18 March 2024

**By Email:** To Senior Executive Officers, Compliance Officers and Money Laundering Reporting Officers of DFSA Authorised Firms

**Key Themes and Findings from 2023 DFSA Risk Assessments: Brokerage Business Models**

In line with our regulatory objectives, and our 2023 supervisory priorities, the DFSA conducted a series of on-site risk assessments of Authorised Firms ('firms') operating brokerage business models. The focus of the risk assessments was to assess firms' compliance with regulatory obligations relating to the General, Conduct of Business, and Anti Money Laundering Modules of the DFSA Rulebook.

The purpose of this letter is to share the key themes and findings arising from our risk assessments to promote best practice, high standards of regulatory compliance and wider improvements across the industry.

## Background

The DFSA adopts a risk-based approach to supervising firms, focusing our resources on those firms that pose the highest risks to our regulatory objectives. This is shaped by the nature, scale and complexity of each individual firm and the risks it poses. On-site risk assessments are one of the key supervisory tools we use to assess the adequacy of firms' systems and controls, and identify risks to the DFSA's objectives.

Brokerage remains a key sector in the DIFC, enhancing its position as a global financial hub. Brokerage firms (both wholesale and retail) play a key role in the financial markets, acting as intermediaries between buyers and sellers to match and facilitate the trading of financial instruments. Relevant firms reported facilitating c.12 million trades for over 25,000 clients during 2023.

We have continued to see an upward trend of growth in the sector over the past few years, with an increase of c.20% in the number of Authorised Firms in 2023 compared with the previous year. There remains a strong interest in the sector, with a healthy pipeline of new licensing applications. In addition, firms already authorised are seeking to strengthen and deepen their operations in the DIFC, including the transfer of trading desks from other international financial centres to their DIFC entities. We are also seeing individual brokers relocating to Dubai to be closer to their clients in the GCC and Asia and to gain greater access to and participation in local and regional markets.

The growth we are seeing in the brokerage sector is reflective of a vibrant and diversified marketplace. Clients are offered a growing choice of brokers and we welcome this competition; it signifies the increasing attraction of doing business in the region. However, this business model, taken together with the rate of growth and a trend of acquisitions and consolidation within the industry, also presents some risks which require mitigation by firms. This includes firms' compliance with requirements in the Conduct of Business and General Modules, and strengthening financial crime related systems and controls[1].

[1] See DFSA Thematic Review on Brokerage Anti Money Laundering (2021).

This letter summarises the key themes and findings from our 2023 cycle of risk assessments, which included over a third of firms operating in this sector. These risk assessments involved on-site visits to interview senior management, including Senior Executive Officers, Compliance Officers, Money Laundering Reporting Officers, and other relevant staff, together with desk-based reviews of policies and procedures, management information, and training materials.

**Key findings**

Below is a summary of the key themes and findings relating to firms' compliance with the General, Conduct of Business, and AML Modules of the DFSA's Rulebook. The findings are detailed further in the Annexes to this letter. Weaknesses were identified in the following areas:

General and Conduct of Business Compliance

- Governance arrangements
- Systems and controls and compliance resourcing
- Client classification policies and procedures
- Appropriateness assessments
- Remuneration practices
- Handling of staff related misconduct
- Outsourcing and reliance on Group entities
- Suspicious Transaction Order Reports

Financial Crime Systems and Controls

- Assessing business AML risks
- Assessing customer AML risks
- AML systems and controls
- Customer Due Diligence
- Enhanced Customer Due Diligence
- Ongoing Customer Due Diligence
- Qualities of a MLRO

**Next steps**

We will elaborate on the key themes and findings from our risk assessments in an upcoming outreach session specifically for brokerage business models. We encourage all firms to attend and participate.

The DFSA expects all firms operating brokerage business models in or from the DIFC to consider these key themes and findings in the context of their specific activities and obligations. While the risk assessments were focused on a specific business model, some of the findings likely apply more widely across firms. The DFSA expects all firms to take note of this letter and consider further enhancements to their systems and controls (where appropriate).

We also remind firms of their continuing obligations to ensure that the DFSA is promptly informed of any significant events or anything else relating to the firm of which we would reasonably expect to be notified.

If you have any questions in relation to this letter, or more generally, please contact us via the Supervised Firm Contact Form found on the DFSA's website.

Yours sincerely,

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

**Annex A: Key Themes and Findings from Risk Assessments of Brokerage Business Models – General and Conduct of Business Modules of the DFSA Rulebook**

**Finding 1: Governance arrangements (GEN 4.2.11/5.2/5.3.2/5.3.3)**

We expect firms to have a corporate governance framework in place that is appropriate to the nature, scale and complexity of their business and structure, which is adequate to promote the sound and prudent management and oversight of its business and to protect the interests of its customers and stakeholders.

Having robust governance arrangements is particularly important where firms are planning to expand their business activities, including acquiring other brokerage firms or consolidating their own Group entities. These scenarios can introduce new risks into the business which require proper oversight by senior management and the Board.

We observed weaknesses in firms' governance arrangements, including Board composition and a lack of clarity on the roles, responsibilities, and reporting lines of senior management. Specific examples included:

- Weaknesses in Board composition (both number and skillset of members) and a lack of independent challenge and oversight of the business by the Board;
- Senior Executive Officers not having the required level of ultimate responsibility, decision making and accountability for the DIFC entity;
- Senior Executive Officers 'double hatting' by actively broking, leading to the potential for conflicts of interest and their focus being skewed towards revenue generation rather than day to day management, supervision, and control of the firm; and
- Overlap in responsibilities between key individuals and functions of the firm.

In addition, where senior management are subject to dual reporting lines both at the firm and Group level, firms should ensure such arrangements do not lead to confusion in terms of accountability and decision making. Firms must ensure that proper segregation of duties and independence of key functions are maintained.

**Action:** Firms should review the adequacy of their current governance arrangements to ensure they are appropriate and aligned to the nature, scale, and complexity of their business activities. This should include, but not be limited to Board composition and effectiveness as well as the roles, responsibilities, and reporting lines of senior management.

**Finding 2: Systems and controls and compliance resourcing (GEN 5.3.7/5.3.9/5.3.11)**

Firms must establish and maintain compliance arrangements, including processes and procedures that ensure and evidence compliance with all legislation applicable in the DIFC. Firms must also ensure that the Compliance Officer has access to sufficient resources, including an adequate number of competent staff, to perform their duties objectively and independently of operational and business functions. Failure to meet these requirements could result in regulatory breaches not being identified and/or existing systems and controls not operating effectively.

As already noted, a number of firms are seeking to expand their operations in the DIFC, which we welcome. However, in many instances we are not seeing a commensurate increase in the systems and controls or resources to support such growth and to ensure it is delivered in a controlled way.

In a number of risk assessments, we identified inadequacies in the resourcing levels and capacity of the compliance function. We observed instances where:

- The Compliance Officer was over-stretched;
- There was a blurring of first and second line of defence responsibilities, with the Compliance Officer carrying out wider activities which were diverting focus from the core compliance function;
- Clients were allowed to trade prior to their onboarding and classification by the DIFC entity; and
- There were inadequacies in Compliance Monitoring Programmes, including gaps in coverage, absence of monitoring/testing in key regulatory areas, and delays in conducting monitoring/testing activities.

Through our risk assessments, we have uncovered examples of poor conduct and serious breaches of our rules, including name passing, use of unrecorded communication applications and personal account dealing. These issues were either not identified by compliance or, if they were identified, they were not addressed in an appropriate and timely manner.

**Action:** Firms should review the adequacy of their current compliance resources to ensure that their systems and controls are appropriate to the nature and extent of the firm's business, including the pace of business growth. Where appropriate, firms should strengthen their compliance functions by increasing resources. Firms should also review their Compliance Monitoring Programmes to ensure they have the right level of coverage and effective monitoring/testing is carried out. Failure to do so could lead to regulatory breaches and/or conduct risks crystallising and going undetected.

**Finding 3: Client classification policies and procedures (COB 2)**

We observed continued weaknesses in firms' approaches to client classification despite our previous 2017 thematic review[2] in this area and subsequent follow up work. Firms must demonstrate they are fully compliant with the DFSA Rules on client classification. This remains a supervisory priority for the DFSA.

Identified weaknesses included:

- Unsatisfactory assessments of clients' knowledge and experience, including a lack of supporting rationale and verifiable information;
- Net assets assessments being conducted based on outdated rules;
- Over-reliance on the client classification assessments performed by Head Office/Group entities without conducting a gap analysis to ensure alignment between the DFSA client classification regime and that used by Head Office/Group; and
- Limited evidence of challenge from firms' compliance functions.

**Action:** Firms should review the adequacy of their client classification policies and procedures to ensure they are aligned with the applicable DFSA Rule requirements. Any deficiencies should be addressed as a priority.

[2] See DFSA's Client Classification and Suitability Thematic Review 2017.

**Finding 4: Appropriateness assessments (COB 6.16.3)**

Through our risk assessments and supervisory engagement with firms providing Restricted Speculative Investments (RSIs)[3] trading services to Retail Clients, we have also identified issues with the quality of appropriateness assessments being undertaken by some firms. This is despite the existing guidance in COB 6.16.3. Inadequate appropriateness assessments have the potential to cause significant harm to Retail Clients as they may be allowed to access high-risk complex products that they do not sufficiently understand or have the ability to absorb losses from.

**Action:** Firms should review the adequacy of their appropriateness assessments to ensure they are aligned with the applicable DFSA Rule requirements. Any deficiencies should be addressed as a priority.

**Finding 5: Remuneration practices (GEN 4.2.12/5.3.31/A3.2)**

Firms 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.

Our risk assessments identified several examples where the fixed and variable remuneration elements were not appropriately balanced, resulting in the broker's remuneration being materially driven by the revenue generated. In these instances, there was little or no regard for other non-financial metrics, such as conduct considerations and adherence to compliance policies and procedures.

In addition, we noted that remuneration policies were often lacking deferral and claw-back provisions to mitigate against short term risk taking by brokers. In certain instances, where deferral or claw-back mechanisms were included in policies, there was no evidence they had been appropriately considered or implemented when compliance issues had arisen with staff. This, coupled with a lack of robust compliance monitoring, can result in delays in identifying breaches and some time after compensation has been paid to the individual broker. Such remuneration structures do little to encourage good conduct and can promote excessive risk-taking, exposing the firm and its clients to unacceptable risks.

**Action:** Firms should review their remuneration policies and associated HR documents to ensure they are aligned with promoting a positive compliance culture and good market conduct by brokers.

**Finding 6: Handling of staff related misconduct (GEN 5.3.18/5.3.19)**

We remind firms of their obligations to ensure their employees remain fit and proper. This includes implementing appropriate systems and controls and maintaining the required relevant records.

During our 2023 risk assessments and engagement with firms, we observed examples where:

- As part of the recruitment process, firms failed to give appropriate weight or consideration to previous misconduct or issues impacting the individual's employment with the firm;
- There were delays in taking appropriate action concerning employee misconduct, or, in certain instances, a failure to take any disciplinary action; and

[3] Defined in COB 6.16.2(e).

- Firms failed to notify the DFSA where there had been a significant breach of our rules by staff.[4]

We also observed instances where firms were deficient in implementing staff training. For example, in relation to the firm's regulatory obligations in the General and Conduct of Business Modules of the DFSA Rulebook. Failure to ensure staff are adequately trained increases the risk of regulatory breaches and/or conduct risks materialising. This is particularly important where firms are transferring trading desks and staff to DIFC entities from other international offices.

**Action:** Firms should review the adequacy of their systems and controls relating to staff and agents, including HR disciplinary processes and training programs. This is to ensure that staff are appropriately trained, and any instances of serious misconduct are identified and addressed appropriately in a timely manner.

**Finding 7: Outsourcing and reliance on Group entities (GEN 5.3.21)**

Many firms in this sector have close collaboration with and reliance on the policies, procedures, and resources of Group entities. However, in certain instances, we observed a failure to give proper consideration to the DIFC and the DFSA requirements in firms' policies and procedures. We also observed instances where there was an over-reliance by firms on the services provided by Group entities (for example, Compliance, risk management, HR). This was to the extent that the local DIFC staff with apparent responsibility and oversight for the particular function were unable to demonstrate sufficient understanding of the operations and performance of that function or were by-passed for decision making purposes.

We also observed in certain instances that Service Level Agreements governing key support and services provided to firms by Group entities were outdated, lacking in detail, or simply not reflective of the services being provided in practice.

We remind firms of their obligations under GEN 5.3.21, where a firm outsources functions or activities to service providers (including within its Group), it is (i) not relieved of its regulatory obligations; and (ii) remains responsible for compliance with legislation applicable in the DIFC.

**Action:** Firms should review their contractual and oversight arrangements of any key functions or activities outsourced to Group entities, and any related processes and procedures, to ensure they are adequate to meet the applicable DFSA Rule requirements.

**Finding 8: Suspicious Transaction Order Reports (GEN 11.10.12A/5.3.20)**

Suspicious Transaction Order Reports (STORs) have been another area of focus in our engagement with firms. Firms are required to have systems and controls in place to prevent and detect market abuse. Firms must notify the DFSA immediately if they: (i) receive an order from a Client, or arrange or execute a transaction with or for a Client; and (b) have reasonable grounds to suspect that the order or transaction may constitute Market Abuse, through submission of a STOR.

We note that over the course of 2023, a total of 68 STORs were reported by six brokerage firms. Some of the STORs submitted contained inaccurate and/or incomplete information.

[4] See Dear SEO Letter on Regulatory Notifications (15 March 2022).

Given the low volume and quality of STORs submitted, we are concerned about the level of understanding amongst firms on what constitutes a STOR and their obligations in relation to the reporting of STORs. This also raises a question around the robustness of the systems and controls used by firms to identify, assess and report suspicious transactions. We note that trade/market surveillance is another area which a number of firms in the sector outsource to Group entities to perform (see above).

**Action:** Firms are reminded of their obligations to have systems and controls in place to prevent and detect market abuse and to notify the DFSA immediately if they suspect that an order or transaction may constitute market abuse, through submission of a STOR. Firms should ensure STORs are accurate and contain complete, proper and relevant information before being submitted to us. Firms should also carry out appropriate testing and calibration of their systems and controls to ensure they are adequately identifying, assessing, and reporting suspicious transactions when they occur.

**Annex B: Key Themes and Findings from Risk Assessments of Brokerage Business Models – Anti-Money Laundering, Counter-Terrorist Financing and Sanctions Module (AML) of the DFSA Rulebook**

**Finding 1: Assessing business AML risks (AML 5.1)**

The 2021 Thematic Review on Brokerage Anti-Money Laundering (the 2021 Review) focused on the AML Business Risk Assessments (ABRAs) obligations within a sample of Authorised Firms drawn from the wider DIFC Brokerage population. As part of our review of the Risk Mitigation Plans issued to firms following the 2021 Review, we noted an improved level of compliance in relation to this finding. However, we identified various deficiencies in the quality of the ABRAs across most of the assessed firms in 2023, including:

- Certain firms did not have a clear business risk assessment and scoring methodology;
- Certain firms relied on its wider Group methodology without being able to clearly articulate how it applied to the DIFC firm;
- ABRAs excluded either inherent risk, controls effectiveness, or residual risk ratings;
- ABRAs were too generic and not sufficiently detailed to enable a clear understanding of the risks;
- No quantitative data was considered to support the conclusions reached in an objective manner;
- ABRAs omitted certain inherent risk factors set out in the AML Module e.g. risks arising from the use of new or developing technologies and the development of new products and business practices, including new delivery channels and partners;
- ABRAs omitted a detailed assessment of Targeted Financial Sanctions (including proliferation financing); and
- ABRAs failed to evidence that the outcomes of the UAE National Risk Assessment (NRA) were considered as part of the assessment (as relevant to the firm's business model).

Inadequate ABRA processes may lead to firms failing to identify and assess AML risks to which their businesses are exposed, resulting in failures to implement appropriate AML systems and controls.

**Action:** Firms are reminded of their obligations to identify and assess money laundering, terrorist financing and proliferation financing risks, to which their business is exposed, taking into consideration the nature, size, and complexity of their activities, as mandated in Chapter 5 of the AML Module. Furthermore, Firms are reminded to take note of the outcomes of the 2021 Review and consider how the key findings and observations may be relevant to their operations.

**Finding 2: Assessing customer AML risks (AML 6.1)**

We identified various firms with inadequate or unclear customer risk assessment (CRA) risk scoring methodologies. In certain instances, the CRA methodology omitted certain risk factors e.g., the nature of business, product/services risk, and other source of wealth jurisdictions, where a client's wealth was generated from multiple jurisdictions.

We also observed the following findings:

- Instances where there was no clear correlation between the ABRA, CRA and the client risk scoring formula as per the firm's policy;
- The application of the CRA was inconsistent, resulting in a lack of aligned final risk ratings awarded in line with the Firm's policy; and

- Instances where the methodology resulted in a situation where a client could not be classified as high risk, requiring manual intervention by the MLRO.

Inadequate CRA processes may result in firms failing to identify the correct level of risk posed by both new and existing clients, and the appropriate extent of due diligence measures to mitigate those risks.

**Action:** Firms must establish an adequate customer risk assessment framework to meet the applicable DFSA Rule requirements, including those set out in AML 6.1.1.

### Finding 3: AML systems and controls (AML 5.2)

We observed that certain firms' AML policies and procedures were out of date. In addition, we observed inadequate AML policies and procedures due to not being customised to the firm's business activities and processes. Certain of these policies and procedures simply duplicated the AML Module and lacked detailed operational procedures and guidance for employees.

Certain firms simply relied upon their Group sanctions procedures, lacking detailed local operational procedures necessary to comply with the UAE Targeted Financial Sanctions requirements. For example: roles and responsibilities, screening standards, turnaround times, funds freezing procedures, funds freezing reporting, and partial name match reporting.

We also observed instances where firms lacked sufficient detail in their management information (MI)/metrics covering key AML processes e.g., Customer Due Diligence (CDD) file reviews, transaction monitoring alerts, screening alerts, suspicious transaction reporting and Quality Assurance results. These deficiencies in MI hamper effective local senior management oversight and consideration of key risks by local governance committees.

**Action:** Firms must ensure they establish and maintain effective AML policies, procedures, systems and controls, which are tailored to the nature, scale, and complexity of their business activities.

### Finding 4: Customer Due Diligence (AML 7.3)

Through our review of client files, we observed a failure to consistently or appropriately implement Customer Due Diligence measures, including but not limited to, identification and verification of customers, beneficial ownership and addresses. In a number of instances, these clients had been onboarded remotely through an online onboarding platform.

**Action:** Firms must implement robust CDD procedures, including identification and verification of customers and any beneficial owners, to ensure compliance by relevant employees responsible for conducting customer due diligence.

### Finding 5: Enhanced Customer Due Diligence (AML 7.4)

Our review of client files revealed that most assessed firms referred high-risk customers to be approved by the compliance function only. In addition, we observed inconsistencies in: (i) identifying the source of funds (SOF) and source of wealth (SOW) for high-risk clients; and (ii) obtaining evidence to corroborate the SOF and SOW for high-risk clients.

**Action:** Firms must implement robust Enhanced Due Diligence procedures, including taking appropriate corroboration steps, to ensure compliance by relevant employees responsible for conducting customer due diligence and approving high risk client files.

**Finding 6: Ongoing Customer Due Diligence (AML 7.6)**

Our review of 2023 AML Returns revealed that 71% of firms use automated and manual AML/CTF transaction monitoring processes. However, where the firm used only a manual process, we observed that the process applied was not appropriate given the size and nature of the firm's business, its customer base, complexity, and volume of customer transactions.

In certain instances, we also observed that ongoing due diligence measures were not properly applied, leading to incomplete and outdated Know Your Customer documents in client files, and review comments were sporadic and did not include commentary on the review of the client's transactional activity patterns. In such instances, no meaningful challenge was provided by the checker / approver from the operations function or the compliance/AML team, thereby rendering the control mechanism ineffective.

Ineffective ongoing CDD may inhibit a firm's ability to identify, assess, and mitigate, potential money laundering risks on an ongoing basis.

**Action:** Firms must implement effective procedures, systems and controls, and monitoring mechanisms, to ensure ongoing customer due diligence is conducted effectively and in a timely manner in accordance with the applicable DFSA Rules.

**Finding 7: Qualities of a MLRO (AML 11.3)**

Our review of 2023 AML Returns revealed that 65% of MLRO functions are in-house functions. We observed instances where, given the nature, size and complexity of the firm's business, its customer base and volume of transactions, the MLRO did not have sufficient resources to assist in the performance of his/her duties in an effective, objective and independent manner. This resulted in the MLRO being overstretched and the AML function being insufficiently resourced.

**Action:** Firms must review the adequacy of their current AML resources to ensure that their systems and controls are appropriate to the nature and extent of the firm's business, including the pace of business growth. Where appropriate, firms should strengthen their AML functions by increasing resources.