



CONSULTATION PAPER NO. 84

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**PROPOSED ENHANCEMENTS TO THE DFSA RULEBOOK TO MEET
INTERNATIONAL BEST PRACTICE STANDARDS**

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Why are we issuing this paper?

1. The DFSA seeks public comment on its proposals to enhance its Rulebook to promote compliance with the principles of the international standard setters in the financial sector, namely:
 - (a) the Basel Committee on Banking Supervision (BCBS, referred to as Basel in this paper), which sets international standards for banking supervision;
 - (b) the International Association of Insurance Supervisors (“IAIS”), which sets international standards for the supervision of insurers; and
 - (c) the International Organisation of Securities Commissions (“IOSCO”), which sets international standards relating to securities regulation.
2. The DFSA proposes to make such changes in preparation for a Financial Sector Assessment Programme assessment (“FSAP”) of the UAE (which is expected to occur in November 2012), where it is understood the International Monetary Fund (“IMF”) will be assessing the DFSA’s regulatory regime against the Basel, IAIS and IOSCO principles.

Who should read this paper?

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

How is this paper structured?

4. In this paper we set out:
 - (a) background information to the proposed changes (see paragraphs 8 – 14);
 - (b) proposals to ensure compliance with IOSCO Core Principles (see paragraphs 15 – 28);

- (c) proposals to ensure compliance with IAIS Core Principles (see paragraphs 29 – 44); and
- (d) proposals to ensure compliance with Basel Core Principles (see paragraphs 45 – 55).

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. 84
Policy and Legal Services
Dubai Financial Services Authority
PO Box 75850
Dubai, UAE
TEL No. 04 362 1509**

or e-mailed to: consultation@dfsa.ae

What happens next?

- 6. The deadline for providing comments on the proposals is **15 July 2012**. 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.

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. The international standard setters in the financial sector such as Basel, IAIS and IOSCO promote high standards of regulation and act as a forum for national regulators to cooperate with each other and other international organisations. The DFSA strives to meet the standards of these international organisations. This enables the DFSA to establish best practice standards and carry out effective supervision of all Authorised Persons in the DIFC. In the aftermath of the financial markets crisis in 2008, the international standard setters revised their existing principles and introduced some new principles.
9. IOSCO now has thirty eight principles with eight new principles introduced since 2008. These new principles cover specific policy areas such as hedge funds, credit rating agencies and auditor independence and oversight, in addition to broader areas including monitoring, mitigating and managing systemic risk; regularly reviewing the perimeter of regulation, and requiring that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.
10. The revised Basel Core Principles were under consultation until 31 March 2012, and have not formally been implemented to date. However, as part of the FSAP, the DFSA has opted to be assessed under the new revised Basel framework. The revised Core Principles have increased from 25 to 29 Principles and have introduced significant changes across almost all principles including the addition of new Core Principles relating to corporate governance, disclosure and transparency. There have also been a number of enhancements across Basel Core Principles to reflect increased expectations in relation to key areas such as systemic risk, stress testing, crisis management and resolution planning together with a greater emphasis on supervisory practice across the board.
11. In relation to the twenty six revised IAIS Core Principles, the standards which have had significant changes include those relating to risk management and internal controls, reinsurance and other forms of risk transfer, valuations, enterprise risk management for solvency purposes, and capital adequacy. Two new Core Principles have also been added to tackle issues concerning macro prudential surveillance and insurance, and cross-border cooperation and coordination on crisis management.
12. The DFSA has issued a number of recent consultation papers aimed at addressing compliance with a number of the principles of the international standard setters, including:
 - (a) Consultation Paper No. 77 - Proposals Relating to Corporate Governance and Remuneration Standards Applicable to Authorised Persons;
 - (b) Consultation Paper No. 82 - Proposals to regulate Credit Rating Agencies; and
 - (c) Consultation Paper No. 83 - Proposed changes to the Prudential Investment Business (PIB) module of the Rulebook (which included the DFSA's proposed implementation of the Basel III capital adequacy framework).

13. The DFSA is also proposing to undertake the following reviews of its regulatory regime to address compliance with the following Principles:
 - (a) IAIS Core Principles relevant to new capital adequacy standards. This review is to take place in 2013; and
 - (b) IAIS, Basel and IOSCO principles relevant to a regulator having resolution powers to deal with failing firms consistent with proposals outlined by the Financial Stability Board in its Consultation Paper released in July 2011. This paper focused on the 'Effective Resolution of Systemically Important Financial Institutions'. The DFSA proposes to begin this review in 2013.
14. Taking into consideration the abovementioned proposals in paragraphs 12 and 13, the DFSA's recent self-assessment of its regulatory regime revealed that its regime largely complies with the Basel, IAIS and IOSCO principles. However, the DFSA has identified some principles where changes are required to its Rulebook to achieve compliance.

Proposals relating to IOSCO principles

IOSCO Principle 17: Holders of Securities in a Company should be treated in a fair and equitable manner

15. IOSCO Principle 17, questions 4a(iii) and 5b(ii), require that:
 - (a) In respect of substantial holdings of voting securities, information about the identity and holdings of persons who hold a substantial beneficial ownership interest in a company is disclosed on a timely basis, for example, in the issuer's annual report; and
 - (b) In respect of holdings of voting securities held by directors and senior management, information about such beneficial ownership interest and material changes in beneficial ownership in a company is disclosed on a timely basis, for example, in the issuer's annual report.
16. The proposed MKT Module (see Consultation Paper No 75 – Proposed Changes to the Markets Law Regime), contains a definition of Connected Persons of a Reporting Entity which broadly mirrors IOSCO Principle 17. However, to ensure better alignment with the Principle, the DFSA proposes to include a new requirement that an Issuer includes in its annual report details of the identity and holdings of any Connected Persons. Furthermore, it is proposed that the definition of a Connected Person of a Reporting Entity in the proposed MKT Rule 4.3.2(1) will also be amended to include reference to 'an individual involved in the senior management of the Reporting Entity'.

IOSCO Principle 23: Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them

17. IOSCO Principle 23, questions 3(a)(iv) and 3(b)(ii), addresses in respect of sell-side securities analysts, the need for requirements to:
 - (a) eliminate, avoid, manage or disclose conflicts of interest that can arise from reporting lines for analysts and their compensation agreements; and
 - (b) ensure a firm's compliance systems and senior management has in place procedures to eliminate or manage the undue influence of issuers, institutional investors and other outside parties on analysts.
18. The methodology for IOSCO Principle 23 mainly deals with oversight of sell side securities analysts. In the DIFC, such persons will generally be employed by an Authorised Firm Licensed to carry on the Financial Service of Advising on Financial Products or Credit and where they are providing or publishing Investment Research.
19. The DFSA has Rules which address conflicts of interest including:
 - (a) an overarching conflicts of interest principle applicable to all Authorised Firms to ensure the prevention and management of conflicts between firms and customers and between one customer and another (see GEN Rule 4.2.7); and
 - (b) specific conflicts of interest requirements applicable to an Authorised Firm conducting Investment Business and preparing or publishing Investment Research (see sections 3.5 and 6.3 of the COB Module).
20. However, the DFSA does not explicitly require the disclosure of some of the matters covered by IOSCO Principle 23. In order to comply with this Principle, the DFSA proposes to add to COB Rule 6.3.4, a requirement that where there is an actual or potential conflict of interest, an Authorised Firm must disclose:
 - (a) how the Investment Analyst is remunerated, together with his respective lines of accountability and supervision; and
 - (b) any undue influence i.e. a financial interest, other material interest or relationship which the Investment Analyst or a Close Relative of the analyst has, which relates to the Investment Research.

IOSCO Principle 29: Regulation should provide for minimum entry standards for market intermediaries

21. IOSCO Principle 29, question 6(b), addresses the need for information to be made available to the public about licensed intermediaries, including details in respect of the scope of their permitted activities and the identity of senior management and names of other authorised individuals who act in the name of the intermediary i.e. customer facing staff.

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22. Currently, the DFSA maintains information on its public register (which is available through the DFSA's website) regarding the Financial Services which may be carried on by an Authorised Firm and the persons carrying out Licensed Functions on behalf of the firm. However, the names of other individuals acting in the name of the Authorised Firm, such as 'customer facing staff' are not required to be publicly disclosed.
 23. Therefore, to be in line with IOSCO Principle 29, the DFSA proposes to include a new Rule in section 5.3 of the GEN Module, which requires particular Authorised Firms to disclose publicly those Employees who will be delivering Financial Services to its customers (i.e. those Employees who will be instrumental in the delivery of Financial Services to the firm's customers).
 24. An example of such an Employee is a client relationship manager employed by an Authorised Firm providing wealth management services. In contrast, an Employee who may be employed in the back office of an Authorised Firm with responsibility for setting up client accounts would not be a client facing staff even if for administrative purposes that person may contact clients from time to time regarding account operation matters.
 25. The DFSA considers that appropriate public disclosure should be via the website of the Authorised Firm or by the Authorised Firm maintaining a register at its place of business.
 26. This proposal will apply to all Authorised Firms which carry on Financial Services which are impacted by IOSCO Principle 29. Therefore, the proposal applies to all Authorised Firms which conduct Investment Business or which carry on the Financial Services of Providing Fund Administration or Providing Trust Services. Finally, the proposal will be limited to natural persons as any entity carrying on a Financial Service in the DIFC would require a Licence.

IOSCO Principle 31: Market intermediaries should be required to establish an internal function that delivers compliance with standards for international organisation and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters

27. IOSCO Principle 31, question 7 requires that market intermediaries, who provide clients with direct electronic access ("DEA"), must have automated pre-trade controls which can limit or prevent a DEA client from placing an order that exceeds the intermediary's existing position limits or credit limits.
28. To be in line with IOSCO Principle 31, the DFSA proposes to include in Chapter 6 of the COB Module a new set of requirements where an Authorised Firm provides Clients with DEA to an AMI or regulated exchange. Such a firm will be required to establish and maintain policies, procedures, systems and controls to limit or prevent a Client from placing an order that exceeds the Authorised Firm's existing position limits or credit limits. The Authorised Firm will also be expected to monitor the effectiveness of these systems and controls.

Proposals relating to IAIS principles

IAIS Core Principle 8 – Risk Management and Internal Controls

29. IAIS Core Principle Standard (ICP Standard) 8.5 requires an effective actuarial function capable of evaluating and providing advice to the insurer regarding, at a minimum, technical provisions, premium and pricing activities, and compliance with related statutory and regulatory requirements. Specifically, the guidance in IAIS Core Principle 8.5.11 states the resignation of an actuary should be notified to the supervisor.
30. To comply with IAIS Core Principle 8, the DFSA proposes to introduce a new Rule in Chapter 7 of the PIN Module requiring an Authorised Firm to notify the DFSA of an actuary's resignation.

IAIS Core Principle 13 – Reinsurance and Other Forms of Risk Transfer

31. ICP Standard 13.4 requires that parties to reinsurance contracts promptly document the principal economic and coverage terms and conditions agreed upon by the parties and finalise the formal reinsurance contract in a timely fashion.
32. The DFSA considers the risks associated with the failure to promptly document reinsurance contracts is equally relevant to insurance contracts, and therefore to also comply with IAIS Principle 13, the DFSA proposes to include a new Rule in section 7.10 of the COB Module which will require an Insurer to document promptly all of the relevant economic and coverage terms, and finalise the Contract of Insurance in a timely manner.

IAIS Core Principle 15 – Investment

33. ICP Standard 15.6 requires the supervisor to establish quantitative and qualitative requirements, where appropriate, on the use of more complex and less transparent classes of assets and investment in markets or instruments that are subject to less governance or regulation.
34. Specifically, IAIS Core Principle Guidance 15.6.8 refers to consideration of complex investment instruments such as asset backed securities, credit linked notes or insurance linked securities that may be issued by Special Purpose Entities.
35. To be in line with IAIS Core Principle 15, the DFSA proposes to include in PIN A2.6 – Investment Risk, reference to the specific instruments documented in ICP 15.6.8.

IAIS Core Principle 16 – Enterprise Risk Management for Solvency Purposes

36. In relation to IAIS Core Principle 16, there are 4 standards which require consideration as follows:

ICP Standard 16.2

37. ICP Standard 16.2 requires an Insurer's measurement of risk to be supported by accurate documentation providing appropriately detailed descriptions and explanations of the risks covered, the measurement approaches used and the key assumptions made.
38. To comply with ICP Standard 16.2, the DFSA proposes to amend PIN Rule 2.2.1. Further, given the PIN module applies also to Captive Insurers, the application of the proposed amendments will be subject to the nature, scale and complexity of the Insurer's business.

ICP Standards 16.4 and 16.8

39. ICP Standard 16.4 provides that an Insurer is required to have a risk management policy which describes the relationship between the Insurer's risk tolerance limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk.
40. ICP Standard 16.8 also requires an Insurer to make use of its risk tolerance levels in its business strategy and embed its defined risk tolerance limits in its risk management policies and procedures.
41. To comply with ICP Standards 16.4 and 16.8, the DFSA proposes to:
 - (a) amend PIN Rule 2.2.1 by requiring that an Insurer's risk management system addresses the relationship between the Insurer's risk tolerance limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk; and
 - (b) include Guidance to PIN Rule 2.2.1 indicating that an Insurer's risk tolerance levels should be used in setting its business strategy and included in its risk management policies and procedures.

ICP Standard 16.5

42. ICP Standard 16.5 requires an Insurer to have a risk management policy which includes an explicit asset-liability management (ALM) policy which clearly specifies the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.
43. Currently, section 2.3 of the PIN Module covers the management of particular risks. The DFSA proposes to include a new Rule requiring an Insurer to develop and maintain a risk management system which includes an explicit ALM policy. Such policy must clearly specify the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.
44. The DFSA also proposes to include Guidance indicating that an Insurer's ALM policy should be appropriate to the nature, scale and complexity of the Insurer's risks associated with its assets and liabilities. Further, an Insurer should set out how:

- (a) the investment and liability strategies adopted by the Insurer allow for the interaction between assets and liabilities;
- (b) the correlations are taken into account;
- (c) the liability cash flows will be met by the cash inflows; and
- (d) the economic valuation of assets and liabilities will change under an appropriate range of different scenarios.

Issues for consideration

1. Do you have any concerns or comments about our proposed changes to our Rulebook arising from our review against the IAIS and IOSCO principles?

Proposals relating to Basel principles

PIB Review

45. In conducting its review of the PIB module, the DFSA also undertook a self-assessment against the updated Basel Core Principles for Effective Banking Supervision which were issued for consultation in December 2011. Following this review, the DFSA released Consultation Paper No. 83 - proposed changes to the Prudential Investment Business (PIB) module of the Rulebook. This Consultation Paper indicated that the DFSA would be releasing a further paper to deal with specific powers required by regulators under the Basel Core Principles.
46. There are a number of Basel Core Principles which require the regulator to have powers to address prudential concerns. These include the:
 - (a) power to impose additional capital requirements or limits to a firm's material exposures (Core Principle 16 – Capital Adequacy – Essential Criteria 3);
 - (b) power to increase prudential requirements based on the risk profile and systemic importance of banks (Core Principle 1 – Responsibilities, objectives and functions – Essential Criteria 3);
 - (c) power to instruct minimum provisions (Core Principle 18 – Problem Assets, provisions and reserves – Essential Criteria 7); and
 - (d) power to impose limits for exposures to related parties (Core Principle 20 – Transactions with related parties – Essential Criteria 5).
47. In its Consultation Paper No. 83, the DFSA outlined its proposal to include a power under section 10.6 of the draft PIB Module to impose an Individual Capital Requirement on firms in Categories 1, 2, 3A and 5. There are also various other requirements which are set out in the draft PIB module which enable the DFSA to direct a firm, and potentially a class of firms, to take particular action.

48. The DFSA notes that the current draft of the Capital Requirements Directive IV (“CRD IV”) also requires the competent authorities to have a range of supervisory powers, including some specific prudential related powers such as the power to impose additional capital and additional or more frequent reporting requirements. Further, benchmarking undertaken by the DFSA indicates other prudential regulators (such as the Hong Kong Monetary Authority, Monetary Authority of Singapore and the Australian Prudential Regulatory Authority) all have the power to direct a relevant firm, or a class of firms, to take particular action.
49. Given the requirements for regulators to have more prudential powers, the DFSA proposes to recommend to the Ruler to make a change to the Regulatory Law 2004 (proposed Article 75A of the Regulatory Law 2004) to enable the DFSA to issue a direction to a particular Authorised Firm, or Authorised Firms within a specified class, for prudential purposes. It is also proposed that the DFSA can revoke or vary, whether in part or full, any direction given pursuant to the proposed article 75A(1) of the Regulatory Law 2004.
50. Further, where the DFSA proposes to issue a direction under Article 75A on Authorised Firms within a specified class, the direction will remain in force for a period of no more than 12 months in the first instance, unless the DFSA specifies a shorter period of time in the notice. The DFSA considers that such a direction should remain in force for a limited period as it has a Rule making power under the Regulatory Law 2004 at its disposal, which the DFSA would ordinarily use where it was proposing to change its Rules relating to Authorised Firms within a specified class.

Process for issuing a directions notice on an Authorised Firm or Authorised Firms within a specified class in relation to a prudential matter

51. Before issuing a direction under Article 75A, the DFSA will provide the affected firm with an opportunity to make written and oral representations. Where the DFSA needs to exercise its powers swiftly under Article 75A, it will not be possible to provide an affected firm with an opportunity to make representations to the DFSA prior to the issue of the relevant direction. However, an opportunity to make representations immediately after the issue of such direction will be afforded to the affected firm.
52. The DFSA will not publish a direction on its website unless it considers it is appropriate or necessary to do so, such as to bring to the attention of those likely to be affected by a directions notice and others who may be likely to become subject to a directions notice.
53. It is also proposed that an affected firm will be entitled to a right of appeal to the Regulatory Appeals Committee. Therefore, the DFSA proposes to recommend to the Ruler to provide an affected firm with a right to appeal to the Regulatory Appeals Committee where the DFSA exercises its powers under Article 75A of the Regulatory Law 2004.
54. A firm may further appeal the decision of the Regulatory Appeals Committee by way of judicial review proceedings before the Court on a point of law.

55. Given the proposals outlined above to recommend to the Ruler to seek a directions power under the Regulatory Law 2004, the DFSA will in due course update its draft chapters 4 (Supervisory and Enforcement powers) and 6 (Decision Making) of its RPP Sourcebook attached to Consultation Paper No. 81 to include information in respect of its proposed directions power in relation to prudential purposes and how the DFSA will exercise such powers.

Issues for consideration

2. Do you have any concerns or comments about our proposal to seek a directions power where it relates to prudential purposes under the Regulatory Law 2004?