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Briefing note September 2014

DIFC Judge rules on the regulatory perimeter of the DFSA and suitability standards in Al Khorafi v. Bank Sarasin-Alpen and Bank Sarasin[1]

The DIFC Court of First Instance (the Court) has found Bank Sarasin & Co. Ltd, a Swiss incorporated bank with no registered presence in the Dubai International Finance Centre (DIFC), and its Dubai Financial Services Authority (DFSA) authorised DIFC subsidiary, Bank Sarasin-Alpen ME Limited (Sarasin-Alpen), in breach of the DIFC Regulatory Law with liability to pay compensation to the members of a family who purchased US$200 million of structured products, which were financed, in part, by loans from Bank Sarasin and from another bank.

The ruling of Sir John Chadwick addresses two areas of DFSA regulation: (1) how far does DFSA regulation extend, and (2) acceptable practice in treating customers fairly (i.e. assessing suitability) in relation to complicated financial products.

Current understanding of the DFSA's regulatory perimeter is seriously challenged by the reasoning for holding Bank Sarasin liable.

The Court's conclusions in relation to suitability standards are a reminder that maintaining effective internal controls is a daily objective which has to be rooted in an effective and competent compliance culture.

If the judgment is appealed, we hope that the DFSA might intervene in the appeal proceedings to allow the DIFC Court of Appeal to benefit from the regulator's point of view as to where the regulatory perimeter should lie.

Some implications

- If this judgment is appealed, will the appeal succeed in confirming the *status quo ante* as to the regulatory perimeter?
- If the judgment is not appealed or the appeal fails on the regulatory perimeter question, how will the DFSA respond?

[1] Case CFI 026/2009.

The Claimants, Mr Al Khorafi, along with his mother and his wife, invested US$200 million in a series of structured products sold by Bank Sarasin and Sarasin-Alpen in late 2007 and 2008. The investment was financed by lending from Bank Sarasin and Al Ahli Bank of Kuwait. When the financial crisis resulted in these investments losing value, the Bank demanded the Al Khorafi family provide additional capital to support the loans (a 'margin call'). When this capital was not provided, Bank Sarasin liquidated the structured products resulting in a substantial loss for the Al Khorafi family.

The Court heard evidence from Mr Al Khorafi, his mother Mrs Al Hamad and his wife Mrs Al Rifai as to their level of financial sophistication and the communication with the Defendants prior to making the investments. It also heard evidence from the CEO of Sarasin-Alpen, Mr Walia. Sir John preferred the evidence of the Al Khorafi family and held that "*there is no doubt that the suitability requirement was not met*" by Sarasin-Alpen.[2]

Findings against Sarasin-Alpen

In one of the longest judgments yet issued by the Court, Sarasin-Alpen was found liable to pay compensation under Article 94(2) of the DIFC Regulatory Law (which imposes liability on a person who breaches DFSA regulations) for breaches of the DFSA's Conduct of Business Rules (the COB Rules) in force at the time.

Sarasin-Alpen was held to have failed to carry out sufficient investigations in order to ascertain whether Mr Al Khorafi, along with his mother and his wife, satisfied the definition of "Client".[3] If they did not meet this definition, they were "*retail* customers", and, as the DIFC was at the time a 'wholesale jurisdiction' only, Sarasin-Alpen was prohibited by the COB Rules from carrying out any investment business with the Claimants. Sarasin-Alpen was held to have failed to carry out the net asset test properly under the COB Rules or to assess the Claimants' level of financial experience.

The Court ruled that Sarasin-Alpen employees had completed key information in customer on-boarding forms sometime *after* they were signed, with the intention of leading the uninformed reader to believe that they had been completed by the signatory. It was also found that even if the forms had been completed properly, the Claimants would not have met the definition of "Client" (or in today's version of the COB Rules, the definition of "Professional Client").

Unconnected to the case before the Court, the DSFA has since updated its framework to allow Authorised Firms to carry on business with retail customers in certain circumstances. However, the Court's findings remain relevant in determining the manner in which Authorised Firms assess a customer's suitability for the purposes of the COB Rules.

Notwithstanding Sir John's finding that the Claimants were retail customers, he went on to consider whether the structured products recommended by Sarasin-Alpen were suitable for them. Sarasin-Alpen was found to have made investment recommendations without giving any consideration as to their suitability, having regard to the investment objectives and risk attitudes of the Al Khorafi family (as required by the COB Rules and other DFSA rules then and now.[4])

The Court found that, but for these breaches, the Al Khorafi family would not have invested in the structured products.

Having made this finding, Sir John went on to consider the contractual relationship between the Claimants and Sarasin-Alpen. He found that the contracts between Sarasin-Alpen and the Claimants were unlawful because the Claimants were retail customers. Sir John also considered whether he would have reached a different conclusion had the Claimants not been retail customers. He found that Sarasin-Alpen would have breached the contracts by not acting with reasonable skill and care when recommending the structured products to the Claimants.

Findings against Bank Sarasin

The Court went on to find that Bank Sarasin, incorporated in Switzerland and with no registered place of business in the DIFC, had provided financial services in or from the DIFC in contravention of the Financial Services Prohibition (that is, the general prohibition on providing

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2 Judgment, paragraph 299.

3 An individual who the "*Authorised Firm had determined, prior to the establishment of a relationship, had at least $1 million in liquid assets, had provided the Authorised Firm with written confirmation of that fact, appeared to the Authorised Firm, after analysis, to have sufficient financial experience and understanding to participate in financial markets and had consented in writing to being treated as a Client*".

4 DFSA regulated firms can obtain a suitability waiver from Professional Clients in certain circumstances exempting them from the requirement to assess the suitability of particular transactions for these clients. However, it is not permitted for firms to obtain such a waiver from Retail Clients.

financial services in or from the DIFC without DFSA authorisation). As a result, Bank Sarasin cannot enforce any contract against the Claimants and has been ordered to compensate them for their losses.

What does this mean for regulated firms in the DIFC?

The findings against Bank Sarasin have fundamental consequences for the conduct of financial services business in or from the DIFC. The model used by Bank Sarasin, involving a DFSA Category 4 licensed firm (in this case, Sarasin-Alpen) advising on and arranging investments and financial products sold from/booked in a foreign booking centre (that of Bank Sarasin in Switzerland) is popular. More DIFC originated business is booked in foreign locations than in the DIFC. The Court held that individuals employed by Sarasin-Alpen (not by Bank Sarasin) were in fact providing financial services for the unlicensed Bank Sarasin, even though the Claimants never entered the DIFC and Bank Sarasin had no registered presence in the DIFC.

The judge at paragraph 395 held that:

"..*whatever may have been the intentions of those responsible for setting up ...Sarasin-Alpen, the evidence before the Court leads to the conclusion that, in practice, Bank Sarasin dealt with the Claimants through Mr Blonde*[5] *as its own Client Relationship Manager. It was immaterial that Mr Blonde was employed by Sarasin-Alpen; his role vis a vis Bank Sarasin, was indistinguishable from what it would have been if he had been employed by Bank Sarasin. That conclusion, as it seems to me, makes it impossible for Bank Sarasin to maintain that, in its dealing with the Claimants, it was not carrying on activities which constituted a Financial Service in or from the DIFC; and impossible for it to maintain that it was not doing so in breach of the Financial Service Prohibition.*"

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DIFC firms which rely on this model (or something close to it) might consider a review and assessment of their operational and control frameworks to ensure that employees are making a clear distinction between the DFSA Authorised Firm and the booking entity (whether this is a head office in the case of a DIFC branch or a parent company in the case of a DIFC subsidiary). The Court found the use of the word "*we*" by employees of Sarasin-Alpen particularly misleading to the Claimants, in that it suggested both Sarasin-Alpen and Bank Sarasin, one authorised by the DFSA and the other not, were acting through the same employees.

Firms should ensure that no activities are being carried out in or from the DIFC that might be considered to go beyond the activities authorised by their license – especially where the booking entity is structuring a transaction and then dealing in the component products of that transaction for a client who is advised by the DIFC entity. In the case of Sarasin-Alpen, the Court blurred the line between the separately regulated activities of arranging and of dealing in investments and found that the activity of dealing (which requires a higher category of license and is subject to more stringent requirements) was carried out by the DIFC-based employees of Sarasin-Alpen. The specific facts of the case, as pleaded and as substantiated in the judge's view by particular witness testimony, led him to draw the conclusion about the booking entity quoted above from paragraph 395 of his judgment.

Firms must now take care to ensure that activities undertaken in or from the DIFC cannot be confused by clients with those activities that take place in other locations. Client documentation, including the entire suite of documents and processes that make up a firm's on-boarding process for new clients, that explains these structural arrangements with sufficient depth and clarity, is one immediate step to be taken. Putting clients on notice is important. It is the first defensive line to stand behind in the event of clients claiming that they have suffered from mis-selling.

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[5] Original witness name removed following a ruling of the DIFC Court in October 2015.

Authors

Tim Plews
Partner

T: +966 11481 3770

E: tim.plews
@cliffordchance.com

James Abbott
Partner

T: +971 4 362 0608

E: james.abbott
@cliffordchance.com

Philip Jolowicz
Counsel

T: + 971 4 362 0742

E: philip.jolowicz
@cliffordchance.com

Payam Beheshti
Senior Associate

T: +971 4 362 0631

E: payam.beheshti
@cliffordchance.com

Mark Padley
Associate

T: +971 4 362 0619

E: mark.padley
@cliffordchance.com

Ricky Ghosh
Associate

T: +971 4 362 0706

E: ricky.ghosh
@cliffordchance.com