If not, why not?

Q7. Is there other information that a firm should obtain, and consider, when making a limited suitability assessment? If so, what is that information, and why is it necessary?

Q8. Are there other matters that should be included in the Guidance? If so, what are they, and why should they be included?

Q9. Do you agree with the proposed Guidance? If not, why not?

Q10. Are there other issues that Guidance should cover? What are they, and why should they be included?

Q11. Are there any practical difficulties which a firm may face with the proposed changes? If so, what are they, and how should they be addressed?

Q12. Should the proposed changes come into effect on 1 January 2020? If not, why not?

Q13. Do you have any comments on the proposed change to the Law regarding the DFSA's reserves? If so, what are they?