Client Alert

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Managing regulatory investigation and enforcement action in the UAE financial free zones

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With the UAE regulatory landscape changing steadily, it can be a challenge at the best of times for financial institutions (firms) to stay on top of and comply with the many laws and rules that apply to their activities. This is particularly true for firms based in the UAE financial free zones, the Dubai International Financial Centre (DIFC) and the Abu Dhabi Global Market (ADGM).

By way of example, the DIFC regulator, the Dubai Financial Services Authority (DFSA) has a rulebook which runs to 1555 pages. The "Big 4" DFSA rulebooks, GEN, COB, AML, and PIB,[1] which apply to most firms, run to a total of 721 pages. Moreover, DFSA enforcement action can result not only from a serious or systematic breach of a specific rule, but also where the DFSA considers that a firm has deviated from one of its 12 high-level principles which, by their nature, are ill-defined. Additionally, DFSA enforcement action has important implications for authorised individuals, as the DFSA looks increasingly to enforce senior management accountability.

Even the most well-meaning firms with seemingly iron-clad compliance systems and controls can become subject to a potential DFSA investigation, with all its obvious reputational and financial hazards. When this happens, there are generally three strategies for managing the situation: avoidance, mitigation and litigation. The first is always the ideal objective, but is not always achievable. The second is key once enforcement action is underway. The third is for the brave, but may on occasion be the best way to proceed.

This brief guide discusses each of the above three enforcement management strategies in the context of a DFSA investigation, takes a quick look at publicity in DFSA enforcement actions and finishes with a brief consideration of the issue of privilege. The basic principles set out in this briefing also apply to managing enforcement action by the ADGM's regulator, the Financial Services Regulatory Authority, which will soon have enforcement capability, and may start to flex its muscles.

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[1] GEN is the DFSA's General Rulebook module, COB is the Conduct of Business module, AML is the Anti Money Laundering, Counter-Terrorist Financing and Sanctions module and PIB is the Prudential - Investment, Insurance Intermediation and Banking Business module.

1. Avoidance

Although a firm cannot always avoid enforcement action, it can follow these "golden rules" when faced with the prospect of potential regulatory action. This might happen, for example, where a firm suspects that it may have committed a material rule breach.

Rule 1. Begin an internal investigation: Whether or not the firm's DFSA supervisory contact is aware of the matter, the firm should start an internal investigation to assess whether a material rule breach has occurred. If necessary, it should engage external advisers to assist with the investigation so it has some degree of independence (which may also have legal privilege benefits, albeit not against the DFSA).

The investigation should be thorough, identify the root causes of any breach, suggest any solutions (such as a programme of remedial measures) and reach basic – and clearly independent – conclusions. If the firm's DFSA supervisory contact is not aware of the matter, the firm should notify them as soon as possible about the internal investigation (see GEN Rule 11.10.7 for a list of notifiable matters).

Rule 2. Establish who is to blame: A firm should identify the relevant individual(s) responsible for the breach. If the breach was a result of an individual's blatant violation of a firm's internal procedures, then this should be disclosed to the DFSA. It may also be appropriate for the firm to start disciplinary proceedings against the individual(s) concerned. Firms cannot eliminate the risks of a rogue employee bypassing the firm's systems and controls and causing the firm to breach its regulatory obligations. The DFSA will take into consideration in any investigation whether there is individual or corporate responsibility for a breach of the law or rules. However, in cases where an individual is clearly responsible for a rule breach, it will look closely at whether the firm's systems and controls were satisfactory to mitigate the relevant internal risks.

Rule 3. Tell the DFSA everything: Provide a written report to the DFSA, and do not forget the "3 Cs" – Cooperate, Cooperate and Cooperate with the DFSA during the course of its enquiries. Under Principle 10 of the DFSA's Principles for Authorised Firms, firms must be open and cooperative with the regulator and must keep the DFSA promptly informed of significant events or anything else relating to the firm of which the DFSA would reasonably expect to be notified. To the extent possible, volunteer any further information or developments that may be relevant to the DFSA's understanding of the matter.

Firms are generally best advised to put all their cards on the table because, if the DFSA thinks a firm may be withholding relevant information, it will be more likely

to begin its own investigation into the suspected breaches, and may add a suspected breach of Article 66 of the Regulatory Law 2004 (misleading the DFSA).

Rule 4. Plan remedies: Once a firm has identified the source of the problem which caused the breach of the relevant law or rule, it should quickly put in place any recommended programme of remedial measures. The programme should entail at least:

- changes to internal systems and controls to address the problem;
- new or adapted staff procedures/guidance;
- comprehensive training/re-training of relevant staff; and
- (crucially) compensation to any clients who suffered financial loss because of the breach or, where the amount is not clear, an undertaking to compensate clients.

Whether the DFSA will decide to investigate a matter itself may depend on the firm's previous history of compliance, on its supervisory relationship with the DFSA and/or whether the matter scores highly on the DFSA's "risk dashboard"[2] If a firm has a good relationship with its supervisory contacts this can have a positive impact on the DFSA's enforcement approach. Swift internal action, particularly where it involves ensuring that no third parties are prejudiced by the firm's conduct, can sometimes tilt the balance away from enforcement action, or may at least help to reduce the level of the eventual financial penalty if enforcement action is taken.

2. Mitigation

Given that it does not have unlimited resources, the DFSA usually prefers a case to settle or conclude swiftly. There are also advantages for the firm in concluding a case promptly, the most important of which is that it reduces the amount of senior management time and financial resources a firm must divert to dealing with the investigation and its wider impact.

Enforcement action is never simple and even the most winnable cases

[2]The DFSA's focus from a supervisory perspective is typically set out in its Annual Business Plan. The DFSA's "DFSA in Action" publication may also contain an indication of its possible supervisory and enforcement focus.

take considerable time to complete, given the procedural hurdles which have been built-in to the DIFC regulatory framework. So if your firm has broken a rule and has no arguable defence, it is best to cooperate fully with the resulting DFSA investigation and settle the matter at the earliest possible stage. This might include making “admissions” at an early stage to reduce the level of DFSA investigation required.

Admissions should help create goodwill because DFSA enforcement staff appreciate being able to reduce the scope of their investigation on agreed matters and concentrate their resources elsewhere.

The other obvious attraction of settlement is the discount for early settlement. The DFSA provides firms opting to settle a discount on a sliding scale, depending on the timing of the settlement. The discounts are not published but we understand that they broadly apply as follows:

- Stage 1 (early settlement stage before the issue of a Preliminary Notice[3]): approximately 20%, but it may be possible to negotiate a higher discount;

- Stage 2 (between the Preliminary Notice and the hearing by the DFSA's Decision Making Committee (DMC): 10-20%;

- Stage 3 (up to the issue of the Decision Notice): up to 10%.

Cooperating with the DFSA throughout the life of a case can also help to reduce the level of financial penalty, effectively creating a second layer of available “discount”. In a recent DFSA enforcement case, a firm received a 20% discount for early settlement, as well as a further 20% discount to take account of the cooperation and commitment by the firm and its senior management to resolving the issues with the DFSA. The outcome was a total discount on the financial penalty of 36%.

Firms subject to DFSA enforcement action also have the option to offer the DFSA an enforceable undertaking, which offers a way for the firm to agree to an undertaking to take various steps and actions to address the DFSA's concerns as a means of ending a DFSA enforcement action. It will typically, but not always, include an undertaking to pay an agreed financial penalty. An enforceable undertaking will generally always be

[3] The DFSA issues a person with a Preliminary Notice following the conclusion of its investigation. The Preliminary Notice contains a summary of its findings and a statement of the DFSA's proposed action.

published, so while it is not a way to avoid the bad publicity of a published enforcement outcome, it does provide the firm with a way to retain a degree of control over the potential outcome of the action, including negotiating any financial penalty.

The DFSA's Regulatory Policy and Process Sourcebook provides a useful source of guidance on the DFSA's policy on enforcement actions and its use of financial and other sanctions. Chapter 5 sets out the DFSA policy on taking enforcement action and investigating breaches of its laws and rules. Chapter 6 sets out DFSA guidance on how it decides the appropriate penalty, which includes a financial penalty (a fine) or a public censure. In deciding the appropriate level of financial penalty to be imposed by the DFSA, the DFSA takes a 3-step approach:

- Step 1, disgorgement, looks at depriving the firm of the economic benefits gained from the contravention;
- Step 2 looks at the seriousness of the contravention; and
- Step 3 looks at mitigating and aggravating factors.

In terms of the mitigating factors when looking at the level of financial penalty, the DFSA will consider the following factors:

a) the conduct of the firm in bringing the contravention to the DFSA's attention quickly, effectively and completely;

b) the degree of cooperation the firm showed during the investigation of the contravention by the DFSA;

c) where the firm's senior management were aware of the contravention or of the potential for a contravention, whether they took any steps to stop the contravention, and when these steps were taken; and

d) the nature, timeliness and adequacy of the firm's responses to any supervisory interventions by the DFSA and any remedial actions proposed or required by DFSA's supervisors.

There is scope for effective use of these factors to reduce any potential financial penalty.

3. Litigation

In other cases a firm may consider that it has done everything by the book, or all which it reasonably could have done in the circumstances (in the absence of a specific rule or guidance). If this is so, a firm should not be coerced into settlement just because it appears to be the easiest option for both the firm and the DFSA. A firm may have good reason to dispute the DFSA’s investigation findings. The DFSA does not always get it right and many of its investigations conclude without any action being taken.

Where a firm considers that the DFSA has misguided itself on the law, that there is a reasonable defence to an alleged breach, or that the penalty proposed by the DFSA in its Preliminary Notice or during settlement negotiations is plainly disproportionate to the alleged contraventions, it may be appropriate for the firm to challenge the DFSA’s findings at the DFSA's DMC. The DMC is the DFSA's internal decision maker for its enforcement actions. It hears representations from persons who have received a preliminary decision from the regulator proposing to take specified action.

It may sometimes also be worth referring the matter to the Financial Markets Tribunal (the Tribunal), a tribunal with power to review the DFSA's enforcement decisions in full. Although not entirely independent of the DFSA, the Tribunal is operationally independent, and its members are not DFSA employees, but rather leading lawyers and experts from the UAE and from common law jurisdictions, with experience of financial services regulation. The Tribunal will make a fresh review of all the facts, considering new evidence where necessary. It is also possible to cross-examine any relevant parties before the Tribunal, including DFSA staff. The Tribunal's decisions may be appealed to the DIFC Courts.

Clearly, all litigation – let alone a dispute with your regulator – is expensive and time-consuming, and has an uncertain outcome. But it may be worth litigating if there is genuinely no fault by the firm or where the DFSA appears to be acting unfairly or unreasonably. Increasingly, the DFSA brings enforcement action based on high-level principles instead of discrete rules. So there may be room for debate about what conduct warrants a penalty and what is simply a failure to achieve perfection or “best practice”. However, before the Tribunal stage, judicial review may also be an option. This type of challenge is worth considering only in limited circumstances, for example where the DFSA has acted

unreasonably, has clearly failed to follow its own procedures, or has taken into account irrelevant considerations.

4. Publicity in DFSA enforcement actions

When the DFSA refers a case to its Enforcement team, it will invariably be looking to impose a fine, and to do so publicly. Indeed, the DFSA has emphasized what those who work on enforcement cases have long known, namely that the real sanction feared by firms subject to enforcement action is the publicity which accompanies a fine and any consequent damage to reputation, rather than the level of any fine itself. A public censure alone may cause significant damage to a firm and its relationship with customers – and ultimately its profits.

Firms trying to negotiate a fine without public censure will be sorely disappointed. The DFSA may not be enforcement-led, but it is always keen to use a successful enforcement case to publicise examples of behaviours it wishes to stamp out in a particular market or market segment, both as a deterrent to others, and to raise awareness. In fact, it often seems the DFSA is more concerned with getting the message across to the market than with the specific breach in question – and firms must take this into account when they deal with the DFSA. The issue of publicity in regulatory hearings was actually considered in the Tribunal and the DIFC Courts (on appeal) in a 2012 case, with both deciding unequivocally in favour proceedings being heard in public. The point at which an enforcement action becomes a matter of public knowledge is when the subject of the action refers the matter to the Tribunal. Prior to that, it is confidential, including representation hearings in the DMC.

5. Privilege and self-incrimination in DFSA investigations

In most common law jurisdictions, legal professional privilege applies in respect of regulatory investigations and would permit a person who is subject to an investigation to refuse to give the regulator information which is subject to such privilege. The principle behind this is that a person (or company) should be free to take legal advice on his or her legal rights without fear that any disclosure of the communications with his or her lawyer may prejudice the person in the future.

In the DIFC, as a matter of law, if the DFSA requests information from a person (whether in writing or at interview) it is a contravention of the law to refuse to provide the information to the DFSA in the grounds that it is

subject to legal professional privilege. This particular provision of DIFC law was imported from the Australian regulatory regime. In Australia, the information which is subject to such privilege may be obtained by the regulator from the subject of its investigation, but it may not be used in evidence in any subsequent proceedings (including criminal proceedings). However, in the DIFC, no such protection exists for subsequent use of the privileged information and, in particular, the UAE criminal authorities may use such information to bring a criminal case against a person e.g. for breach of trust or fraud. We note with interest that, although the ADGM borrowed generously from the DIFC regulatory framework, one area in which it did not was in respect of the disapplication of legal professional privilege in enforcement investigations. Accordingly, communications between a lawyer and his client are protected in the ADGM in the context of regulatory investigations.

This does not mean that firms in the DIFC should not take legal advice when faced with enforcement action. It simply means that firm should be aware that they cannot use privilege as a shield and should be wary of the fact that what they tell their lawyer, they may also need to tell the regulator. For firms which are part of an international group, although legal professional privilege may not be protected in the DIFC, it may still be worth ensuring that legal advice is protected by such privilege if there is a risk of a foreign regulator making a request for information which may be legitimately protected, or at the very least retaining the right to waive one's privilege.

A poorly-managed regulatory investigation and subsequent enforcement action can result in a significant drain on a firm's financial resources and senior management time, and potential reputational damage for both the firm and the individuals involved in an alleged contravention. With the right approach and strategy, firms can mitigate the potential harm of a regulatory investigation and, in the best case scenario, avoid it.

Contacts

Matt Shanahan
Partner, Financial Services Regulatory, UAE
Matt.Shanahan@bakermckenzie.com

Mazen Boustany
Partner, Banking & Finance, UAE
Mazen.Boustany@bakermckenzie.com

Borys Dackiw
Partner, Head of Corporate & Compliance, UAE
Borys.Dackiw@bakermckenzie.com

Hugh Lyons
Partner, Dispute Resolution, UK
Hugh.Lyons@bakermckenzie.com

www.bakermckenzie.com

Abu Dhabi
Level 8, Al Sila Tower
Abu Dhabi Global Market Square
Al Maryah Island
P.O. Box 44980
Abu Dhabi, UAE

T: +9712 6123700
F: +9712 6581811

Dubai - Business Bay
Level 14, O14 Tower
Al Abraj Street
Business Bay
P.O. Box 2268
Dubai, UAE

T: +9714 4230000
F: +9714 4479777

Dubai - DIFC
Level 3, Tower 1
Al Fattan Currency House
DIFC
P.O. Box 2268
Dubai, UAE

T: +9714 4230005
F: +9714 4479777

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