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WHITE PAPER

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Changes to the Regulatory and Prudential Requirements for European Investment Firms

The regulatory and prudential environment for investment firms has recently changed significantly. This is a result of Regulation (EU) 2019/2033 ("IFR") on the prudential requirements of investment firms and Directive (EU) 2019/2034 on the prudential supervision of investment firms ("IFD") (collectively, "IFR/IFD Framework"). Most of the provisions of the IFR will become directly applicable in all Member States on 26 June 2021. By that date the Member States must also implement the IFD. The IFR/IFD Framework categorizes investment firms based on a combination of quantitative criteria with other criteria and introduces major changes in the prudential regime of investment firms based on K-factors.

The IFR/IFD Framework left a great number of issues to be dealt with by the level 2 implementation acts. In this context, this summer the European Banking Authority ("EBA") published a consultation (EBA/CP/2020/06 Consultation Paper on Draft Regulatory Technical Standards related to implementation of a new prudential regime for investment firms dated June 4, 2020) ("Draft RTS") relating to prudential requirements, reporting, and disclosure by investment firms and remuneration issues.

The purpose of this *White Paper* is to outline, in a Q&A format, the main changes stemming from the IFR/IFD Framework and challenges that the firms will be facing in the coming months.

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CLASSIFICATION AND RELATIONSHIP WITH REGULATORS

The IFR/IFD Framework introduces a new classification of investment firms based on their activities, size, and interconnectedness with other financial and economic actors, such classification resulting in differentiated requirements applying to investment firms.

At the early stages of preparation of the IFR/IFD Framework, EBA proposed to categorize investment firms into three categories, which are reflected in the IFR/IFD Framework.

The so-called Class 1 Firms are systemic investment firms or investment firms that are exposed to the same types of risks as credit institutions to which the full Capital Requirements Regulation/Capital Requirements Directives ("CRR/CRD") requirements apply.

Class 2 Firms are other non-systemic investment firms above specific thresholds that should be subject to a more tailored prudential regime based on K-factors as set out in the IFR/IFD Framework.

Class 3 Firms are small and non-interconnected investment firms providing limited services in terms of number and size, to which a very simple regime should apply.

Class 1 Firms

Question 1. What criteria are common to all Class 1 Firms?

Answer. The feature common to all Class 1 Firms is that they carry out the activities of dealing on own account and/or underwriting and/or placing on firm commitment basis ("IFR Services").

Q2. Which firms will be required to apply for a license as a credit institution?

A. Whether a Class 1 Firm will be required to apply for a license as a credit institution will depend on various size and related criteria.

The largest investment firms carrying out the IFR Services and:

- Whose total value of assets at the firm's level on December 24, 2019, is at least €30 billion, or

- Whose total value of consolidated assets on December 24, 2019, is less than €30 billion but the firm belongs to a group where the total value of the consolidated assets of all undertakings of the group that carry out any of the IFR Services is at least €30 billion, or

- The average of monthly total assets, calculated over a period of 12 consecutive months, is at least €30 billion, or

- The average of monthly total assets of the firm, calculated over a period of 12 consecutive months, is less than €30 billion but the firm belongs to a group where the total value of the consolidated assets, calculated as an average over a period of 12 consecutive months, that carry out any of the IFR Services is at least €30 billion,

will be required to apply for a license as a credit institutions and will be subject to the CRR/CRD requirements in the same manner as any credit institution ("Largest Class 1 Firms"). This has a major impact on the existing investment firms that should apply for a license as a credit institution within the time frames set out under the IFR/IFD Framework.

Q3. When should the firm apply for a license as a credit institution?

A. The investment firms that qualified as Largest Class 1 Firms on December 24, 2019, are required to apply for authorization as credit institutions by December 27, 2020. This timeline leaves little time for preparation, and the relevant firms should start preparing their authorization filing without delay.

In other cases, the application for authorization as a credit institution must be made at the latest on the day when the firm crosses the €30 billion threshold, on individual or group level, based on the average monthly total assets calculated over a period of 12 consecutive months.

Q4. When should the firm calculate the €30 billion threshold?

A. The Draft RTS suggest that the monthly calculation would be too burdensome and opts for a quarterly calculation aligned with the frequency of reporting to the regulator for the purposes of monitoring the significance of an investment firm under the IFR/IFD Framework. In this way, the firms will be required to perform the calculations four times a year taking into account the monthly averages.

Q5. How will the €30 billion threshold be calculated?

A. The Draft RTS specify the method of calculation of the €30 billion threshold for the purposes of the categorization of an investment firm as a Largest Class 1 Firm. Pursuant to these Draft RTS, in order to determine whether the €30 billion threshold is crossed on an individual level, the firm should calculate the total value of its assets on the basis of the prudential individual reporting or, if such calculation is not possible, on the basis of the most recent annual IFRS accounts. If the latter is not possible, it will be calculated on the basis of the annual accounts prepared in accordance with applicable local laws.

Q6. When the threshold is calculated at a group level, which entities should be taken into consideration?

A. Pursuant to the Draft RTS, where the total individual value of the assets is less than €30 billion and the firm is part of a group, the test should be carried out at the group level. For these purposes, the threshold is assessed taking into account the value of the consolidated assets of all credit institutions, investment firms, and third-country subsidiaries of the group and which carry out any of the IFR Services ("Consolidation Relevant Firms"). In the case of third-country groups having established branches in the European Union authorized to carry out IFR Services in the European Union, the assets of each EU branch are included in the calculation of the total value of the assets of all undertakings in the groups.

Q7. How will intragroup exposures be dealt with in view of calculating the €30 billion threshold?

A. To avoid double counting of intragroup exposures, the calculation method set out under the Draft RTS basically consists in aggregating the assets of all undertakings in the group carrying out the IFR Services and subtracting intragroup exposures between the Consolidation Relevant Firms. This method allows intragroup exposures to be disregarded when calculating the threshold.

Q8. Are there any restrictions on the carrying out of the IFR Services during the period until the license as a credit institution is obtained?

A. The firm should be able to continue to carry out the IFR Services until it obtains the authorization as a credit institution.

Q9. If a Class 1 Firm does not have to apply for a license as a credit institution, what other requirements will apply?

A. Depending again on the level of their assets, a number of Class 1 Firms that do not qualify as Largest Class 1 Firms will not be required to become licensed as a credit institution but will be subject to CRR/CRD requirements.

Q10. Will the Class 1 Firms with assets between €15 billion and €30 billion be required to apply for a license as a credit institution?

A. No, such firms will remain licensed as investment firms in compliance with MiFID 2 and will not be required to apply for a license as a credit institution.

Q11. To what prudential and governance regimes will the Class 1 Firms with assets between €15 billion and €30 billion be subject?

A. Such investment firms are exempted from almost all the IFR/IFD, subject to the prudential regime stemming from the CRR/CRD Framework.

Q12. What happens if the firm crosses the €30 billion threshold?

A. If the total value of the consolidated assets of the investment firm calculated as an average of the previous 12 months, on individual or group level, reaches the €30 billion threshold, the investment firm would be required to:

- Notify the breach to its competent authority without undue delay; and
- Apply for a license as a credit institution.

Q13. Under what circumstances may a competent regulator decide to subject an investment firm to the CRR/CRD prudential regime?

A. Competent authorities may decide to subject an investment firm to the CRR/CRD prudential requirements when such firm carries out IFR Services, provided that the total value of the consolidated assets of the firm, calculated as an average of the previous 12 months, is €15 billion or more and one of the following conditions is satisfied:

a) The firm carries out IFR Services on such a scale that the failure or the distress of the investment firm could lead to systemic risk; or

b) The firm is a clearing member. Pursuant to the Draft RTS, this criterion should apply when the firm effectively provides clearing services to entities that are not clearing members; or

c) The competent authority decides that the firm should be subject to CRR/CRD Framework in light of its size, nature, scale, and complexity of its activities, taking into account the following factors:

   - the importance of the investment firm for the economy of the Union or the relevant Member State;
   - the significance of the investment firm's cross-border activities; and
   - the interconnectedness of the investment firm with the financial system.

The criteria mentioned in (c) above provide room for judgment from the competent authorities; as such, factors are not related to any quantitative limits.

Q14. What will be the level of discretion of the competent regulators to subject a firm to the prudential framework of CRR?

A. The EBA Consultation Paper on the Draft RTS stresses that the conditions relating to the size, nature, scale, and complexity of activities of the investment firm leave room for judgment from the regulator, who can use indicators or a combination of indicators as long as these relate to the size, nature, scale, and complexity of the activities of the firm. Whereas the discretion of the regulator in respect of the conditions set out in (a)[1] and (b) of Q13 above is limited by quantitative or objective factors, the discretion of the regulator in determining whether the condition in (c) above is satisfied clearly has a subjective or discretionary element.

Q15. What is meant by carrying out "activities on such a scale that the failure or the distress of the investment firm could lead to systemic risk"?

A. The Draft RTS provide four quantitative thresholds to specify when a firm carries out its activities on such a scale that the failure or distress of the firm could lead to systemic risk. Such thresholds were inspired by the indicators of the EBA Guidelines on criteria for the assessment of other systemically important institutions ("O-SIIs"). The four thresholds set out under the Draft RTS are the following:

- Total gross notional value of non-centrally cleared OTC derivatives is equal to or more than €50 billion;
- Total value of underwriting and/or placing on a firm commitment basis is equal to or more than €5 billion;
- Total value of granted credits or loans to investors in relation to transactions is equal or more than €5 billion; and
- Total value of debt securities outstanding of €5 billion.

Q16. Firms that elect to be subject to the CRR/CRD prudential framework: What criteria will be used to authorize a firm to apply the CRR/CRD prudential framework?

A. Under the IFR/IFD Framework, some investment firms may elect to apply the CRR/CRD prudential framework.

In order to facilitate the application of prudential requirements for investment firms that are part of banking groups and to avoid disrupting certain business models whose risks are already covered by the application of prudential rules, investment firms may opt for the application of the CRR/CRD Framework, provided that they satisfy certain conditions set out under the IFR/IFD Framework. The decision of the firm to apply for such authorization should not be driven by regulatory arbitrage purposes. Please refer to the summary table of Class 1 Firms below for further details on such conditions.

Q17. Are there any steps to be taken by a firm willing to be subject to the CRR/CRD prudential framework to be authorized to apply such framework?

1 Please refer to the following question for further details on the definition of the condition in paragraph (a).

A. Yes, the firm will need to notify its competent authority as well as the consolidating supervisor, if relevant.

Q18. How will the average of the €15 billion and €5 billion thresholds over the 12 consecutive months be calculated?

A. To the extent that the IFR/IFD Framework does not give a mandate to the EBA to clarify the methodology of calculation of the €15 billion or €5 billion thresholds, the Draft RTS do not deal with this matter. At this stage, one can only speculate that the same methodology, or at least a similar methodology to the one developed in the Draft RTS in respect of the crossing of the €30 billion threshold, could also apply for the purposes of calculating the €15 billion or €5 billion thresholds.

Q19. What should happen when the Class 1 Firm criteria are no longer satisfied?

A. Where the firm no longer satisfies the criteria set out under the IFR/IFD Framework to be subject to the CRR/CRD prudential requirements, the firm is required to notify the competent authority without undue delay. Such firm will become subject to the IFR/IFD Framework.

Q20. Considering that these firms will be subject to CRR/CRD framework, to what extent does the IFR/IFD Framework apply to these firms?

A. Class 1 Firms with total value of assets of at least €30 billion should not be subject to the IFR/IFD Framework. For other Class 1 Firms subject to the CRR/CRD prudential regime, only certain provisions of the IFR/IFD Framework will apply to them. Please refer to the summary table of Class 1 Firms below for further details on the relevant provisions of the IFR/IFD Framework.

Summary of Class 1 Firms and the Applicable Regime

The table below sets out a summary of the investment firms that will or may become Class 1 Firms and the rules to which they will be subject. The provision of IFR Services is a common condition to all scenarios set out in the table below.

	Applicable Criteria	License and Applicable Regime
Direct application of CCRR/CRD	Where the total value of assets of the firm on December 24, 2019, is at least €30 billion, *or* Whose total value of consolidated assets on December 24, 2019, is less than €30 billion but the firm belongs to a group where the total value of the consolidated assets of all undertakings of the group that carry out any of the IFR Services is at least €30 billion; *or* The average of monthly total assets, calculated over a period of 12 consecutive months, is at least €30 billion; *or* The average of monthly total assets of the firm, calculated over a period of 12 consecutive months, is less than €30 billion but the firm belongs to a group where the total value of the consolidated assets, calculated as an average over a period of 12 consecutive months, that carry out any of the IFR Services is at least €30 billion.	Must obtain a license as a credit institution. CRR/CRD Framework applies.
	Investment firms whose total value of the consolidated assets at the individual or group level (i.e., total assets of all undertakings within the group carrying out IFR Services, excluding the assets of subsidiaries established outside the EU), are at least equal to €15 billion.	Remains licensed as an investment firm under MiFID 2. CRR/CRD governance and prudential requirements apply + IFR/IFD Framework initial capital requirements and reporting to the regulators requirements.
Discretionary designation by the competent authority	Consolidated assets of the investment firm are equal to or more than €5 billion calculated as an average of the previous 12 months; *and* The firm carries out IFR Services on such a scale that the failure or the distress of the investment firm could lead to systemic risk; *or* The firm is a clearing member; *or* The competent authority decides that the firm should be subject to the CRR/CRD Framework in light of its size, nature, scale, and complexity of its activities.	
Election by the firm	All of the following conditions must be met for the election to be available: The firm is part of a group including a credit institution and is supervised on a consolidated basis by such credit institution/financial holding company/mixed financial holding company; and The competent authority is satisfied that the election is prudentially sound, does not reduce the own funds requirements of the investment firm, and is not used for the purposes of regulatory arbitrage; and The firm notifies the competent authority of its request to benefit from the election.	Remains licensed as an investment firm under MiFID 2 CRR/CRD governance and prudential requirements apply + IFR/IFD Framework initial capital requirements

Class 2 Firms

Q21. Which investment firms are categorized as Class 2 Firms?

A. Class 2 Firms are investment firms that are neither Class 1 Firms nor do they satisfy the criteria set out under the IFR/IFD Framework to qualify as a small and non-interconnected investment firm within the meaning of the IFR/IFD Framework.

Q22. What prudential regime will apply to the Class 2 Firms?

A. Class 2 Firms will be subject to the full IFR/IFD Framework prudential regime.

Class 3 Firms

Q23. Which investment firms are categorized as Class 3 Firms?

A. Class 3 Firms are small and non-interconnected investment firms, being those that satisfy the criteria for a small and non-interconnected investment firm set out under the IFR/IFD Framework and that have obtained an exemption by their competent authority from compliance with certain provisions of the IFR/IFD Framework. Such firms will be subject to the IFR/IFD Framework but can be exempted from various requirements under the IFR/IFD Framework, including the K-factor requirements, concentration risk, liquidity requirements, and disclosure and reporting requirements.

PRUDENTIAL REGIME UNDER IFR/IFD FRAMEWORK

Q24. Why has the European Union changed its prudential framework for investment firms?

A. Despite the highly calibrated approach underlying the determination of regulatory capital of the Basel framework, it is tailored to banking business whose core elements are lending and deposits. Since many investment firms' business models do not carry any substantial credit risk, large parts of the CRD/CRR are irrelevant for them. More importantly, the methods determining the regulatory capital largely provide financial stability as banks usually hold deposits and provide other systemically important functions such as payment services or securities custody. With rather few exceptions, however, investment firms do not carry financial stability risks comparable to credit institutions.

Q25. Is this revision of the prudential rules for investment firms good or bad?

A. While a new legal or regulatory approach is usually burdensome in terms of implementation, the IFR may open relevant room for maneuver when it comes to optimizing the applicable own funds ratio compared to the CRR, particularly in light of the explicit goal of the IFR to provide (more) appropriate and proportionate methods. Technically, the IFR aims at correcting imprecisions of the CRR (Pillar 1), avoiding the need for heavy capital add-ons in the Supervisory Review and Evaluation Process (SREP/Pillar 2). For a growing number of firms, a benefit may be that the new rules also take account of environmental and social objectives for prudential purposes.

Q26. From a prudential perspective, what are the key steps that investment firms should take already in the run-up to IFD/IFR?

A. Step 1: Review of consolidation options

- As a first step, investment firms should assess whether the IFR allows for new consolidation or provides for continuation of current consolidation, including the new "group capital test." The EBA will soon publish draft RTS on methods of prudential consolidation.

Step 2: Classification of company according to its risk profile

- The second step should be a determination of the applicable regime for the calculation of own funds, which depends on qualifying either as a Class 1, 2, or 3 Firm. If the aim is to qualify as small and non-interconnected, companies should apply due care. For an investment firm not satisfying the requirements of small and non-interconnected, a monitoring phase can be provided where the company must stay below the relevant threshold for at least six consecutive months.

Step 3: Transformation of CRD/CRR risk classifications into "K-factors"

- Investment firms, unless small and non-interconnected, must revise their calculation of prudential own funds by reference to the new “K-factors” (quantitative factors that represent risks that an investment firm can pose), which include Risk-to-Client (“RtC”), Risk-to-Market (“RtM”), and Risk-to-Firm (“RtF”). This means a transfer of the current risk categories into this new system.

Step 4: Application of the K-factors

- Once the firm’s relevant risks have been successfully allocated to the K-factors, it should be assessed how to achieve the most favorable outcome.

Step 5: Assessment of the K-factors against the fixed overheads and the permanent minimum capital

- As the formula for calculating the own funds ratio requires that the denominator be set as the highest of: (i) the fixed overheads requirement, (ii) the permanent minimum capital requirement, or the (iii) K-factor requirement, each of these figures must be calculated.

Step 6: Preparing for a beneficial K-factor adjustment through assessing and defining activities with environmental or social objectives

- The EBA is assessing whether a dedicated prudential treatment of assets exposed to activities associated substantially with environmental or social objectives, in the form of adjusted K-factors or adjusted K-factor coefficients, would be justified.

Q27. What exactly are the K-factors, and how does a firm get to the applicable capital requirement?

A. The overall own funds requirement under the K-factors is the sum of the requirements of the K-factors under RtC, RtM, and RtF. The IFR subdivides them into categories that are more granular.

- The RtC K-factors capture:

- Client assets under management and ongoing advice (“K-AUM”)

- Client money held (“K-CMH”)

- Assets safeguarded and administered (“K-ASA”)

- Client orders handled (“K-COH”)

The RtM K-factor captures:
- Net position risk (“K-NPR”) in accordance with the CRR market risk provisions, or

- Where permitted for specific types of investment firms, which deal on own account through clearing members, based on the total margins required by an investment firm’s clearing member (“K-CMG”).

It will be possible to apply K-NPR and K-CMG simultaneously on a portfolio basis.

The RtF K-factors capture:
- An investment firm’s exposure to the default of their trading counterparties (“K-TCD”) in accordance with the CRR’s simplified provisions for counterparty credit risk

- Concentration risk in an investment firm’s large exposures to specific counterparties based on the CRR large exposures provisions in the trading book (“K-CON”), and

- Operational risks from an investment firm’s daily trading flow (“K-DTF”)

K-AUM, K-ASA, K-CMH, K-COH, and K-DTF relate to the volume of activity referred to by each K-factor. The volumes for K-CMH, K-ASA, and K-DTF are calculated on the basis of a rolling average from the previous nine months. The volume for K-COH is calculated on the basis of a rolling average from the previous six months, while for K-AUM, it is based on the previous 15 months. The volumes are multiplied by the corresponding coefficients set out in the IFR in order to determine the own funds requirement.

The own funds requirements for K-NPR are derived from the CRR, while the own funds requirements for K-CON and K-TCD use a simplified application of the corresponding requirements under the CRR for, respectively, the treatment of large exposures in the trading book and of counterparty credit risk.

The amount of a K-factor is zero if an investment firm does not undertake the relevant activity.

GOVERNANCE AND REMUNERATION

Q28. What firms will be subject to the governance and remuneration rules under the IFR/IFD Framework?

A. All Class 2 Firms will be subject to the full IFR/IFD Framework regime, including the governance and remuneration rules, unless they can benefit from exemptions provided for under the IFD. Smaller Class 2 Firms whose on- and off-balance-sheet assets on average over the four-year period immediately preceding the given financial year are equal to or below €100 million ("Small Class 2 Firms") may not be required to set up a risk committee and a gender-neutral remuneration committee. Furthermore, Small Class 2 Firms will not be required to: (i) issue at least 50% of variable pay in non-cash instruments; (ii) defer a proportion of variable pay for three to five years; or (iii) retain the discretionary pension benefits in respect of retiring employees for those employees whose annual variable remuneration does not exceed €50,000 and does not represent more than one quarter of that employee's total annual remuneration.

Class 1 Firms will be subject to the CRR/CRD Framework requirements, whereas Class 3 Firms will remain subject to MiFID 2 remuneration and governance requirements.

Q29. What governance requirements will the firms be subject to?

A. The IFR/IFD Framework provides that investment firms should have robust governance arrangements including all of the following:

- A clear organizational structure with well-defined, transparent, and consistent lines of responsibility;
- Effective processes to identify, manage, monitor, and report the risks that investment firms are or might be exposed to, or the risks that they pose or might pose to others;
- Adequate internal control mechanisms, including sound administration and accounting procedures; and
- Remuneration policies and practices that are consistent with and promote sound and effective risk management.

It further requires that the remuneration policies and practices referred to in point of the investment firm be gender neutral. The EBA, in consultation with the ESMA, is still expected to issue guidelines on gender-neutral remuneration policies.

Q30. What remuneration requirements will the firms be subject to?

A. The IFR/IFD Framework provides for a number of principles with which the remuneration policy of the investment firm should comply. The investment firms should already be familiar with and apply many of those principles. Under the IFR/IFD Framework, investment firms will be required to comply with the following principles when establishing and applying their remuneration policies for the risktakers[2]:

- Remuneration policy is clearly documented and proportionate to the size, internal organization, and nature, as well as to the scope and complexity, of the activities of the investment firm;
- Remuneration policy is gender neutral;
- Remuneration policy is consistent with and promotes sound and effective risk management;
- Remuneration policy is in line with the business strategy and objectives of the investment firm, and also takes into account long-term effects of the investment decisions taken;
- Remuneration policy contains measures to avoid conflicts of interest, encourages responsible business conduct, and promotes risk awareness and prudent risktaking;
- Investment firm's management body in its supervisory function adopts and periodically reviews the remuneration policy and has overall responsibility for overseeing implementation;
- Implementation of the remuneration policy is subject to a central and independent internal review by control functions at least annually;

2 For further details on categories of staff that should be considered as risktakers please, refer to the following question.

- Staff engaged in control functions are independent from the business units they oversee, have appropriate authority, and are remunerated in accordance with the achievement of the objectives linked to their functions, regardless of the performance of the business areas they control; and

- Remuneration of senior officers in the risk management and compliance functions is directly overseen by the remuneration committee or where such committee has not been established by the management body.

Taking into account national rules on wage setting, the remuneration policy makes a clear distinction between the criteria to determine the following:

- Basic fixed remuneration, which primarily reflects relevant professional experience and organizational responsibility as set out in an employee's job description as part of their terms of employment; and

- Variable remuneration, which reflects a sustainable and risk-adjusted performance of the employee, as well as performance in excess of the employee's job description.

Fixed component represents a sufficiently high proportion of the total remuneration so as to enable the operation of a fully flexible policy on variable remuneration components, including the possibility of paying no variable remuneration component.

Q31. What categories of employees of the investment firm will be subject to the remuneration policies?

A. Under the IFR/IFD Framework, the remuneration policies apply to the senior management, risktakers, staff engaged in control functions, and employees receiving overall remuneration equal to at least the lowest remuneration received by senior management or risktakers, whose professional activities have a material impact on the risk profile of the investment firm or of the assets that it manages (further referred to as " risktakers").

The Draft RTS specify qualitative—which refer to specific categories of positions—and quantitative criteria—minimum amount of annual remuneration for the preceding financial year—that the investment firms will be required to apply to identify categories of risktakers. Among the qualitative criteria, the Draft RTS refer to staff members whose managerial responsibility for a business unit that contributes to more than a certain percentage of the investment firm's total own funds requirement at the end of the preceding financial year. In its consultation relating to the Draft RTS, the EBA seeks feedback on the appropriate percentage of own funds to determine that a business unit has a material impact on the risk profile of the investment firm. The materiality threshold proposed in the Draft RTS refers to 10% or 20% of the investment firm's total own funds.

Q32. What arrangements can be considered as appropriate for the purposes of variable remuneration?

A. Under the IFR/IFD Framework, investment firms must comply with a number of requirements relating to the remuneration of the risktakers. Such requirements will apply from January 26, 2021. These requirements are quite similar to the requirements under the CRR/CRD Framework.

Furthermore, the IFR/IFD Framework requires that at least 50% of the variable remuneration consists of certain instruments, including Additional Tier 1 instruments or Tier 2 instruments or Other Instruments that can be fully converted to Common Equity Tier 1 instruments or written down and that adequately reflect the credit quality of the investment firm as a going concern.

The Draft RTS set out the conditions for the classes of additional Tier 1 (AT 1), Tier 2, and Other Instruments that are appropriate to be used for variable remuneration. Such conditions take their inspiration from the Delegated Regulation 527/20149 applicable under the CRR/CRD Framework but provide for additional flexibility to the investment firms. The purpose of these rules is to link the value of instruments awarded as variable remuneration and the credit quality of the firm so as to incentivize the risktakers for prudent and long-term oriented risktaking.

The IFR/IFD Framework further provides that by way of derogation, where an investment firm does not issue any of the AT 1, Tier 2, and Other Instruments mentioned above, competent authorities may approve the use of alternative arrangements fulfilling the same objectives. The Draft RTS specify such possible alternative arrangements. Pursuant to the Draft RTS, alternative arrangements that may be used by investment firms for the purposes of variable remuneration of risktakers must comply with the following conditions:

- The alternative arrangement contributes to the alignment of the variable remuneration with the risk profile of the investment firm;

- The alternative arrangement allows the application of deferral and retention of the amounts of variable remuneration received;

- The amount received under an alternative arrangement and the applicable conditions, including the application of deferral and retention, are well documented and transparent to the staff member receiving variable remuneration under such arrangements;

- For amounts received under deferral and retention arrangements, the alternative arrangement ensures that staff cannot access, transfer, or redeem the deferred part of variable remuneration;

- The alternative arrangement is subject to an appropriate retention policy designed to align the incentives of the individual with the longer-term interests of the investment firm, its creditors, and clients. The retention period must be at least six months;

- The alternative arrangement does not foresee the increase of the variable remuneration received during deferral periods by interest payments or other similar arrangements other than by arrangements that fulfil certain conditions;

- Where the alternative arrangement allows for predetermined changes of the value received as variable remuneration during deferral and retention periods, based on the performance of the investment firm or the managed assets, the following conditions must be met:

  - The change of the value is based on predefined performance indicators that are based on the credit quality of the institution or the performance of the managed assets;

  - Value changes should be calculated at least annually and at the end of the retention period;

  - The rate of possible positive and negative value changes should equally be based on the level of positive or negative credit quality changes or performance measured;

  - Where the value change is based on the performance of assets managed, the percentage of value change should be limited to the percentage of value change of the managed assets;

  - Where the value change is based on the credit quality of the investment firm, the percentage of value change should be limited to the percentage of net revenue in relation to the investment firms total own funds; and

- The alternative arrangement does not hinder the application of the requirements under the IFR/IFD Framework that up to 100% of the variable remuneration must be contracted where the financial performance of the investment firm is subdued or negative, including through *malus* or clawback arrangements.

In any case, under the Draft RTS, any alternative arrangements must be first approved by the competent authority of an investment firm before they can be used by the investment firm.

Q33. Will the investment firms be required to set up a remuneration committee?

A. Yes, under the IFR/IFD Framework, similarly to the requirements that apply under the CRD/CRR Framework, the investment firms are required to set up a remuneration committee, unless they can benefit from an exemption provided from under the IFD. Please refer to the answer in Q28 in respect of such exemption.

Q34. To what disclosure and reporting requirements will the firms be subject?

A. Investment firms will be required to publicly disclose a variety of information, including in particular in respect of the remuneration policies, risk management objectives and policies, governance, own funds, investment policy, and environmental, social, and governance risks.

The Draft RTS provide for a set of templates and instructions for both Class 2 and Class 3 Firms in relation to the reporting on different items, including in particular on the information to be provided to allow the competent authorities to monitor the thresholds triggering classification of the firms into one or another category, i.e., Class 1 Firms, Class 2 Firms, and Class 3 Firms.

Investment firms that have branches or subsidiaries in EU Member States or in third countries other than the country in which the investment firm has obtained its license that is a financial institution will be required to disclose, on a country-by-country basis, certain information relating to its branches and subsidiaries. The information to be provided relates to the identification of the branches and subsidiaries, their activities, their turnover, the number of employees, profit or loss before tax, tax on profit or loss, as well as the public subsidies perceived.

Furthermore, similar to the reporting requirements under the CRR/CRD Framework, the investment firms will be required to provide to their competent regulators certain information relating to the remuneration of the risktakers. More specifically, investment firms will be required to provide reporting on the number of natural persons that are remunerated at least €1 million per financial year and on their job responsibilities, the business area involved, and the main elements of salary, bonus, long-term award, and pension contribution.

Furthermore, they can be required to provide to their competent authority, on demand, the total remuneration figures for each member of the management body or senior management.

THIRD-COUNTRY GROUPS

Q35. Why would third-country firms be affected by the IFR/IFD Framework?

A. The IFR/IFD Framework is part of an EU package that implements earlier announcements of the EU Commission to amend a number of EU rules (including EMIR and Benchmarks Regulation) relating to the access of third-country firms to the EU Member States.

The IFR/IFD Framework introduces requirements in relation to the supervision of investment firms with parent undertakings in third countries.

The IFR/IFD Framework also introduces amendments to MiFIR provisions relating to equivalence decisions taken by the Commission concerning third country jurisdictions.

Q36. When may the regulator require the establishment of an investment holding company or mixed financial holding company in the Union?

A. Under the IFR/IFD Framework, where two or more EU investment firms are subsidiaries of a third-country parent undertaking, the Member States are required to ensure that when such EU investment firms are not subject to effective supervision at the group level, the competent authority assesses whether the investment firm is subject to supervision by the third-country supervisor and whether such supervision is equivalent to the supervision under the IFR/IFD Framework.

If, further to its assessment, the competent authority concludes that no such equivalent supervision applies, the Member States must allow for appropriate supervisory techniques that achieve the objectives of supervision in accordance with the IFR/IFD Framework. Among such arrangements, the IFR/IFD Framework provides for a possibility for the competent authority to require the establishment of an investment holding company or mixed financial holding company in the European Union. Such supervisory techniques would be decided by the competent authority that would have been the group supervisor had the parent undertaking been established in the European Union, after consultation with the other competent authorities involved.

Similarly, an equivalent provision has been introduced in respect of EU credit institutions into CRD IV by the Directive EU no. 2019/878. These provisions prescribe the application of the CRR and CRD IV provisions to subsidiaries of the same third-country undertaking, provided that the same configuration applies (i.e., two or more institutions in the Union, which are part of the same third-country group).

Q37. How will the regulators decide whether a firm belonging to a third-country group is subject to effective supervision at group level?

A. The requirement is set out in the IFD, which imposes this obligation on the EU Member States without giving any details as to the criteria to be taken into account to carry out the assessment of whether the investment firm is or is not subject to effective supervision at group level. The EBA has not received a mandate to specify such criteria. This means that at this stage, it is not clear whether such criteria will be determined at the level of each Member State in the course of implementation of the IFD into their local legislation.

BREXIT-RELATED ISSUES

Q38. The Brexit transitional period is expected to end on 31 December 2020, before the IFD/IFR is due to come into force. What approach is the United Kingdom taking to implementing the IFR/IFD? Will the United Kingdom copy and paste EU rules?

A. The FCA released a Discussion Paper in June 2020 setting out its detailed thoughts on how to implement the IFR/IFD Framework.

There is no indication that the FCA intends to deviate from the EU texts on the basis that:

- The United Kingdom supports having a prudential regime specifically designed for investment firms.
- With Brexit negotiations ongoing, the United Kingdom will presumably want to remain closely aligned for the purposes of equivalence determinations.
- As such, the FCA's approach is very similar to what it would have taken if it were still a member of the European Union and fully bound by the IFR/IFD Framework.

Q39. Has the UK FCA given any indication of whether it intends to make use of the various national competent authority ("NCA") discretions set out in the IFR/IFD?

A. Yes. A detailed Discussion Paper was issued in June 2020. This sets out the FCA's current thinking on IFD/IFR implementation but also specifically addresses NCA discretions.

One area to mention is that (as has been seen before regarding EU vs. UK remuneration debates) the FCA currently intends to seek to apply discretions that would limit the scope and scale of remuneration requirements, and to offer flexibility where permitted to do so.

It should be noted that the FCA appears content to operate within the boundaries set for NCAs, so it is operating as if it were still fully bound by the EU texts.

LAWYER CONTACTS

Philippe Goutay
Paris
+33.1.56.59.3939
pgoutay@jonesday.com

Aidan E. Lawes
London
+44.20.7039.5700
alawes@jonesday.com

Michael R. Fischer
Frankfurt
+49.69.9726.3943
mrfischer@jonesday.com

Martin Schulte
Frankfurt
+49.69.9726.3939
schulte@jonesday.com

Olga Goncharska
Paris
+33.1.56.59.46.14
ogoncharska@jonesday.com