



CONSULTATION PAPER NO. 77

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**PROPOSALS RELATING TO CORPORATE GOVERNANCE AND
REMUNERATION STANDARDS APPLICABLE TO AUTHORISED
PERSONS**

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Why are we issuing this paper?

1. The DFSA proposes to make enhancements to corporate governance standards applicable to Authorised Firms and Authorised Market Institutions (“Authorised Persons”). The current corporate governance requirements are contained in the GEN and AMI modules of the DFSA Rulebook and are supported by the policies and procedures for administering those requirements contained in the RPP Sourcebook.
2. Our proposals to enhance corporate governance standards applicable to Authorised Persons arose as a result of the enhancements adopted by international standard setting bodies (“international standard setters”) in the financial sector, in particular:
 - (a) the Financial Services Board (“FSB”);
 - (b) Basel Committee on Banking Supervision (“Basel”);
 - (c) The International Association of Insurance Supervisors (“IAIS”); and
 - (d) International Organisation of Securities Commissions (“IOSCO”).
3. In the aftermath of the financial markets crisis that began in 2007, poor governance in financial institutions was found to have been a major contributor to that crisis. As a result, these international standard setters have adopted a range of measures to enhance corporate governance practices among financial institutions, with a higher focus on systemically important financial institutions to mitigate systemic risks emanating from such firms where they are poorly and imprudently managed. These measures include:
 - (a) corporate governance standard issued by IAIS (ICP 7) in early 2011;
 - (b) ‘Principles for enhancing corporate governance’, issued by Basel in late 2010;
 - (c) principles for sound compensation practices issued by the FSB in late 2009, which are to be implemented by IAIS, Basel and IOSCO;
 - (d) the recent peer review carried out by the FSB’s Standing Committee on Standards Implementation on compensation practices adopted by SIFIs in G20 jurisdictions; and
 - (e) the guidelines issued by the Organisation for Economic Cooperation and Development (“OECD”) relating to corporate governance, which are adopted by IOSCO.

4. The objectives of our proposals in this paper are two fold:
- (a) first, they are designed to better align our current regime with the enhancements promoted by the international standard setters noted above. This is particularly important as the International Monetary Fund (“IMF”), when carrying out its next Financial Sector Assessment Programme assessment (“FSAP”) of the UAE (which is expected to occur in 2012) will be assessing compliance of our regime against those standards; and
 - (b) secondly, we believe that the proposed enhancements to corporate governance standards would strengthen the prudent and sound management of the financial institutions within the DIFC. This would also be in the best interests of the UAE as it would enhance the international reputation of the UAE as a whole.

Who should read this paper?

5. The proposals in this paper would be of interest to:
- (a) Authorised Firms and Authorised Market Institutions, including those applying to obtain licences as Authorised Firms or Authorised Market Institutions;
 - (b) individuals who are or propose to be members of the Governing Body or senior management of an Authorised Firm or Authorised Market Institutions (such as Directors, Partners senior executives of the firm);
 - (c) persons providing compliance, audit and other risk management and control services to Authorised Firms or Authorised Market Institutions;
 - (d) Persons providing legal, accounting and audit services or acting or proposing to act as third party advisers in respect of offers of Securities; and
 - (e) Financial Services Regulators, particularly in the GCC.

How to provide comments?

6. 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 or emailed to:

Consultation Paper No. 77
Policy and Legal Services
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Dubai, UAE
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What happens next?

7. The deadline for providing comments on the proposals is **14 August 2011**. Once we receive your comments, we shall consider if any further refinements are required to these proposals. We shall then proceed to enact the relevant changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Structure of the paper

8. The corporate governance enhancements which we propose are reflected in the amendments to the GEN module (Appendix 1) and the Authorised Market Institution (AMI) module (Appendix 2) of the DFSA Rulebook and the RPP Sourcebook (Appendix 3). The considerations that underpin these enhancements and the key aspects of these proposals are set out as follows:
 - (a) Terminology – see paragraph 9;
 - (b) scope of corporate governance – see paragraphs 10 – 12;
 - (c) proportionate application to firms depending on the nature, scale and complexity of their operations – see paragraphs 13 and 14;
 - (d) expansions to the current overarching corporate governance standard – see paragraphs 15 – 17;
 - (e) a new overarching standard relating to remuneration practices – see paragraphs 18 and 19;
 - (f) a detailed corporate governance related requirement and best practice – see paragraphs 20 – 22;
 - (g) a detailed remuneration related requirement and best practice – see paragraphs 23 – 26;
 - (h) other related enhancements – see paragraphs 27 – 30;
 - (i) enhancements relating to the DFSA's authorisation and supervision process – see paragraph 31; and
 - (j) transitional arrangements – see paragraph 32.

Terminology in this paper

9. 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 in this paper. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

Scope of corporate governance

10. What lies at the heart of sound corporate governance is a cohesive set of systems, policies, procedures and controls (collectively referred to as a corporate governance framework) through which a financial institution is expected to promote sound and prudent management of its business in the interest of its stakeholders. For this purpose, such a framework encompasses:
 - (a) placing clear responsibility for the proper management, and the oversight of the management, of the firm on the individuals at the helm of the firm, i.e. the Governing Body and its members and the senior management of the firm;
 - (b) certain checks and balances, in the form of increased accountability and independence from the management of the firm for persons undertaking control functions relating to the firm (such as risk management, compliance and internal audit); and
 - (c) increased supervisory attention to the governance structure and governance practices adopted by financial institutions.
11. The DFSA regime already contains adequate requirements covering some of the above aspects, particularly those relating to checks and balances provided by risk, compliance and internal audit functions – see GEN Rules 5.3.4 – 5.3.15) and adequate supervisory powers and oversight. Accordingly, the focus of the proposals in this paper is to enhance other areas of corporate governance, particularly relating to the accountability and internal governance of the Governing Body and that of the senior management of a firm.
12. Prudent and sound management of a firm by its Employees requires a sound remuneration structure and strategy to reward their performance in such a way so as to promote optimal performance outcomes without exposing the firm to unacceptable financial, reputational or other risks. Therefore, the remuneration structure and strategy of a firm form an important aspect of sound corporate governance, although the proposals relating to remuneration are set out separately from the corporate governance enhancement proposals.

Issue for consideration

1. Do you think that there are any other aspects relating to corporate governance that are not taken into account in our approach? If so, what are they and why should they be taken into account?

Proportionate application to firms depending on the nature, scale and complexity of their operations

13. The corporate governance standards needed to ensure that large financial institutions (including international groups) are managed prudently and soundly are generally more extensive and rigorous than those required for smaller financial institutions with tightly held ownership (with the consequences of a failure of large financial institution or an international group being much more drastic from a systemic and investor detriment perspective than that of a failure of a smaller institution). Structures adopted

by institutions carrying on financial services are also different, requiring differential application of corporate governance standards to different institutions.

14. Accordingly, the corporate governance standards adopted by international standard setters provide for a proportionate and scalable application of those standards, taking due account of the nature, scale and complexity of the operations of the financial institution and its organisational structure. We have adopted a similar approach in our proposals.

Issue for consideration

2. Do you have any concerns that the proportionate application of the corporate governance and remuneration standards to firms as proposed may cause practical difficulties for firms in complying with those standards? If so, what are those difficulties, and how should they be addressed?

Overarching corporate governance standard

15. Under the current regime, Authorised Firms are subject to an overarching corporate governance requirement set out as one of the 11 high level Principles applying to such firms (see Principle 11 in GEN Rule 4.2.11). A requirement in identical terms (although not set out as a high level Principle), applies to AMIs under AMI Rule 7.2.2(1)(d). This standard provides that *a firm must meet applicable standards of corporate governance as appropriate considering the nature, size and complexity of the firm's activities*.
16. This current overarching corporate governance requirement falls somewhat short of the enhanced corporate governance standards required by international standard setters because it does not specify the objective intended to be achieved by the corporate governance standards, which is to promote the prudent and sound management of the firm in the interests of the firm and for the protection of its customers and other stakeholders.
17. Therefore, we propose that the current overarching corporate governance requirement applicable to Authorised Firms in GEN Rule 4.2.11 (Principle 11) and AMIs's in AMI Rule 7.2.2(1)(d) be replaced with a more expansive overarching provision in line with the international standard setters' enhanced standards as follows:
 - (a) in the case of Authorised Firms, with a Principle that provides that "*An Authorised Firm must have a corporate governance framework as appropriate to the nature, scale and complexity of its business and structure, which are adequate to promote the sound and prudent management and oversight of the Authorised Firm's business and protect the interests of its customers and stakeholders.*" (see GEN Rule 4.2.11); and
 - (b) in the case of Authorised Market Institutions, a similar requirement, with the omission of the words "customers" in the relevant provision, as Authorised Market Institutions do not have "customers" as such, but only members (see AMI Rule 7.2.2(1)(d).

Issue for consideration

3. Do you have any concerns relating to the changes proposed to the overarching corporate governance standard? If so what are they and how should they be addressed?

Overarching remuneration related standard

18. Having sound remuneration practices forms an integral aspect of prudent and sound management of financial institutions. As became evident in the aftermath of the financial market crisis that began in 2007, some of the large financial institutions whose failure led to that crisis were found to have had remuneration strategies that led to excessive risk taking by their staff. This led to the adoption by the FSB of nine detailed and high level principles relating to 'sound compensation practices' for financial institutions, especially for systemically important financial institutions, which are now reflected in the international standard setters' requirements.
19. Under the current regime, the DFSA does not have any remuneration specific requirements applying to Authorised Firms and Authorised Market Institutions. To address this gap, we propose that an overarching outcome based remuneration standard be adopted:
 - (a) in the case of Authorised Firms, by way of an additional Principle for Authorised Firms (see GEN Rule 4.2.11 - Principle 12) which would provide that "*An Authorised Firm must have a remuneration structure and strategies which are well aligned with the long term interests of the firm, and are appropriate to the nature, scale and complexity of its business*" (see GEN Rule 4.2.12); and
 - (b) in the case of Authorised Market Institutions, as an additional requirement in similar terms (see AMI Rule 7.2.2(e)).

Issues for consideration

4. Do you have any concerns relating to the proposed overarching remuneration related standard? If so what are they and how should they be addressed?

Detailed requirement and best practice relating to corporate governance

20. The above overarching corporate governance and remuneration standards provide both the mechanism and flexibility for setting more detailed requirements and best practice by way of Guidance. They also provide firms more flexibility for achieving the outcome intended by those standards, taking due account of the nature, scale and complexity of their own operations and structure.
21. Using the above overarching corporate governance standard, and in line with the international standard setters' approach to corporate governance enhancements, we propose more detailed corporate governance requirements applicable to Authorised Persons (See GEN Rule 5.3.30.) This proposed new Rule:

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- (a) assigns to the Governing Body of an Authorised Person the clear responsibility for:
- (i) setting/approving the business objectives of the firm, and the strategies for achieving those objectives; and
 - (ii) providing effective oversight of the management of the firm to ensure that the senior management carries out the day-to-day management of the firm's business in accordance with the objectives and strategies set/approved by the Governing Body;
- (b) sets out two sets of broad requirements relating to the Governing Body:
- (i) the composition of the Governing Body (in terms of the number and mix of individuals with adequate knowledge, skills, expertise and time commitment necessary); and
 - (ii) the resources, powers and internal governance procedures that the Governing Body must have, in order to be able discharge its duties and functions effectively; and
- (c) assigns to the senior management of the Authorised Person the responsibility for effectively carrying out the day-to-day management of the business of the firm in accordance with the objectives and strategies set/approved by the Governing Body.
22. The Guidance items no 1 – 9 under proposed GEN Rule 5.3.30 provides clarification as to how the DFSA will apply the requirements in that Rule to Authorised Persons. Detailed best practice which Authorised Persons may adopt to achieve compliance with that Rule are set out in App3.1. These Guidance give flexibility for Authorised Persons to adopt governance structures and procedures that are appropriate to the nature, scale and complexity of their operations. In particular we note that unlike large operations, it would be neither feasible nor appropriate for smaller firms with a tightly held ownership structure to comply with all best practice specified in Guidance. As best practice guidance does not have the status of Rules, such firms will not be required to adhere to those aspects of best practice that are not appropriate, or not feasible, for compliance by them. However, appropriate overall measures to achieve the sound and prudent management of the business would still be needed.

Issues for consideration

- 5. Do you think that the detailed corporate governance requirements proposed in GEN Rule 5.3.30 contain all the relevant elements that are needed to promote sound corporate governance? If not, what are the changes needed and the reasons for such changes?
- 6. Do you think the level of detail in Guidance under GEN Rule 5.3.30 and App3.1 is sufficient to enable firms to adopt a proportionate application of the requirements in that Rule to suit their operations? If not, what improvements are needed?

Detailed remuneration related requirement and best practice

23. Consistent with the approach we have adopted in relation to corporate governance enhancements, the overarching remuneration related standard is supported by more detailed requirements proposed in GEN Rule 5.3.31, which spell out the key elements which an Authorised Person must take into account in establishing and implementing its remuneration structure and practices. These key elements require the Governing Body of the Authorised Person to ensure that the remuneration structure and the strategy of the firm:
- (a) is consistent with its business objectives and risk strategy;
 - (b) provides for the effective alignment of the remuneration structure of Employees and the risk outcomes associated with the roles and functions assigned to those Employees;
 - (c) covers, at a minimum, the members of the Governing Body, senior management, Persons Undertaking Key Control Functions in the firm and any major risk-taking Employees of the firm; and
 - (d) is implemented effectively on an on-going basis.
24. The Guidance items no 1 – 5 under proposed GEN Rule 5.3.31 provides clarification as to how the DFSA will apply the remuneration-related requirements in that Rule to Authorised Persons. Detailed best practice which Authorised Persons may adopt to achieve compliance with that Rule are set out in App3.2. As with the Guidance on corporate governance, Guidance on remuneration provides the flexibility for Authorised Persons to tailor their remuneration structure and strategies to suit the nature, scale and complexity of their operations. For example, the best practice in Guidance items no. 5 and 6 of App3.2 will be neither relevant nor needed for a firm which does not adopt performance based variable remuneration in compensating its Employees. Similarly, a firm which does not provide significant severance pay-outs need not adopt the best practice in Guidance item no. 7 in App3.2.
25. We also propose that *“the Governing Body of an Authorised Person must provide to the DFSA and relevant stakeholders sufficient information about its remuneration structure and strategies to demonstrate that such structure and strategies meet the requirements in GEN rule 5.3.30(1) on an on-going basis.”* The DFSA expectations for disclosure of information relating to the remuneration structure and strategies of an Authorised Firm are set out in Guidance items No. 3 – 5 under GEN Rule 5.3.31.
26. These remuneration related requirements and best practice substantially cover the requirements set out in FSB’s sound compensation principles and are consistent with the standards adopted by international standard setters. We note that what is proposed in this paper are not as prescriptive or detailed as those adopted in other some jurisdictions such as the UK or Australia relating to remuneration. We believe that the approach reflected in our proposals is more suited to and appropriate for the financial institutions within the DIFC.

Issues for consideration

7. Do you think that the detailed remuneration related requirement proposed in GEN Rule 5.3.31 contains all the relevant elements that are needed to promote sound remuneration practices within an Authorised Person? If not, what are the changes needed and the reasons for such changes?
8. Do you think the level of detail in Guidance under GEN Rule 5.3.31 is sufficient to enable firms to adopt a proportionate application of the requirements in that Rule to suit their operations? If not, what improvements are needed?

Other enhancements

27. We also propose some further enhancements to a number of other provisions in the GEN module, dealing with overall systems and controls, where they have an impact on corporate governance enhancements proposed.
28. One of the key enhancements we propose relates to GEN Rules 5.3.2 which deals with the organisational requirements applicable to Authorised Persons. Under the standards adopted by international standard setters, a key aspect of a sound and prudent corporate governance framework is to ensure that there is a clear division of roles and responsibilities assigned to Employees, and in doing so, that Employees are not assigned conflicting duties which impair the effectiveness of the performance of the relevant roles and functions.
29. While we already have requirements relating to apportionment of responsibilities at a high level (see GEN Rules 5.2.1 and 5.2.2), the enhancements proposed to GEN Rule 5.3.2 expand the current requirements to explicitly require a clear definition of roles and functions as appropriate to the nature, scale and complexity of the firm's business and the roles assigned to the individuals. In doing so, firms are required to avoid assigning roles and functions to individuals where those roles and functions conflict with each other, thereby impairing the effective discharge of such roles and functions by the relevant individuals. The Guidance set out under GEN Rule 5.3.2 provides best practice in achieving compliance with these Rules taking account of the nature, scale and complexity of the operations of a firm.
30. The other enhancement we propose is to require any significant changes to the corporate governance framework and remuneration strategies of an Authorised Firm (see GEN Rule 11.10.20) or Authorised Market Institution (see AMI Rule 10.5.3(1)(b)) to be provided to the DFSA as soon as practicable. This enables the DFSA to address any concerns it may have in relation to such changes in consultation with the Authorised Person. A Branch is required to provide such information only if the change is relevant to the activities and operations of the Branch.

Issues for consideration

9. Do you have any concerns relating to the enhancements proposed, described in paragraphs 27 – 30 above? If so, what are they and how should they be addressed?

Enhancements relating to the DFSA's authorisation and supervision process

31. The enhancements which we propose to the RPP Sourcebook (and to the AMI module which contains some aspects of supervision process for AMIs) are designed to ensure that when authorising and supervising an Authorised Person, the DFSA assesses the firm's ability to meet, on an on-going basis, the requirements relating to corporate governance framework and remuneration structure proposed in this paper. See sections 2.2.13(b) and 2.2.14(g) and (h) of the RPP Sourcebook for corporate governance related aspects and sections 2.2.13(f) and 2.2.14(l) for remuneration related aspects which the DFSA will take into account in assessing the suitability of an applicant to be an Authorised Person. Similar enhancements are made to the RPP Sourcebook and the AMI module to capture these enhancements as part of the overall supervision of Authorised Persons (see section 3.2.3(l) RPP Sourcebook and AMI Rule 10.5.3).

Issues for consideration

10. Do you have any concerns relating to the proposed changes described in paragraph 31? If so, what are they and how should they be addressed?

Transitional arrangements

32. The proposals in this paper require some transitional arrangements as far as existing Authorised Persons are concerned as they contain enhancements relating to existing corporate governance requirements and new remuneration-related requirements. Therefore, in order to ensure a smooth transition for existing firms, we propose that a maximum transitional period of one year be allowed from the date on which the enhancements come into effect for existing firms to achieve compliance with the new requirements. With regard to any new applications for licences after the proposed enhancements come into effect, we propose that they apply immediately to such applicants. See GEN Rule 10.7.2 for transitional arrangements for existing firms.

Issues for consideration

11. Do you think that the proposed transitional period of one year is adequate? If not, what transition period would be suitable?