INVESTMENT FIRMS

A new Prudential framework

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EXECUTIVE SUMMARY

What is it?

The EU has finalised and issued a new framework for the prudential regulation of investment firms. It will set new classification for investment firms that will in turn determine which of the new capital requirements apply to them. The framework will also set governance and remuneration requirements. As a broad overview:

- Class 1 firms will remain subject to the current CRD IV/CRR framework (as amended by CRD V/CRR II);
- Class 2 firms will become subject to the new requirements in full (including prudential requirements, remuneration and governance rules);
- Class 3 firms will be put under a less stringent 'lighter' regime within the new framework (eg no need to calculate K-factors with respect to prudential requirements).
- What form does it take? As with much recent EU financial services legislation, the framework takes the form of a Regulation and a Directive. Level 2 measures (such as regulatory technical standards) and guidance setting out the detail are scheduled to follow prior to implementation.

Who does it apply to?

It will apply to all MiFID II investment firms. It may also impact the capital requirements of other types of firms such as AIFMs and UCITS management companies.

When does it take effect? The framework will apply 18 months from its date of entry into force. EU financial services legislation ordinarily has a two year lead-in, so firms have six months less than they are used to.

What should firms do now?

Given the short timescale until implementation, affected firms should assess which new category they will fall into. They should start to compile the information necessary to assess their new capital requirements, as well as consider what impact these changes may have on their governance and remuneration policies. Some firms may also want to consider engaging in group reorganisations in advance of these changes.

What impact will Brexit make?

As this is new (rather than updating existing) EU legislation, the UK would need to decide whether to apply equivalent rules on UK firms following Brexit. The current expectation is that in-flight EU legislation would be implemented into UK law regardless. However, the UK political situation remains in flux at the time of writing, so this should be monitored by UK investment firms. Nonetheless, UK firms should work on the assumption that similar standards will likely be adopted by the UK. Furthermore, the wide reach of the rules means that firms with EU27 groups are likely to be subject to the framework at group level

INTRODUCTION

After nearly five years in the making, the European Union has now finalised an extensive new framework for the prudential regulation of investment firms. The new framework will establish a new set of classifications and capital requirements for investment firms, as well as impose governance and remuneration requirements. For most investment firms, this new framework will replace the requirements currently imposed upon them by CRD IV/CRR.

The framework takes the form of a new Investment Firms Regulation ("**IFR**") and a new Investment Firms Directive ("**IFD**"). The objectives of the new IFD/IFR framework are (amongst others) to set more calibrated requirements for the risk profiles of investment firms and to avoid undue administrative burden on investment firms.

This article discusses the key requirements under the new framework and their potential impact. Note that Member States are given various discretions when adopting their local implementing legislation and such discretions are outside the scope of this article. This article is based on the texts of the IFR/IRD published in October 2019 by the Council of the European Union.

BACKGROUND TO THE REFORMS

The process began with a call for advice from the European Commission to the European Banking Authority ("**EBA**") in December 2014. The EBA made its initial recommendations 12 months later in a report (EBA/Op/2015/20) published in December 2015. It subsequently issued an opinion (EBA/Op/2017/11) in September 2017 where the EBA called for a "fundamental change" to the prudential regime currently applicable to investment firms. The European Commission issued its proposals and draft legislation in December 2017. The legislation was then agreed at a political level prior to the European Parliament elections that took place in May 2019. On 8 November 2019, the Council announced that it had adopted the IFD and IFR. The framework is expected to be published in the Official Journal soon.

SCOPE

Investment firms

The new IFD/IFR package applies to EU investment firms authorised under the Markets in Financial Instruments Directive 2014/65/EU ("**MiFID II**"). In other words, "investment firms" for these purposes exclude EU credit institutions (such as banks and building societies) but include firms such as securities broker-dealers, investment advisors and investment managers. In the UK, these firms are currently known as "IFPRU firms" and "BIPRU firms".

With respect to investment management, only individual (as opposed to collective) portfolio management falls within MiFID II. Therefore, alternative investment fund managers (such as hedge fund managers) authorised under the Alternative Investment Fund Managers Directive 2011/61/EU and management companies of undertakings for the collective investment in transferable securities ("**UCITS**") authorised under the UCITS Directive 2009/65/EU are not "investment firms" for these purposes and are accordingly outside the scope of the new framework. However, note that AIFMs and UCITS management companies will still need to consider the impact of these changes on their own capital requirements as references to CRD IV/CRR in the AIFMD and UCITS Directive will now be construed as references to the new IFD/IFR.

Investment firms are currently subject to the prudential framework under the Capital Requirements Directive 2013/36/EU ("**CRD IV**") and the Capital Requirements Regulation (EU) 575/2013 ("**CRR**"). Subject to the local implementation of the CRD IV/CRR framework, certain investment firms may instead be currently subject to the CRD III prudential framework (eg BIPRU firms in the UK).

Note CRD IV and CRR have been amended by CRD V and CRR II, respectively, and some of the provisions in CRR II have taken effect since June 2019. As the CRD V/CRR II amendments are essentially relevant to credit institutions only, this article thus does not discuss such changes and, to avoid potential confusion, this article continues to make references to CRD IV/CRR.

New categorisation

Under the IFD/IFR framework, investment firms are categorised into three "classes". The application of the new requirements will therefore differ depending on which of these classes an investment firm falls into.

The three classes can be summarised as follows:

Class 1

In summary, class 1 firms are investment firms that meet both of the following conditions:

- it carries out one or both of the following MiFID II investment activities: dealing on own account (ie proprietary trading) and underwriting/placing on a firm commitment basis; and
- it has total assets exceeding EUR15 billion;

  or

- where its total assets are below EUR15 billion, it is part of a group where the total consolidated assets of all group entities that perform dealing on own account and/or underwriting on a firm commitment basis (with each such group entity individually having assets below EUR15 billion) exceed EUR15 billion.

Class 1 firms will remain within the current CRD IV/CRR prudential framework (excepted for a limited number of requirements such as reporting).

A firm that would otherwise fall within class 1 but which has total assets exceeding EUR30 billion under condition (ii) above will be re-categorised as a "credit institution" under the CRD IV/CRR framework. Such firms which are considered "systemically important" or "bank-like" will be required to become re-authorised as credit institutions under the CRD IV/CRR framework instead (at which point they will no longer be "investment firms"). Systematically important firms caught in this category will have a transition period in which to obtain their re-authorisation and may continue to carry on their investment business under its current MiFID II authorisation until it obtains the re-authorisation under CRD IV.

Class 2

Class 2 firms are those that are neither class 1 nor class 3. This class is the primary target of the framework and are subject to the new framework in its entirety.

Class 3

Class 3 firms are referred to as "small and non-interconnected investment firms". These are firms that meet each of a set of specified criteria including:

- AUM (asset under management) must be below EUR1.2 billion;
- COH (client orders handled) must be below either EUR100 million/day (cash trades) or EUR1 billion/day (derivatives);
- ASA (assets safeguarded and administered), CMH (client money held), DTF (daily trading flow) and TCD (trading counterparty default) must be 0;
- NPR (net position risk) or CMG (clearing margin given) must be 0;
- on/off-balance sheet total must be below EUR100 million; and
- -total annual gross revenue from MiFID II activities must be below EUR30 million.

Class 3 firms are also subject to the new framework but the requirements are less stringent (as compared with those applicable to class 2 firms).

Rationale for new categorisation

The new categorisation reflects the perceived systemic significance of an investment firm. By contrast, the current categorisation of investment firms under the CRD IV/CRR framework is made by reference to the particular investment services/activities a firm undertakes, which is one of the features that was criticised by the EBA in its 2015 report. The EBA identified (in its 2015 report) 11 different types of investment firms in accordance with only the wording in the CRD IV/CRR. In other words, individual Member States may have had more than those 11 types of investment firms depending on their own local implementation measures. Consequently, it is difficult to "map" the new classes to the existing categories of investment firms. Firms should instead individually assess the new class that they are likely to fall into.

In the UK, a small number of systemically significant IFPRU firms are dual-regulated by the Financial Conduct Authority ("**FCA**") and the Prudential Regulation Authority ("**PRA**"). These firms may likely fall within class 1 under the new framework. However, there may also be other large IFPRU firms that are currently solo-regulated by the FCA but which will also fall within class 1. Certain of these firms will need to re-apply to become credit institutions under the new framework and cease to be investment firms.

BIPRU firms and most remaining IFPRU firms are likely to fall within either class 2 or class 3, with a significant portion of BIPRU firms likely falling within class 3.

As class 1 firms (and those which must be re-authorised as credit institutions) will largely remain subject to the current CRD IV/CRR framework, the following sections of this article focus on class 2 and class 3 firms.

CAPITAL REQUIREMENTS

Prudential consolidation

The IFD/IFR introduces a special regime for investment firm only groups (ie no credit institutions in the group) with a group structure that is deemed sufficiently simple and that, as a whole, poses no significant risks to clients/market. For such groups, the parent company may be allowed to hold capital to cover the full book value of its holdings in the subsidiaries.

Initial capital

The IFD/IFR increase the initial capital requirement on firms. This is the amount of capital that a firm must hold at the time of its authorisation and which sets the base level below which its "own funds" (ie on-going capital requirement) must not fall at any time thereafter. This is also referred to as the "permanent minimum capital requirement" in the IFD/IFR.

Note that the initial capital requirements apply to all three classes of investment firms.

EUR750,000

Investment firms that carry out both dealing on own account and underwriting on a firm commitment basis must have an initial capital of EUR750,000.

An investment firms that operates an OTF and can or is permitted to deal on own account falls within this category as well.

EUR150,000

This applies to investment firms that do not fall within either of the other two categories here.

EUR75,000

This applies to investment firms that provide one or more of the following MiFID II services/activities: reception and transmission of orders; execution of orders for clients; portfolio management; investment advice; and placing without a firm commitment basis.

Accordingly, the new requirements see an increase from the (roughly) corresponding levels under the current framework (€730K, €125K and €50K). Most of the current MiFID firms' own funds requirements (as calculated under the CRD IV/CRR framework) would likely exceed their minimum/initial capital. Accordingly, the increases may have little practical impact.

Note that for those firms that need to be re-authorised as credit institutions, their initial capital will become EUR5 million under CRD IV (subject to the local implementation in the relevant EU member state).

Own funds

The "own funds" requirement is commonly known as the on-going capital requirement. This is the capital a firm must maintain on an ongoing basis throughout its life as a regulated investment firm.

Generally, the own funds requirement under the IFD/IFR is calculated by reference to a set of quantitative factors known as "K-factors". There are three K-factors representing three different types of identified risks that a firm is perceived to pose: Risk to Customers ("**RtC**"); Risk to Market ("**RtM**"); and Risk to Firm ("**RtF**"). Each group of K-factors must be calculated in accordance with its specified methodology.

A class 2 firm must maintain own funds that equal to the highest of the following:

→ its "fixed overhead requirement" (ie one quarter of its fixed overheads in the preceding year);

→ its "permanent minimum capital requirement" (ie its initial capital requirement); and

→ its "K-factor requirement" (ie the sum of each K-factor multiplied by a prescribed coefficient).

A class 3 firm's own funds requirement is the higher of those first two requirements. In other words, a class 3 firm only needs to calculate its fixed overheads requirement and its permanent minimum capital requirement, but does not need to calculate the "K-factor requirement". In a UK context, BIPRU firms (most of which may likely fall within class 3) must currently calculate their fixed overheads and capital components that reflect credit risk and market risk. Subject to the UK implementation, capital calculations for those BIPRU firms that fall within class 3 will likely become less complex under the new framework.

The IFR does not set out details on how the fixed overheads should be calculated. Instead, this will fall to the Level 2 measures which will follow. The EBA is mandated to prepare regulatory technical standards for calculation of fixed overheads.

Transition period

The IFD/IFR provide a five-year transition period for existing investment firms. In broad terms, where the on-going capital of existing investment firms as calculated under the new framework is more than double the amount calculated under the current CRD IV/CRR framework, then they may limit their capital requirements, during this transition period, to twice the current amount.

REMUNERATION REQUIREMENTS

In addition to setting out requirements on capital and governance, the IFD/IFR sets out a remuneration regime for investment firms.

Most of the remuneration requirements under the IFD/IFR are similar to those under the existing CRD IV/CRR framework. For example, the overarching principle of proportionality remains which requires application of the remuneration requirements to take into account the nature, scope and complexity of a firm's business. Staff subject to these new remuneration requirements are also broadly the same as those who are already caught within the current CRD IV/CRR regime (ie risk takers).

The new remuneration requirements are generally less stringent and less prescriptive than those under the CRD IV/CRR.

Class 2 firms are subject to the new remuneration regime. Class 3 firms are only subject to the remuneration provisions under MiFID II which are fairly limited (eg there are no remuneration disclosure requirements under MiFID II).

Key requirements

Under the CRD IV/CRR, a firm may set the maximum ratio of variable remuneration at 200% of fixed remuneration provided that this is approved by shareholders in accordance with specified procedures (essentially, a 66% majority approval is needed). The IFD/IFR prescribe no specific ratios between variable and fixed remuneration. However, as it does under CRD IV/CRR, the IFD/IFR requires the use of variable and fixed remuneration to be "appropriately balanced".

With respect to retentions and deferrals, the core requirements will be the same as the current rules, ie at least 50% of variable remuneration must be paid in certain instruments (such as shares of the firm) and at least 40% of variable remuneration (or 60% for particularly high variable remuneration) must be deferred for three to five years. However, the IFD/IFR provide a specific exemption from such retention and deferral rules both at the firm level and for individual employees provided certain conditions are met. The CRD IV/CRR regime does not expressly permit exemptions, although individual Member States may have rules with similar effect by operation of the proportionality principle.

The IFD/IFR require remuneration policies and procedures to be gender neutral. This is not currently expressly provided for under the CRD IV/CRR (although the amendments made by CRD V/CRR II will add a gender neutral requirement).

Remuneration disclosures

The remuneration disclosure requirements under the IFD/IFR are also less extensive than under the CRD IV/CRR. For example, unlike the CRD IV/CRR, the IFD/IFR does not require disclosure on the decision-making process for determining a firm's remuneration policy, nor do they expressly require disclosure on information relating to link between pay and performance. Furthermore, as mentioned above, there are no remuneration disclosure requirements for class 3 firms under IFD/IFR.

GOVERNANCE AND THIRD COUNTRY

Internal governance

In addition to the requirements on capital and remuneration, the IFD also requires investment firms to put in place "robust governance arrangements". The IFD/IFR governance requirements are broadly based on corresponding CRD IV provisions, such as having a clear organisational structure, effective risk management and adequate internal controls. The IFD/IFR requirements are generally less extensive and less prescriptive than those under the CRD IV/CRR.

As with the remuneration requirements (which are considered to form a part of the overall internal governance requirements), the new internal governance requirements apply to class 2 firms. Other than a few limited provisions on risk management processes, class 3 firms are not subject to them.

The management body of relevant firms is required to undertake periodic reviews of its strategies and policies on risk. Firms must also establish reporting lines to the management body for all material risks. This will therefore have echoes for UK firms currently grappling with compliance with the Senior Managers and Certification Regime!

It is important to note that these governance requirements supplement (and do not replace or amend) the management body and organisational requirements in articles 9 and 16 respectively of MiFID II. All investment firms will still be required to comply with those requirements.

Relevant firms are required to establish a risk committee. The only exception is for firms that have an average on/off-balance sheet of no more than EUR100 million over the preceding four years. Under CRD IV/CRR, a risk committee is required to be established by "significant" firms, which is not then defined. In the UK, the FCA has set out a number of criteria in this respect;

an IFPRU firm is currently only considered "significant" if it meets one of such criteria, such as having total assets over £530 million. The likelihood is therefore that more investment firms will have to establish risk committees than do under the current regime.

Third country

MiFID II sets out a complex regime for how firms from a non-EU country (a "**third country**") may conduct investment business with EU clients. In general terms, the ability of third country firms to provide services to EU clients depends on whether or not the third country firm's home country has regulatory requirements equivalent to the EU. The European Commission is responsible for making such equivalence decisions.

The IFD/IFR will tighten the equivalence provisions that are currently set out in MiFID II. Under the IFD/IFR, where a third country firm's activities in the EU are likely to be of "systemic importance", the European Commission must assess equivalence of the third country on a "detailed and granular" basis and may include operational conditions in its equivalence decision by requiring such third country firms to comply with certain MiFID II requirements including post-trade disclosure, transaction reporting, obligation to trade certain instruments on EU trading venues. If and when the UK becomes a third country following Brexit, this may have a significant impact on UK firms given the UK's significance in the EU investment sector and it is fair to assume that following Brexit, the UK would be subject to a more rigorous equivalence assessment than that currently provided for in MiFID II.

Furthermore, for a third country group with investment firm subsidiaries in the EU, the relevant Member State regulator within the EU will assess whether the group (in relation to such EU subsidiaries) is subject to prudential consolidation requirements in that third country which are equivalent to those under the IFD/IFR. If there is no such equivalent supervision, that Member State regulator must apply supervisory techniques to ensure the objectives of the IFD/IFR prudential consolidation requirements are achieved. One such technique set out in the IFD/IFR is to require the third country group to establish an intermediate holding company within the EU which will then be required to comply with the IFD/IFR prudential consolidation requirements for the EU sub-group. This could therefore impose a significant operational burden on global firms with EU investment firm subsidiaries.

TIMING AND IMPLEMENTATION

The Council adopted the IFR and the IFD on 8 November 2019. It is expected to be published in the Official Journal of the European Union in Q4 2019 or early Q1 2020.

The IFD and the IFR are scheduled to apply 18 months after the 20th day of their publication in the Official Journal. Depending on the date of such publication, the new framework is expected to apply from Q2 or Q3 2021. This is a much shorter lead-in time than most EU financial services legislation which ordinarily has a 2-year implementation period.

Brexit has created some uncertainty as regards the implementation of the IFD/IFR in the UK. The UK government indicated in the Financial Services (Implementation of Legislation) Bill 2017-19 (which deals with "in-flight" EU legislation that is in the pipeline during the Brexit negotiation) that it intended to implement the IFR/IFD. The FCA also suggested in its 2019/20 business plan that it would publish a consultation in Q4 2019; although given the delay to the finalisation at EU-level, this is likely to follow now in 2020. However, while the Bill had essentially completed the legislative process in Parliament, it did not receive Royal Assent before Parliament was prorogued on 9 September 2019. The prorogation was subsequently declared void and Parliament has been reconvened, but the UK is now facing a general election. At the time of writing, it is not entirely clear what would happen to the Bill.

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