



CONSULTATION PAPER NO. 71

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FINANCIAL SERVICE DEFINITIONS REVIEW

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Why are we issuing this paper?

1. This Consultation Paper seeks public comments on the DFSA proposal to make changes to the current definitions of Financial Services in the General Module (GEN) of the DFSA Rulebook. As part of this review the DFSA also proposes changes to the prudential categories in Chapter 1 of Prudential – Investment, Insurance Intermediation and Banking Module (PIB).
2. The changes proposed are to enhance the current Financial Service definitions framework, to ensure the DFSA is able to regulate in an effective and efficient manner, and to reflect the DFSA’s risk based approach to regulation. Another consequence of these changes is where possible to reduce the regulatory burden and costs on Authorised Firms conducting business in or from the DIFC.

Who should read this paper?

3. The proposals in this paper would be of interest to Persons:
 - (a) carrying on, or considering carrying on, Financial Services in or from the DIFC; and
 - (b) Advisors to Persons carrying on, or considering carrying on, Financial Services in or from the DIFC.

How is this paper structured?

4. In this paper, we set out:
 - (a) the background to the proposals and overview (paragraphs 8 - 9);
 - (b) the proposed changes to the GEN and PIB Modules (paragraphs 10 - 51), in relation to the following Financial Services;
 - (i) Dealing In Investments as Principal;
 - (ii) Dealing in Investments as Agent;
 - (iii) Advising on Financial Products and Credit;
 - (iv) Providing Credit;
 - (v) Arranging Custody; and
 - (c) proposed additional guidance in relation to Islamic Finance (paragraphs 52- 54);
 - (d) proposed changes to Providing Trust Services (paragraphs 55 - 60)
 - (e) proposed miscellaneous enhancements (paragraphs 61- 62)

How to provide comments?

5. All comments should be in writing and sent to the address or email specified below. If sending your comments by email, please use the Consultation Paper number in the subject line. You may, if relevant, 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.

Comments to be addressed to:

**Consultation Paper No. 71
Policy and Legal Services
Dubai Financial Services Authority
PO Box 75850
Dubai, UAE**

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What happens next?

6. The deadline for providing comments on the proposals is **23 November 2010**. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to enact the changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We will issue a notice on our website telling you when this happens.

Terminology in this paper

7. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in GLO or in the proposed amendments. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

Background

8. As part of its ongoing review of the regulatory framework within the DIFC, the DFSA has reviewed the definitions for Financial Services activities in the General Module (GEN) of the DFSA Rulebook. As part of this review, we have also considered whether changes are warranted to the prudential categories to which Financial Services activities are allocated.
9. This review of GEN was focused on enhancing the current Financial Service definitions by identifying and remedying any areas of overlap, technical irregularities or unintended consequences in drafting. In this context, the DFSA has noted the regulated activities regime administered by the Financial Services Authority in the UK, upon which a number of our definitions and our “by way of business” exclusions are largely based. We have also considered similar definitions introduced by European Directives such as MiFID.

Proposed changes

A. Dealing in Investments as Principal

A1. Regulatory treatment of private equity investments by a fund manager

10. Authorised Firms (Firms) that Manage Assets of a Private Equity Fund, may make an initial subscription of Units in that fund. This type of investment typically occurs where a private equity fund manager seeks to seed, at least partially, such a fund with its own capital. A number of private equity Firms in the DIFC have raised this matter with the DFSA as material to their operations. The motivation behind the investment appears to have two main drivers:
 - (a) establishing a track record of performance for a fund; and
 - (b) showing investors a private equity Firm’s willingness to share the risk of investment decisions.
11. Currently, this type of Investment is captured by the Financial Service activity of Dealing in Investments as Principal. This results in the Authorised Firm being subject to a higher prudential category, namely Category 2 rather than the lower prudential Category 3 which would reflect their core activity of Managing Assets. The Base Capital Requirement for a Category 2 Firm is US\$2 million whereas for a Category 3 Firm it is US\$500,000. In addition, both categories of Firms are subject to the variable capital requirements in PIB such as credit risk and market risk.
12. A private equity fund manager investing in its own fund may face market risk, in so far as market movements may have an adverse impact on the value of its holding in the fund. However, such an investment does not seem to fit well

with the aim of the regulatory mitigant, which is to minimise risks in a trading book, for example, solvency risk. An investment by the private equity fund manager in its own fund is not generally held for trading purposes, and is probably difficult to value on a 'real-time' basis. Typically private equity funds are closed ended structures and, therefore, realisation of the assets and redemptions to its investors do not occur until the end of the funds investment lifecycle.

13. The current regulatory treatment of initial private equity investment appears inconsistent with benchmarked jurisdictions such as the FSA (UK). In its Perimeter Guidance (PERG) the FSA (UK) has stated that it does not consider that Dealing on Own Account is likely to be relevant in cases where a person acquires a long term stake in a company for strategic purposes or for most venture capital or private equity activity. We would agree with this policy.
14. For example, private equity Firms already have the benefit of being able to make particular Investments which do not fall within the activity of Dealing in Investments as Principal. For example, the exclusion set out at GEN Rule 2.3.3, enables a private equity Firm carrying out investment strategies such as leveraged buyouts, to buy a majority control of an existing company.
15. In order to adequately address the above, the DFSA proposes that the activity of a fund manager making an initial subscription of Units in a Private Equity Fund for a period of more than 12 months should be specifically excluded from the Financial Services activity of Dealing in Investments as Principal.
16. We, therefore, propose to add a further exclusion to the Financial Service of Dealing in Investments as Principal.
17. The proposed amendments are contained in **Appendix 1**.

Issues for consideration

1. Should the exclusion proposed apply only to private equity fund managers? If not, why?
2. If so, are the proposed circumstances under which they are to be allowed to do so appropriate? If not, why?
3. Should the investment by a private equity fund manager only be excluded at the initial subscription into the fund? If not, why?
4. If so, are the proposed circumstances to be allowed to do so appropriate? If not, why?

A2. Commodity Derivatives Principal Trading on Exchanges

18. Currently, where a firm only carries on principal trading involving commodity derivatives the DFSA treats the activity in two ways as follows:
 - (a) Recognised Members of an Authorised Market Institution who do not have a physical presence in the DIFC but have a place of business in another jurisdiction and meet the requirements set out under REC

7.2.3 (b) in order to be exempted from the Financial Services Prohibitions; or

- (b) Members of an Authorised Market Institution or Recognised Bodies based in the DIFC can apply for a modification of GEN Rule 2.3.2 that provides an exclusion to the 'by way of business' test which in effect means the Firm is not carrying on a Financial Service. A number of Firms have sought and been granted such a modification.
19. The current approach, for Recognised Members and Authorised Firms, appears inconsistent with several benchmarked jurisdictions, such as the U.S.A., Singapore and those European countries that have adopted MiFID. Benchmarking suggests that in many jurisdictions, principal trading (excluding market-making) in commodities or commodity derivatives, where it is the sole Financial Service being carried out, is exempt from the requirement for authorisation. Historically, the aim has been not to require authorisation of commodity producers or users of commodities in manufacturing, where those producers are only dealing for their own trading book.
20. The regulatory rationale for such exclusion is that the only monies at risk are the Firm's own, and that the conduct risks are adequately addressed through exchange membership requirements and ongoing market supervision. Any financial risk is mitigated by the fact that all trades conducted on the exchange are cleared and settled through a clearing house. For example, with respect to the DME, such trades are cleared and settled through NYMEX.
21. Furthermore, a Firm trading on a principal basis, in or from the DIFC, in commodity derivatives not listed on an Authorised Market Institution currently requires authorisation, because this activity constitutes a Financial Service namely Dealing as Principal. We currently do not have any Firms operating such a business model in the DIFC.
22. The DFSA proposes to amend Chapter 2 of the GEN Module to provide for a further exclusion to the by way of business requirements for Financial Services. In doing so the DFSA will be further in line with other jurisdictions, notably the U.S.A., Singapore and those European countries that have adopted MiFID. It is intended that this exemption would only apply if the Person does not undertake any other Financial Service.
23. If these proposed amendments to GEN are implemented, consequential amendments will be required to the Recognition regime in REC in order to bring REC into alignment with GEN.
24. The proposed amendments are contained in **Appendix 1**.

Issues for consideration

5. Should the exclusion be limited to Commodity Derivatives Principal trading? If not, why?

B. Dealing in Investments as Agent and Arranging Deals in Investments

25. A few Firms have raised an issue in regard to receiving and transmitting client orders on behalf of clients. These Firms are generally authorised only to

advise and arrange, and the actual execution of the client order takes place in another jurisdiction, where the client has a relationship with the broker who will execute the order on the client's behalf. The issue is whether such receipt and transaction constitutes Dealing as Agent.

26. We note that in our Consultation Paper No 65 of 2009 in relation to our Representative Office regime we advised that, activities amounting to order routing or passing in relation to Investments, were outside the scope of a Representative Office's authorised activities.
27. In order to provide clarity to Firms that such activity does not constitute Dealing, but merely Arranging, it is proposed that an exclusion be added to the Financial Service definition of Dealing as Agent and also some appropriate modification to the Financial Service definition of Arranging Credit or Deals in Investments.
28. The proposed amendments are contained in **Appendix 1**.

Issues for consideration

6. Have the proposed changes clarified the Rules adequately? If not, why?

C. Advising on Financial Products and Credit

29. We propose to include Deposits and Profit Sharing Investment Accounts as financial products within the Financial Service activity of Advising on Financial Products or Credit. Currently, the scope of 'financial products' as set out at GEN 2.11.1(5) includes Investments, and it also captures Long Term Insurance products.
30. In the UK, advising on deposits is not a regulated activity. However, the UK FSA has recently introduced a conduct of business regime for banking which addresses, for example, financial promotion of deposits. Further, they have provided guidance indicating that where an authorised deposit-taker decides to make a personal recommendation to a customer who is entitled to rely upon its judgement, it should take reasonable steps to ensure that the recommendation is suitable. In both Australia and Singapore a person is generally required to be licensed to advise on deposits particularly where the person makes a personal recommendation. However, a number of exclusions apply both for retail and professional clients.
31. Notwithstanding, there is no consistency in international models, the DFSA is of the view that advising on Deposits needs to be addressed to maintain an appropriate level of regulatory protection. For example, the nature of wholesale deposits is becoming more complex with respect to the terms and the rates of return on offer, as well as the insured nature of those deposits. The DIFC is an international centre where wholesale banking activity is undertaken by a variety of institutions with access and links to a number of jurisdictions. Accordingly, we propose to include advising on Deposits as a Financial Service.
32. In regard to inclusion of Profit Sharing Investment Accounts within the term 'financial product', the DFSA takes the view that Profit Sharing Investment Accounts are a form of investment vehicle. Thus, for example, we already bring Managing a Profit Sharing Investment Account within our definition of

Investment Business and require a firm doing this to notify a client that he alone will bear any risk of loss from the Profit Sharing Investment Account.

33. Furthermore, when introducing the Representative Office regime, the DFSA incorporated within the term “financial product” in GEN 2.26.1(3) Deposits and Profit Sharing Investment Accounts.
34. Therefore, to capture within the definition any activities related to advising Clients on Deposits or Profit Sharing Investment Accounts, and provide greater protection to Clients and consistency the DFSA proposes that the term ‘financial products’ be broadened by making an amendment to the existing GEN Rule 2.11.1(5), to include Deposits and Profit Sharing Investment Accounts.
35. The proposed amendment is contained in **Appendix 1**.

Issues for consideration

7. Should Deposits be included in the Financial Services activity of Advising on financial products? If not, why?

D. Providing Credit

D1. Exclusion in GEN 2.5.2

36. The current exclusion in GEN 2.5.2 provides that an Authorised Firm does not Provide Credit where the Financial Service it provides a client is incidental to or in connection with another Financial Service other than Accepting Deposits.
37. It has become apparent from our dialogue with Firms that the current exclusion in GEN 2.5.2 may be too broad, with the unintended consequence of potentially permitting any Firms licensed for other Financial Services to Provide Credit. It is understood this exclusion was originally intended only for brokers who provide margin lending as an ancillary service to their main brokerage activity.
38. In addition, the reference in GEN Rule 2.5.2 with respect to Accepting Deposits is now obsolete and is a historical legacy from when Banking Business (now a deleted definition) was defined as Accepting Deposits and Providing Credit.
39. We, therefore, propose to amend the current exclusion to the Financial Services definition of Providing Credit by limiting the exclusion to trading activities relating to Investments or conducting Insurance Business.
40. The proposed amendments are contained in **Appendix 1**.

Issues for consideration

8. Have the proposed changes clarified the Rules adequately? If not, why?
9. Are there any activities other than brokerage services that may require the exclusion? If so, please explain which activities and why.

D2. Prudential Category

41. Currently, a Firm that is Providing Credit in the DIFC is in prudential Category 1, pursuant to PIB Rule 1.3.1 where the Base Capital Requirement is US\$10 million.
42. Historically, in other jurisdictions for example in United Kingdom and Australia the provision of credit has not been considered a prudential category 1 financial service. Typically, licensing for the provision of credit in those jurisdictions was overseen by a consumer protection agency whose remit is one of essentially ensuring that credit agreements are not unfair.
43. Providing Credit was initially coupled with Accepting Deposits in the DFSA regime and defined as Banking Business (now a deleted definition). This caused its allocation to Category 1. In addition, the DFSA's regime does not allow Providing Credit to Retail Clients, unless the Retail Client is an Undertaking and the Credit Facility is provided for a business purpose.
44. When considering the appropriate prudential category for a Financial Service it is useful to revisit the underlying principles for prudential regulation, namely that consumers (both a customer and other market participants) are not in practice in a position to judge the safety and soundness of financial firms. Accordingly, a lender would appear to represent a lower level of risk than a Person who is a deposit taker for a consumer. The agency/fiduciary risks do not appear as significant, as the consumer has not entrusted his property in the Firm; in fact assets have moved from the lender to the consumer.
45. Regardless of these proposals, it is the DFSA's intention to ensure that any systemic risks that may arise with respect to any lending institution in the DIFC are appropriately identified and mitigated. The recent financial crisis has highlighted the knock on effect and adverse systemic consequences of liquidity stresses at lending institutions, and this cannot be underestimated.
46. The proposal to change Providing Credit to Category 2 would nevertheless keep in place the same prudential requirements that apply, save lowering the Base Capital Requirement to US\$2 million from US\$10 million and introducing an Expenditure Based test which requires a Firm to hold at least 13 weeks of its Annual Audited Expenditure.
47. We, therefore, propose that the prudential category for Firms Providing Credit but not also Accepting Deposits is changed to Prudential Category 2.
48. The proposed amendments are contained in **Appendix 2**.

E. Arranging Custody

49. The Financial Service activity of Arranging Custody generally arises in respect of the introduction of a Person to a custodian, unless, for example, there is no fee derived by the introducer. A drafting improvement has been identified in relation to the exclusion to Financial Service of Arranging Custody as set out in GEN 2.14.2. The current exclusion employs a triple negative which may make the definition hard to follow. Furthermore, the provision is conjunctive in relation to the introducer being a member of the same group as the custodian and remunerated by the custodian. We propose to adopt a similar approach to the UK, which provides that a custodian is connected to the introducer either by being in the same group as the introducer or where he remunerates the introducer.
50. We, therefore, propose to amend the current Financial Service of Arranging Custody by making changes to its current exclusion in GEN 2.14.2.
51. The proposed amendments are contained in **Appendix 1**.

Issues for consideration

10. Have the proposed changes clarified the Rules adequately? If not, why?

F. Islamic Financial Services and Substance over Form

52. The DFSA believes that there is a need to provide Guidance to explain the DFSA's "substance over form" approach when determining whether an activity constitutes the carrying on of a Financial Service. This is particularly so when considering the treatment of Islamic Financial Business arrangements.
53. We, therefore, propose to add guidance to the Islamic Finance Rules module explaining our approach.
54. The proposed amendments are contained in **Appendix 3**.

Issues for consideration

11. Have the proposed changes clarified the Rules adequately? If not, why?

G. Providing Trust Services

55. The current prudential category for Providing Trust Services is Category 3, which has a Base Capital Requirement of US\$500,000. We believe that this prudential category may not accurately reflect, and is not proportionate to, the prudential risks that a Firm undertaking such activity represents, and is therefore unduly burdensome.

56. Providing Trust Services in the DIFC has the following component categories:
- (a) the provision of services with respect to the creation of an express trust;
 - (b) arranging for a Person to act as a trustee in respect of any express trust;
 - (c) acting as trustee in respect of an express trust;
 - (d) the provision of Trust Administration Services in respect of an express trust; or
 - (e) acting as protector or enforcer in respect of an express trust.
57. By comparison, other jurisdictions, which have a regulatory regime for the provision of trust services, such as Jersey, Guernsey and Isle of Man, do not impose a capital requirement equivalent to the DFSA's Base Capital Requirement. All three benchmarked jurisdictions addressed capital resource concerns through the mandatory requirement of professional indemnity insurance. The DFSA also places a mandatory requirement pursuant to COB 5.4, for professional indemnity insurance but this is in addition to the Base Capital Requirement.
58. Nevertheless, in relation to the activities described in paragraph 56 above, only sub-paragraph (c) "acting as a trustee in respect of an express trust" represents any significant level of risk through the fiduciary relationship created and the oversight and control of third party assets. This is particularly relevant where, for example, there is a winding down of a firm that is acting as trustee.
59. It is recommended that Providing Trust Services is altered to Category 4 except where a Firm acts as a trustee in respect of an express trust, in which case it will remain in prudential Category 3 because of the fiduciary relationship created and the oversight and control of third party assets, a trustee provides.
60. The proposed amendments are contained in **Appendix 2**.

Issues for consideration

12. Do you consider these changes adequate to address any risks posed by these activities? If not why?

H. Miscellaneous Enhancements

61. The DFSA has identified a number of improvement opportunities in GEN and PIB with respect to providing greater consistency and correcting anomalies and is proposing appropriate amendments in this regard.
62. The proposed amendments are contained in **Appendices 1 and 2**.

Issues for consideration

13. Have the proposed changes clarified the Rules adequately? If not, why?