DFSA
Dubai Financial Services Authority

Suitability Outreach
DFSA Conduct of Business Team
29 March 2021

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Bushra

Bothaina

Hend

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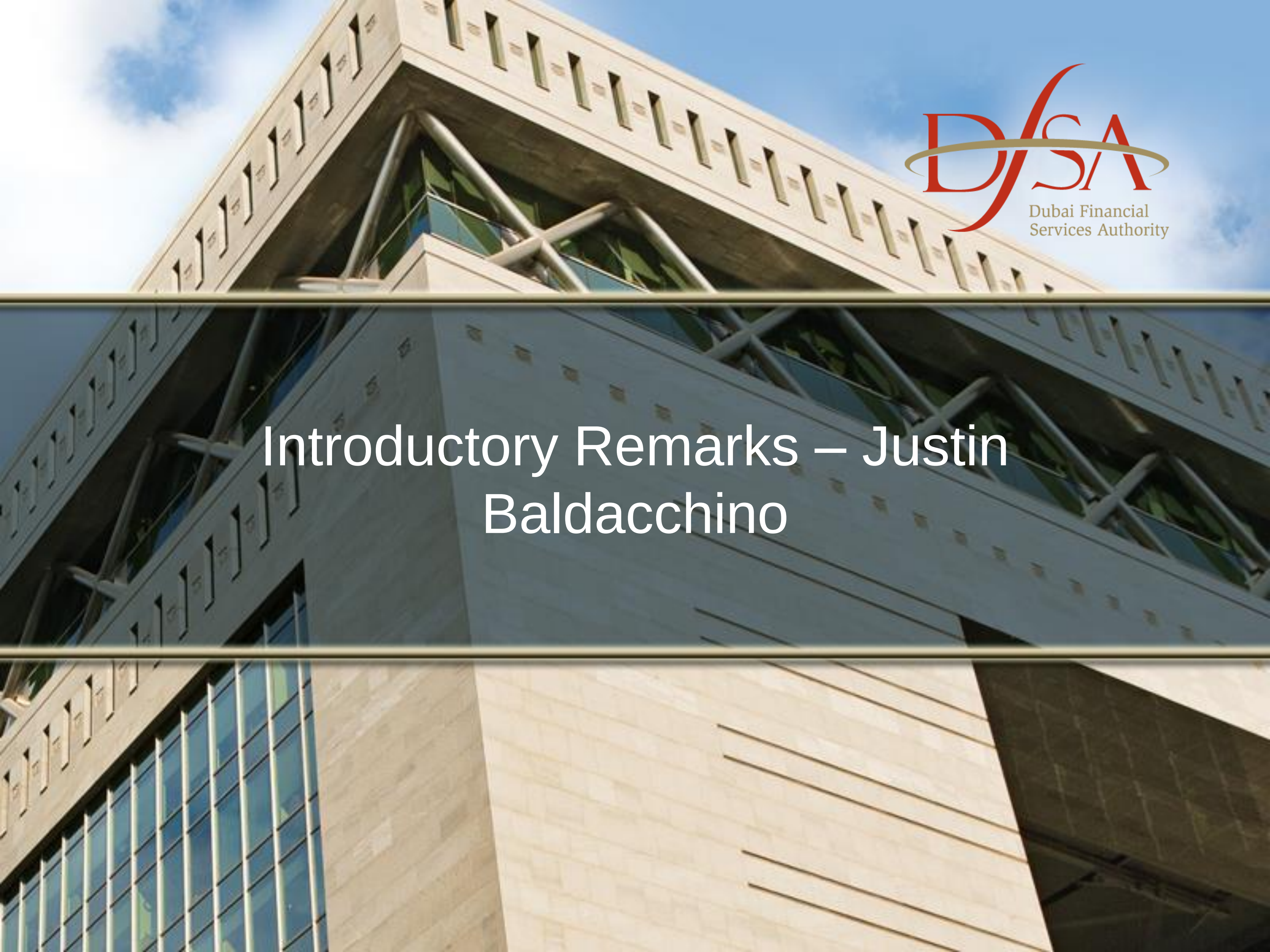
- Please turn off your video and microphone.
- Presentations – followed by…….
- Q&A – We will respond to questions submitted beforehand, and as many of those questions submitted today as we are able in the allotted time.
- To participate:
  - ➢ Please send questions using the question function.
  - ➢ Please provide a subject title.
  - ➢ We will collate and feed back to you during second half.
- If we cannot get to everyone's questions, we'll respond offline.



Dubai Financial Services Authority

Introductory Remarks – Justin Baldacchino

Introduction

- Suitability is a key conduct of business priority for the DFSA.

- 2019/2020 DFSA thematic work on suitability identified opportunities for improvements in firms’ suitability policies and procedures.

Policies and Procedures

- Do you have…
  - Compliance manuals and/or suitability policies that simply restate the DFSA's suitability rule?
- This approach is not considered adequate…
  - At least not on their own
- DFSA's Suitability Rule (COB 3.4.2)
  - Prescriptive on what….but
  - Flexible on how
- We expect Authorised Firms to customise a framework for:
  - Consistency in approaches and standards among staff;
  - Good suitability outcomes; and
  - Reliable documentation.

Policies and Procedures

- Many firms copy and paste DFSA Rules rather than address how the particular firm should operate to demonstrate and ensure compliance with those Rules.

- Customisation should consider:
  - Business model/nature of business/products/services
  - Contributions of different stakeholders
    - Relationship Managers
    - Investment Advisers
    - Product Teams
  - Types of Clients
  - Product range
    - Suitability burden increases with product risk and complexity
  - Nature and extent of limitations on suitability assessment

Policies and Procedures

- Certain firms use generic statements in their policies and procedures referencing “reasonable basis” as a predicate condition for advice. However, what constitutes “reasonable basis” was never explained.

- More specifically, *reasonable basis* and *appropriate assessment*
- COB 3.4.2(1)
- What is *reasonable*? What is *appropriate*?
- Can you tell me?
- More importantly, are employees appropriately informed?
- In light of customisation expectations:
  - ➢ What standards or criteria must be achieved to support a *reasonable basis*?
  - ➢ What procedures must be fulfilled to constitute an *appropriate assessment*?

Suitability Assessment

- Certain firms confuse information acquired during client on-boarding (CDD) with client suitability requirements.

- Weaknesses appear quite prevalent in DIFC
- Firms tend to document:
  - various Client attributes and data
  - what the product is and, sometimes, its attributes (e.g., term sheet, prospectus)
- Some firms document certain objective tests applied to products in connection with suitability.
- Firms tend not to document other steps or results of suitability assessments, including a rationale (often subjective) for trading and product selection for the particular client.

Suitability Assessment

- Certain firms do not perform a suitability assessment for each transaction.

  - Why did you advise *that client* to buy, sell or hold *that product* at *that time*?

Suitability Assessment

- The DFSA observed a lack of consistent understanding of what events may trigger the need to consider client suitability.

- Examples of circumstances that may trigger a client suitability event include:
  - Non-Discretionary Advisory Services
    - Recommend to a client to buy/sell a certain product.
    - Discuss/present investment products/portfolio as suitable to client(s)
    - Any communication (e.g. shortlisting of investment products) based on consideration of the circumstance of the client (e.g. risk appetite)
    - Finding/structuring an investment product based on the client's specifications/personal circumstance
  - Discretionary Management Services
    - Events/triggers/reviews in accordance with the agreed mandate
    - Review mandates regularly (e.g. when there have been significant market movements) taking into account the client's latest circumstances

Suitability Assessment

- The Investment Management Agreements reviewed generally appeared to contain sufficient information as a basis to perform a suitability assessment…….but

- Certain discretionary portfolio managers did not consider client suitability beyond compliance with the Investment Management Agreement.

- While the DFSA considers verifying compliance with the investment management agreement to be an important element of a client's suitability assessment, this is not the only element of such an assessment.

Transaction Record Keeping

- The DFSA observed multiple instances where firms appeared unable to distinguish advised transactions from execution-only transactions.

- Advised and discretionary transactions are held to a higher regulatory standard than execution-only transactions.

- Concerns regarding effectiveness of internal controls and supervisory mechanisms where this distinction cannot be easily made.

Product-driven assessments

- Suitability frameworks appear more product-driven rather than based on specific client's needs.
- Many firms assess (and rate) products in isolation.
- Certain firms seem to erroneously consider the product suitable if the rating of the product matches the rating assigned to the client by the firm (Low/Medium/High etc.)

Product-driven assessments

- Approaches used by certain firms to assess a product against a client's profile relate to:
  - product risk
  - portfolio risk
  - Concentration risk
  - knowledge and experience

- Concerns exist that an emphasis on products may fail to properly consider the particular client's needs.

Product-driven assessments

- These approaches may have merit:
  - As investment screening tools.
  - To provide some assurance that an investment is not fundamentally at odds with the client's profile and objectives.

- However, often product-driven assessments do not satisfactorily address:
  - Why a Client needed to buy or sell any investments at that time.
  - Why or how a firm recommended one particular investment from a range of investments that meet all client parameters.
  - Subjective client elements.

Product-driven assessments

- The DFSA seeks to ensure that:
  - A client's particular needs, objectives, relevant facts and circumstances *at that time* are the starting point for every financial product recommendation.
  - Authorised Firms formulate and document a rationale to explain why a particular financial product was selected or recommended for a client.
  - Authorised Firms document the suitability assessment they undertook – of which these objective tests may form part – to achieve a reasonable basis for considering a particular financial product to be suitable for a particular client.

Assessing product-driven frameworks as control mechanisms

Control failures or mismatches:

1. Product rating is higher than the client's rating
2. Portfolio risk threshold is breached by new transaction
3. Concentration risk threshold is breached by a new transaction
4. Product is incompatible with the client's knowledge or experience

Assessing product-driven frameworks as control mechanisms

Control failures or mismatches: Escalation policies

1. “Soft” blocks
   I. Escalation to Team Lead or Line Manager
   II. Liaise with Client
2. “Hard” blocks

Assessing product-driven frameworks as control mechanisms

Weaknesses of control mechanisms

- Soft block transactions were approved without any documentary evidence to demonstrate that a justified rationale was considered.
- Soft block transactions were approved without any documentary evidence to demonstrate that the presented rationale was challenged.
- The approval for certain soft block transactions appeared to be provided post transaction.
- The DFSA observed no clear policies or procedures addressing when, why or in what circumstances a soft block could be removed or overridden.
- The DFSA observed no instances of a hard block policy being applied.
- Doubts exist regarding the effectiveness and value of providing training materials to clients to reconcile a mismatch.

Assessing product-driven frameworks as control mechanisms

Weaknesses of control mechanisms – 3 Lines of Defence

1. Involvement of line managers or team leaders
2. Compliance and Risk
3. Internal Audit

Using product-driven frameworks as control mechanisms

What we might expect…….

- Policies and procedures that explain what is expected when there is a control failure
- Controls that challenge the rationale for the specific transaction
- Soft and hard blocks that are not simply over-ridden
- Decisions and rationale are properly documented
- Three lines of defence that demonstrate robust challenge to suitability decisions
- Three lines of defence that challenge the effectiveness of policies and procedures

Model Portfolios - A description

Product Team in Country X

Identify investment opportunities or products → Categorise similar products into specific model portfolios → Approve the use of model portfolios and devise products for certain strategies

Investment Team in DIFC

On-board client and establish objectives and investor profile → Assign the client an investment strategy → Match the client investment strategy to the approved model portfolio → Recommend / transact in all investments within the model portfolio

Model Portfolios - Issues

- Certain firms operate a model portfolio approach and apply asset allocation based on the generic rating assigned to the client.
- No further assessment of suitability is performed.
- This approach does not meet the DFSA's suitability requirements.

Exclusion of sell transactions

- Certain firms failed to consider suitability for the sell side of client transactions.

- Suitability obligations apply to BUY, SELL and HOLD advice, recommendations and transactions.

- Why did you advise *that client* to buy, sell or hold *that product* at *that time*?

Suitability documentation

- The quality of documentation evidencing suitability assessments was generally poor.

- Your record keeping scheme should enable you to answer the question:
  - Why did you advise *that client* to buy, sell or hold *that product* at *that time*?

- Relevant policies should provide sufficient direction on:
  - What to document (what details)
  - Where to document it (in what system or media)
  - When to document it (in connection with advice)
- Do not rely on employee recollection

A golden rule..

If it is not documented,
it does not exist!

Ongoing Suitability

Expectations	Reality
Periodic portfolio reviews should be conducted as part of ongoing client suitability requirements.	Periodic portfolio reviews happen, but are not well-documented and may not consider suitability, specifically.
Rule COB 3.4.2(3), requires an Authorised Firm that manages a Discretionary Portfolio Management Accounts for a Professional Client, must ensure that the account remains suitable for that Professional Client.	Authorised Firms may fail to consider the ongoing suitability of client discretionary mandates and accounts.

Frequency of the ongoing review

- **Common practice:**

The frequency of client portfolio reviews varied between firms and tended to range from quarterly to annual.

- **Is this sufficient?**

Answer:

We expect firms to ensure that client portfolio reviews are conducted and that such reviews consider the <u>ongoing suitability</u> of the client's account, perhaps <u>in connection</u> with other performance-oriented metrics, and that such reviews are properly documented.

Participant questions

- [Advance Submissions]

- [Live Submissions]

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Closing Remarks – Chris Cameron


Thank You