

Thematic Review on Suitability | 2021



Executive Summary

Background

In 2020, the DFSA's Supervision Division completed a programme of thematic reviews designed to assess the suitability-related systems and controls implemented by Authorised Firms. This report provides the key observations from the review together with actions the DFSA considers it appropriate for Authorised Firms to take. These findings have already have been communicated to the DIFC Authorised Firms.

Suitability is, and will continue to be, a key priority for the DFSA and, accordingly, will continue to feature in our regulatory agenda. The DFSA intends to continue to strengthen its suitability requirements to align with international best practices as set by IOSCO and other standards-setters with a view to reinforcing the duty of care and emphasising that Authorised Firms extend appropriate protections to Clients who rely on them for advice, including discretionary transactions.

In 2020, the DFSA's Supervision Division (**Supervision**) completed a programme of thematic reviews designed to assess the suitability-related systems and controls implemented by Authorised Firms, including independent tests of the suitability of individual recommendations and discretionary transactions (the **Reviews**).

Next Steps

We encourage Authorised firms to consider their business model and existing suitability framework in the light of these observations. We expect Authorised firms to be proactive in making enhancements to systems and controls, where appropriate.

Methodology

For the Reviews, Supervision selected a diverse sample of Authorised Firms authorised to carry on the Financial Services of Advising on Financial Products and/or Managing Assets. The sample represented a range of business models thereby enabling Supervision to examine different perspectives and approaches to suitability.

Each Authorised Firm was requested to provide copies of all information related to suitability systems and controls, including policies, procedures, forms, templates, training materials and anything else used in connection with suitability. From these we were able to form a preliminary view on the suitability frameworks in place.

Using this information, we examined the authorised Firms' approaches for:

- (i) gathering and analysing relevant information about Clients;

- (ii) obtaining and evaluating information about investment products' attributes and features; and
- (iii) matching this information in a way to give rise to a recommendation or discretionary transaction.¹

Additionally, the control mechanisms explained in these materials were examined.

Following the desk-based review stage, site visits were performed to each of the participating Authorised Firms. Each Authorised Firm provided a list of transactions they had advised clients on, or effected for Clients on a discretionary basis. From these lists samples of transactions were selected and the Authorised Firms prepared for inspection all the information and documentation used or produced in connection with the suitability assessments for those transactions. These files were reviewed in details at the site visit. Interviews were also performed with relevant and key personnel at each Authorised Firm.

In certain cases, Supervision has also provided bespoke feedback, including Risk Mitigation Programmes where necessary, to individual firms to address shortcomings in relevant systems and controls.

Advice, Recommendations and Discretionary Transactions

Any reference to 'advice' made throughout the remainder of this paper should be interpreted to include recommendations and discretionary transactions, unless stated otherwise. This term has been used for convenience only. Capitalised terms used in this letter have the same meaning as set out in the Glossary Module (GLO) and Conduct of Business (COB) Modules of the DFSA Rulebook unless context requires otherwise

Non-Compliance with January 2020 Rule Amendments

The elements of the Review completed in 2019 occurred before the finalisation and effectiveness of the amendments to COB 3.4.2, which came into force in January 2020. These rules were not considered in connection with the review nor was the potential impact of the rule changes. While the 2020 portion of the Review took place after these rule amendments had taken effect:

- All of the transactions selected for review were effected under the prior regime, and

¹ This methodology was based in part on relevant IOSCO principles, taken from its 2013 report on *Suitability Requirements with Respect to the Distribution of Complex Financial Products*, which shone light on these as important, discrete elements of suitability assessments. This report can be found here: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf>.

- The transitional provisions accompanying the rules changes gave AFs until July 2020 to bring their frameworks, including Client agreements, into compliance.

The review did not hold Authorised Firms to 2020 standards in respect of transactions and Client engagements occurring earlier, but, where appropriate, they were informed on potential gaps between past practices and new requirements. Generally, most of the Authorised Firms subject to review in 2020 had taken strides toward enhancing their suitability frameworks to support the new rules, though none had a fully-compliant framework in force by the time of the site visit.

Key Findings and Observations

The following information addresses conduct and other themes observed by the DFSA during the course of this review. Where appropriate, we have presented recommendations or certain informal guidance for Authorised Firms. The DFSA encourages all Authorised Firms to consider this information in the context of its relevant operations to determine whether process improvements may be beneficial or necessary.

Capitalised terms used in this letter have the same meaning as set out in the Glossary Module (GLO) of the DFSA Rulebook unless the context requires otherwise.

Summary of Key Results and Observations

Our thematic observations are summarised below. Each of these issues were observed across multiple firms (but not across all firms) rather than being isolated instances.

Observation

- 1 Many Authorised Firms confuse Client information gathered during on-boarding with a suitability assessment, and may not undertake proper suitability assessments in connection with advice or discretionary transactions.
- 2 Authorised Firms' policies and procedures frequently restate the DFSA's Rules without addressing how they will implement or ensure compliance with them. This might not provide employees sufficient direction or guidance on how to perform a Client suitability assessment.
- 3 Authorised Firms' suitability regimes sometimes appear to be more product-driven than based on specific Client needs. Product-driven suitability controls often do not challenge, or otherwise consider the rationale behind, a particular instance of advice or discretionary transactions.
- 4 Authorised Firms managing discretionary portfolios according to 'model portfolio' approaches, or specified strategies, often effected discretionary transactions without considering the suitability of such transactions for each Client.
- 5 Some Authorised Firms expressly exclude recommendations to 'sell' from suitability frameworks.
- 6 Discretionary portfolio managers generally did not consider suitability beyond compliance with the relevant Client investment management agreement.
- 7 The quality of suitability-related documentation is often weak.

- 8 Some Authorised Firms were unable to easily distinguish advised or discretionary transactions from execution-only transactions.
- 9 Authorised Firms often do not consider the ongoing suitability of discretionary accounts.

Observation 1

Many Authorised Firms confuse information acquired during on-boarding, or the act of acquiring this information, with suitability. Authorised Firms do not perform a suitability assessment in connection with each instance of advice.

More than half of the Authorised Firms sampled told us that they “do suitability” only at the time of on-boarding of Clients, or “do some part of suitability” at on-boarding and other aspects at the time of the particular transaction. Through discussion, we determined this to mean that Authorised Firms obtained from Clients information about their needs and objectives in connection with on-boarding, Client classification and other due diligence. In some cases, these efforts involved consideration of the types of financial products (e.g., asset classes) that may be offered to a Client.² However, this did not include consideration of the particular merits or any reasonable basis for the specific transaction or financial product. Accordingly, these approaches do not qualify as a suitability assessment for the purposes of COB 3.4.2(1). We also observed that a significant number of Authorised Firms were unable to articulate the processes for carrying out suitability assessments in connection with specific advice, recommendations or discretionary transactions, or provide appropriate evidence to demonstrate that they had carried out any such assessment.

We remind Authorised Firms that COB 3.4.2(1) sets out requirements for Authorised Firms to conduct an appropriate assessment of specific Client attributes in connection with a specific instance of advice or a discretionary transaction to ensure that there is a reasonable basis for considering that advice or transaction to be suitable for that Client. Often, Authorised Firms may base this assessment on information about the Client it obtained in connection with on-boarding processes. However, Authorised Firms must take steps to ensure the information it has about a Client remains accurate, complete and up to date, as required by COB 3.4.3.

To be clear, we are not discouraging Authorised Firms from considering the asset classes appropriate for a Client at the time of on-boarding or Client classification. Rather, we seek to emphasise that such efforts do not qualify as a suitability assessment, as required by COB 3.4.2.

² Generally, we observed that, where an Authorised Firm considered asset classes for a Client at the time of on-boarding, they did so in connection with Client Classification – that is, determining the asset classes in respect of which it could classify a Client as a Professional Client (generally, as an Assessed Professional Client).

Observation 2

Authorised Firms' control documents (i.e., policies and procedures) frequently restate the DFSA's suitability Rules and guidance (often verbatim) but fail to address how they will implement and ensure compliance with them. Certain Authorised Firms did not provide sufficient direction or guidance to employees on how to carry out Client suitability assessments.

Many firms provided a copy or excerpt of a compliance manual which simply restated the relevant DFSA Rules. Authorised Firms that adopt this approach do not have an adequate suitability framework in place. While the re-stating of DFSA Rules is a good starting point on how to approach suitability, we observed that many firms had no further policies, procedures or verifiable information to demonstrate how the relevant Rules and guidance are implemented as part of the firm's conduct of financial services business. Furthermore, there was an overall lack of guidance provided to staff on how to perform Client suitability assessments and ensure compliance with the Rules.

The DFSA Rulebook Modules set minimum standards for Authorised Firms' conduct. The DFSA expects Authorised Firms to develop and implement codes of conduct, systems and controls and governance oversight, tailored to the specific needs of its business and to provide practical direction and guidance to staff to enable them to comply with applicable DFSA Rules and internal policies. Without this, decision-making about how to achieve compliance is subject to the unilateral judgment of the concerned employee, which may create inconsistencies amongst employees, lack of alignment with management's expectations and failures to comply with DFSA Rules.

COB 3.4.2(1) prohibits Authorised Firms from recommending to a Client a financial product or service, or executing a discretionary Transaction on behalf of a Client, unless they have a **reasonable basis** for considering the recommendation or Transaction to be suitable for a particular Client. Sub-paragraph (a) requires Authorised Firms to undertake an **appropriate assessment** of particular Clients' needs and objectives and financial situation, and take into account any other relevant requirements and circumstances of the Client of which the Authorised Firm is, or ought reasonably to be, aware.

We observed no instances in which an Authorised Firm explained, in its compliance manual or elsewhere, what constitutes a *reasonable basis* or how this is assessed. Consequently, this may cause employees acting as relationship managers or advisors to have materially inconsistent views as to the appropriate standards and criteria to be applied when providing advice to Clients.

The DFSA expects Authorised Firms' policies, procedures and governance oversight to provide sufficiently clear direction to employees to achieve appropriate suitability outcomes in compliance with the Rules. We encourage Authorised Firms to review their wider compliance control frameworks to determine whether employees have sufficient direction and guidance about the firm's standards, criteria and expectations for fulfilling them, and to

enhance relevant policies, procedures and governance oversight where necessary.

Observation 3

Authorised Firms' suitability regimes sometimes appear to be more product-driven rather than based on specific Client needs. These regimes often do not challenge or otherwise consider the rationale behind a particular instance of advice or discretionary transaction.

We observed an approach to suitability, common to several Authorised Firms, which entails subjecting a selected investment to a variety of tests, then concluding it to be suitable for a Client if that investment passes each test. We regard these as 'product-driven' approaches for two reasons. First, the Authorised Firm appears in many respects to start with a particular financial product in mind, which it then subjects to these tests seemingly to validate it as being appropriate for the Client. Second, the nature of the tests we observed, as discussed further below, generally do not consider the specific Client's needs and objectives in respect of current holdings and portfolio performance. Put differently, these tests emphasise whether the product is fit for the Client over whether the Client actually needs it at that time.

Our view is that these product-driven approaches have some merit as investment screening tools. That is, while generally tick-box oriented, such approaches may help determine whether a product is fundamentally at odds with a Client's specific objectives or profile. However, product-driven approaches are bereft of analysis to establish the rationale for determining whether a financial product is necessary or appropriate for the Client at that particular time, and for selecting a particular product to recommend over other products that may also pass the tests. In other words, while a broad range of investments may pass each of these tests and qualify for a particular Client, not all of the investments in that range are likely to be suitable or equally suitable for the Client at that particular time.

The type of tests observed in this context included, but were not limited to the following:

- a. a comparison of product risk to a Client's risk rating;
- b. a comparison of portfolio risk to a Client's risk rating;
- c. concentration analysis;
- d. leverage impact; and
- e. Client knowledge and experience.

As stated above, we believe each of these types of tests can be very helpful as investment screening tools. However, we expect Authorised Firms to implement Client-driven, or needs-driven suitability programmes that seek first to determine what the Client needs at a point in time (if anything at all) and then, second, seek to identify one or more financial products reasonably expected to fulfil that need. In undertaking this approach, Authorised Firms

should be able to document clear rationales for transacting and product selection.

We observed weaknesses in the control mechanisms used by some Authorised Firms in connection with product-driven suitability frameworks. In particular, we have concerns about the lack of attention given to the rationale behind an instance of advice or a discretionary transaction as well as Authorised Firms' practices for addressing control test failures.

While Authorised Firms, generally, documented whether a transaction passed its control tests, such as those mentioned above, and could explain steps taken to address failures, too often they could not satisfactorily answer questions about the rationale, purpose or objective of the specific advice given or discretionary transactions (i.e. they could not explain why a transaction was proposed or entered into, nor articulate the rationale for selecting a particular financial product, as opposed to other financial products).

Of particular concern was the high number of instances we observed of team leaders or line managers (or similar) approving transactions that caused a control test failure (such as those identified above) without considering, much less challenging, the underlying rationale. Moreover, while most Authorised Firms had frameworks in place for escalation and approval of recommended transactions that would cause a control test breach, none had policies or guidelines addressing when, why or under what circumstances they may consider a recommendation that would knowingly cause such a breach to be acceptable.

In most cases, we observed control test failures to prompt some follow-on action, including soft (can proceed with the transaction once certain steps have been completed) and hard (cannot proceed with the transaction) blocks. However, in some cases Authorised Firms dis-applied these blocks on the basis of the Client's classification or risk tolerance rating. This would cast significant doubt on the effectiveness of these blocks as control mechanisms.³ Common among Authorised Firms were policies requiring only that advisors or relationship managers disclose limit breaches to Clients (e.g., the creation of a concentration or risk limit excess) in order to proceed with the transaction. As above, these approaches give rise to greater concerns where Authorised Firms have no clear guidelines or policies on scenarios in which they regard control breaches as acceptable. We expect suitability control mechanisms to consider the rationale behind the advice given and to provide guidance on the processes and decision-making required when there are control test breaches.

Observation 4

Authorised Firms managing discretionary portfolios according to 'model portfolio' approaches, or specified strategies, often effected discretionary transactions without considering the suitability of such transactions for each Client.

³ We note that the majority of Clients party to advisory and discretionary mandates in the DIFC are Professional Clients. Furthermore, in respect of those participating in this thematic work, Authorised Firms were of the view that the majority of their Clients qualified as more aggressive in terms of their risk tolerance, with some exceptions.

We observed that certain Authorised Firms manage discretionary portfolios for Clients based on model portfolios or specific strategies. That is, the Authorised Firm offers discretionary portfolio management services, and then places each Client into a strategy (e.g., conservative, balanced, aggressive, dynamic) according to the Client's objectives and investor profile. The Authorised Firm then builds a portfolio for the Client using asset allocation models and investments that its product team, often based in another jurisdiction, has approved for each strategy.

In some cases, Authorised Firms will buy for Clients all of the securities approved for a strategy resulting in identical portfolios for each Client in a strategy. In other cases, Authorised Firms may buy some of the approved investments, resulting in bespoke portfolios. We observed that Authorised Firms operating in this manner had generally not undertaken any form of suitability assessment, documented or otherwise, in connection with discretionary transactions effected for individual Clients.

An independent product team may approve or suggest new investments in connection with specific strategies or model portfolios, or propose to discontinue certain investments. However, the Authorised Firm, as the party contracting with the Client for the discretionary portfolio mandate, must still undertake an appropriate assessment to establish a reasonable basis for those particular transactions to be considered suitable for each relevant Client.

Observation 5

We observed instances where Authorised Firms expressly excluded recommendations to 'sell' financial products from their suitability frameworks.

We observed a small number of Authorised Firms that expressly carved out advice to 'sell' an investment from their suitability frameworks.

Neither the DFSA's suitability principle in GEN Chapter 4 nor the relevant COB rules are conditioned or qualified on the basis of a 'buy' or 'sell' direction, advice or discretionary transaction. Rather, these obligations of suitability apply to buy, sell and hold advices, recommendations or transactions, irrespective. There is no distinction.

We expect Authorised Firm's suitability frameworks to reference both 'buy' and 'sell' advice and, where appropriate, recommendations not to sell [i.e. hold] financial products.

Observation 6

Discretionary portfolio managers generally did not consider suitability beyond compliance with the relevant investment management agreement entered into with the Client.

Where Authorised Firms manage discretionary portfolios on behalf of Clients under an investment management agreement (**IMA**), we observed the IMAs, generally, contained sufficient information regarding Client needs, objectives and other requirements to provide the basis for any subsequent suitability determination.

However, we observed instances where discretionary portfolio managers limited their suitability assessments to only verifying that the particular financial product was consistent with IMA requirements. 'IMA-compliance' and 'suitability under the DFSA Rules' are not synonymous concepts. It may be the case that certain investments meet the IMA contractual obligations between the parties, but are otherwise unsuitable for a Client at a particular time for various reasons. At any given time, there may be a wide variety of investments across different asset classes or maturities that meet IMA contractual obligations, however, this does not automatically qualify these investments as being suitable for the particular Client.

While verifying IMA compliance is a critical step for screening investments and one element of a suitability assessment, it is not the only element of a suitability assessment, particularly where Authorised Firms earn remuneration from transacting under a discretionary portfolio mandate.

Observation 7

The quality of suitability-related documentation is generally weak.

Where Authorised Firms performed suitability assessments, we observed that most firms needed to improve their documentation and supporting information to demonstrate that an appropriate suitability assessment was conducted. Moreover, in many cases, firms had no documentation or supporting information to demonstrate that a suitability assessment had been conducted, signifying a failure to comply with COB 3.4.2. Often, we observed Authorised Firms' policies and procedures were silent on where, how, and when to document suitability assessments, giving rise to inconsistencies within firms on the quality, substance and location of suitability documentation.

In many cases, we observed that Authorised Firms were unable to provide evidence of the factors considered by their employees in connection with suitability assessments nor were those firms able to provide any rationale for a recommendation or discretionary transaction beyond relying on the recollection of the relevant employee. This is not acceptable.

We remind Authorised Firms of COB 3.6.1(d) which requires firms to maintain, for a minimum of six years, sufficient records relating to the suitability assessments undertaken to demonstrate compliance with COB 3.4.2. Authorised Firms are reminded that a failure to document suitability assessments may leave them exposed if the investment decisions are challenged subsequently and the Authorised Firm is unable to evidence the rationale behind those decisions.

Observation 8

Some Authorised Firms were unable to easily distinguish advised or discretionary transactions from execution-only transactions.

In selecting relevant transactions for review, we requested Authorised Firms to provide a report identifying advised transactions during a specified period. We found a variety of transactions effected by different Authorised Firms were not advised transactions at all; rather they appeared to be execution-only transactions effected following specific instructions provided by the Client.

We are concerned that, if an Authorised Firm cannot easily distinguish advised transactions from execution-only transactions, its systems and controls are unlikely to be effective in managing the risks or requirements related to each type of transaction.

We expect Authorised Firms to have in place appropriate systems and controls that record all relevant transaction details and that can facilitate the accurate retrieval of this information.

Observation 9

Authorised Firms often do not consider the ongoing suitability of discretionary accounts.

We observed that discretionary portfolio managers undertook some form of periodic review of discretionary portfolios with their Clients. We also noted that most, if not all, Authorised Firms had policies requiring such periodic portfolio reviews. However, the objectives of these reviews were not always clear. We received various descriptions of these reviews: an opportunity to assess portfolio performance against targets or objectives; to gauge Client satisfaction with services or returns; to refresh KYC data; or, simply as social occasions. None of those interviewed specifically identified ongoing suitability requirements under the DFSA Rules as a basis for these reviews.

We expect that Authorised Firms ensure periodic reviews consider the ongoing suitability of the discretionary account, perhaps in connection with other performance-oriented metrics, and that they document this review and assessment sufficiently. We remind discretionary portfolio managers of COB 3.4.2(3), which establishes a requirement to ensure Discretionary Portfolio Management Accounts remain suitable for the Professional Client account holder.