Dubai Financial Services Authority

**By Email**

16 November 2021

Senior Executive Officers of Authorised Firms
Compliance Officers of Authorised Firms

**Re: Outcomes of thematic reviews on Brokerage AML**

Dear all,

The purpose of this letter is to update you on certain findings and observations stemming from the DFSA's recent thematic work on the Anti Money Laundering ("AML") processes applied by brokerage firms.

Following the 2019 UAE National Risk Assessment we performed this Thematic Review ("the Review") to focus on the AML Business Risk Assessments ("ABRAs") prepared by a sample of Authorised Firms drawn from the wider DIFC Brokerage population. The Review:

1. Assessed the quality of the ABRAs carried out by Authorised Firms;

2. Determined the extent to which Authorised Firms based their AML Compliance Programmes on the results of the ABRA; and

3. Tested the linkage between the ABRA and the quality and effectiveness of the systems and controls Authorised Firms had implemented in respect of Know Your Customer ("KYC") and Customer Due Diligence ("CDD") requirements, including, but not limited to, determinations of AML risk ratings for Clients.

We wish specifically to thank the Authorised Firms who participated in the Review. Your cooperation in providing documentation and access to relevant employees made this review more effective and efficient and facilitated our observations summarised below.

**Background**

This Review was conducted during the final quarter of 2020 and the first half of 2021. There were three stages to each Authorised Firm's review: The first stage being the desk based review of the ABRA. Once this had been completed a sample of client files was requested from each Authorised Firm. These were then reviewed before moving onto the final stage, a virtual visit with the participant.

This letter provides a summary of the key observations and themes emerging from the Reviews. Please refer to the Annex to this letter which sets out further details. We encourage you to consider your firm's ABRA in the light of these observations. We expect firms to be proactive in making enhancements to AML related systems and controls, where appropriate.

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

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**Key results and observations**

The following is a summary of our key results and findings. Please refer to the Annex to this letter for further details. Also, please keep in mind these are thematic observations. As such, these issues are common to multiple firms (but not all firms) rather than being isolated instances.

1. AML Rule 5.1.1(b) sets out the seven areas of vulnerability that an Authorised Firm must consider in its ABRA:
   i. its type of customers and their activities;
   ii. the countries or geographic areas in which it does business;
   iii. its products, services and activity profiles;
   iv. its distribution channels and business partners;
   v. the complexity and volume of its transactions;
   vi. the development of new products and new business practices, including new delivery mechanisms, channels and partners; and
   vii. the use of new or developing technologies for both new and pre-existing products.

   Most Authorised Firms addressed items i, ii, iv and v in their ABRAs. However the other areas were not covered by a number of Authorised Firms. A small number of Authorised Firms described the risk without going into further detail and did not assess, or risk rate, any of the identified risk areas;

2. Most Authorised Firms do not make use of quantitative data in their assessment and determination of inherent risk;

3. For a small number of Authorised Firms there was no linkage between the inherent risks identified and the internal control in place;

4. Most Authorised Firms ABRAs did not evidence that the effectiveness of controls had been assessed or that outputs from internal and external reviews that had assessed the quality and effectiveness of controls in place had been referenced;

5. Some Authorised Firms did not demonstrate how they considered the latest National Risk Assessment (NRA) results in their ABRA;

6. A small number of Authorised Firms failed to consider the nature of their client's business in their Customer Risk Assessment; and

7. Some Authorised Firms were found to have nothing on file to demonstrate corroborative evidence of source of wealth and source of funds for high risk clients.

**Next steps**

We will arrange a virtual outreach session in the near future to elaborate on the Reviews, key results and observations. We encourage you and members of your team to participate in this event.

If you have questions about the DFSA's expectations or how they may apply to your particular firm's business model, we encourage you to lodge an enquiry via the Supervised Firm Contact Form available on the DFSA's website.

We look forward to your support as we continue to examine Anti-Money Laundering practices in the DIFC.

Yours faithfully,

**Justin Baldacchino**
**Managing Director, Supervision**

## Annex – Thematic reviews on Brokerage AML: Observations

The following information addresses the themes observed by the DFSA in connection with its recent thematic work on the Anti Money Laundering ("AML") processes applied by brokerage firms. Where appropriate, we have presented recommendations 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. Please contact Supervision via the Supervised Firm Contact Form if you have any questions or would like to discuss.

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.

### Observation 1

General weaknesses in assigning risk ratings in the ABRA:
1. Not rating any of the identified risk areas at all;
2. Not articulating both inherent and residual risk ratings (after implementing internal controls);
3. Not defining the weighting for each risk factor assessed; and
4. Not assigning the Overall Risk Assessment Ratings.

AML Rule 5.1.1 (a) requires Authorised Firms to take appropriate steps to identify and assess money laundering risks to which its business is exposed.

The AML Risk Rating Methodology varied across the Authorised Firms in our sample. However, it was noted that the ABRA of certain Authorised Firms lacked any assessment (or risk rating) of the identified risk areas. Some did not include inherent and residual risk rating, while others did not assign a weighting for each of the risk factors assessed or, in some cases, even have an overall rating.

Most of the Authorised Firms selected for the review did, in fact, identify the vulnerabilities that they are exposed to in accordance with AML Rule 5.1.1(b) that related to:
- type of customers;
- their countries or geographic areas;
- their distribution channels; and
- the complexity and volume of their transactions.

However, a small number of Authorised Firms reviewed described the risks without going further and assessing (and risk rating) any of the identified risk areas at all.

*Inherent risk is the natural level of risk that is inherent in a business process or activity before the Authorised Firm implements any processes to reduce the risk, and Residual Risk is the risk that remains after implementing the relevant controls.*

Although a number of Authorised Firms provided ratings for the identified risk areas, they did not articulate both inherent and residual risk ratings for each of the identified risk areas. The need to assess both inherent risks and residual risks is implied in FATF Recommendation 1.

Furthermore, it is the basic approach commonly known and used internationally in risk management.

Most of the other Authorised Firms reviewed were successful in identifying and assessing both inherent and residual risks for each of the identified risk areas. However, most did not assign weightings for each of the factors assessed to assist them in determining the overall inherent and residual risk ratings. In fact, over a third of the Authorised Firms reviewed did not determine the overall risk assessment rating for their Firm.

## Observation 2

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| Authorised Firms do not make use of quantitative data in their assessment and determination of inherent risk. |

Almost all Authorised Firms include in the ABRA an assessment of the inherent risk factors listed in Rule 5.1.1(b) of the DFSA AML Module. However, we noted that most Authorised Firms do not make use of quantitative data to determine the inherent risk scores/ratings, particularly customer risk, geographic risk and complexity and volume of transactions.

Often, Authorised Firms only provided qualitative statements, some of which were general in nature with no evidence that they were backed by available internal data to determine the inherent risk score. This increases subjectivity when risk scoring/rating the inherent money laundering risk exposure of the Authorised Firm.

Authorised Firms are encouraged to consider making use of available data in their internal systems to objectively assess and determine their inherent risk. This will also increase an Authorised Firm's ability to keep track and monitor changes in their risk profile and take proportionate risk mitigation measures.

## Observation 3

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| Mitigation and controls not linked with inherent risk areas |

An Authorised Firm can mitigate the inherent risk[1] by implementing internal controls. Authorised Firms are required under AML Rule 5.1.1(a) to take appropriate steps to identify and assess money-laundering risks to which its business is exposed, taking into consideration the nature, size and complexity of its activities.

AML Rule 5.1.2(b) states that an Authorised Firm must use the information obtained in undertaking its ABRA to ensure that its AML policies, procedures, systems and controls adequately mitigate the risks identified as part of the assessment.

We observed in a small number of Authorised Firms that, even though inherent risk areas were identified and general controls were designed, those controls were not linked to the inherent risk areas.

[1] See "inherent risk" in Observation 1.

We would expect that, having assessed the vulnerabilities they are exposed to, Authorised Firms would then design internal controls that would mitigate these risks. Further, once these internal controls have been developed and implemented we would expect to see a programme of work that would test the effectiveness of the controls and propose enhancements as and if required (see Observation 4).

**Observation 4**

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| The ABRA did not evidence that the effectiveness of controls had been assessed or that outputs from internal and external reviews, which had assessed the quality and effectiveness of controls in place, had been referenced |

AML Rule 5.1.2(c) requires Authorised Firms to use the information obtained in undertaking its ABRA to assess the effectiveness of its AML policies, procedures, systems and controls.

The ABRA of most of the Authorised Firms reviewed failed to demonstrate they had assessed the effectiveness of the controls. While many of the Authorised Firms had reports from internal and external reviews that had considered the quality and effectiveness of the controls in place (such as internal and external audit reports), most Authorised Firms failed to reference these in their ABRAs.

As well as being a rule requirement, it is an internationally recognised practice in risk management to test that the proposed controls are both designed appropriately and operating effectively. Simply listing potential control measures that may, or may not, address the identified risks without testing whether or not they are effective does not prove the value of such controls in addressing the risks.

Accordingly, it is expected that the quality and effectiveness of such controls is tested both internally (e.g. by Back Office, Compliance, Risk, and Internal Audit) and externally (e.g. by External Auditors), and that any findings identified by any of these parties are fed back to the Authorised Firm's overall ABRA.

**Observation 5**

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| Firms did not demonstrate how they considered the latest National Risk Assessment (NRA) results in their ABRA. |

Some Authorised Firms did not demonstrate in their ABRAs if, and how, they had taken into consideration the results of the recent UAE NRA in so far as they align and apply to their respective business models.

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| *Due to the inherent characteristics of the securities sector in general, the nature of the products and services and the business relationships, the NRA assigned the securities sectors a medium-high risk. Both Federal Regulations and the DFSA Rulebook state that, in assessing its money laundering risks and taking steps to mitigate those risks, a Relevant Person is required to take into consideration the results of the NRA.* |

Authorised Firms should ensure they demonstrate they have considered the NRA results in the ABRA, including whenever these are refreshed, and taking steps to put in place commensurate measures to mitigate those risks.

**Observation 6**

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| The nature of the client's business was not captured in the Customer Risk Assessment (CRA) hence no evidence that it was considered in determining the customer risk rating |

The CRA is a mandatory requirement under the DFSA AML Rules. There are a number of areas an Authorised Firm must consider and cover when conducting a CRA. AML Rule 6.1.1(3) lists those areas.

AML Rule 6.1.1(3) (b), (c) and (d) are areas that relate to identifying the nature of the client's business. It was noted that a small number of Authorised Firms did not consider the nature of the client's business under their CRA. This calls into question the risk ratings for the clients on boarded.

**Observation 7**

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| No Corroboration of Source of Wealth and/or Source of Funds |

The timely review and update of CDD information is a fundamental component of an effective AML/CFT risk management and mitigation programme. Authorised Firms are required to maintain the CDD documents, data and information obtained on customers, and their Beneficial Owners or beneficiaries, in the case of legal persons, up to date.

AML Rule 7.1.1(b) requires an Authorised Firm to perform Enhanced Customer Due Diligence ("EDD") in respect of any customer that it has assigned as high risk. AML Rule 7.4.1 sets out what is required by authorised Firms in terms of EDD. This includes the requirement to take reasonable measures to establish the source of funds and source of wealth of the customer or, if applicable, of the Beneficial Owner[2].

The review of client files identified a number of Authorised Firms where there was nothing on file to demonstrate corroborative evidence of source of wealth and source of funds. We consider that taking reasonable measures to establish source of wealth and source of funds would include seeking external third party corroboration of the information provided by clients.

Senior management of Authorised Firms are reminded of their responsibility to be suitably engaged in the assessment of higher risk customers and those that are subject to EDD. In performing this role we would expect senior management to ensure that appropriate measures have been taken, including independent corroboration of source of wealth and source of funds.

[2] AML Rule 7.4.1 (c)

## Other Matters

### Documentation

During the Review, the Team observed documents of varying length, from a couple that were very brief to others that had numbered over 80 pages across a series of documents. The DFSA does not prescribe the optimum length of an ABRA. Rather, we would expect that it should go into sufficient detail for it to be a useful and relevant document without it extending to a depth that would make it unwieldy and unlikely to be referred to by the business or Senior Management.

As a minimum we would expect an Authorised Firm's ABRA to address the seven areas of vulnerability as set out in AML Rule 5.1.1 (b):

i. its type of customers and their activities;
ii. the countries or geographic areas in which it does business;
iii. its products, services and activity profiles;
iv. its distribution channels and business partners;
v. the complexity and volume of its transactions;
vi. the development of new products and new business practices, including new delivery mechanisms, channels and partners; and
vii. the use of new or developing technologies for both new and pre-existing products.

We would expect the risks in each area to be described together with the controls in place to mitigate the risks. We would further expect that each risk be assigned a risk rating on both an inherent and residual basis.

### Frequency of Reviews

During the Review, we observed that most Authorised Firms would mandate a review period for refreshing CDD (or EDD) based on the risk rating assigned to the client. Commonly this would be one year for high-risk clients, two years for medium and three years for low. We would generally consider that this type of arrangement is in accordance with AML Rule 7.6.1(2), which requires Authorised Firms to perform a periodic review to ensure the information is up to date and that the assigned risk rating remains appropriate.

During the course of the Review, we observed some Authorised Firms that did not stipulate a period for refreshing CDD/EDD. That is not to say that this information is not refreshed at these Authorised Firms, rather there appeared to be no policy in place for when it should be refreshed.

We would expect all Authorised firms to have a stipulated policy for the review of CDD and EDD. This policy should include a rationale for the review periods employed as well as the material changes or events that would trigger a review outside of the assigned review period (AML Rule 7.6.1 (2))