LATHAM & WATKINS

Client Alert Commentary

Latham & Watkins Financial Regulatory Practice

21 April 2021 | Number 2871

Second FCA Consultation on New Prudential Regime for Investment Firms

Latest FCA consultation focuses on remuneration, risk management and governance, and liquidity requirements.

Key Points:

The consultation:

- Sets out the FCA's proposals for the new remuneration rules for FCA investment firms
- Further covers own funds requirements, liquidity requirements, and the regulator's expectations regarding risk management and governance
- Closes on 28 May 2021

On 19 April 2021, the FCA published its second Consultation Paper (CP21/7) on the new UK investment firms prudential regime (IFPR). The IFPR will create a new prudential regime for FCA-authorised MiFID investment firms, and will reflect (but not mirror exactly) the EU IFD/R regime. For an overview of the proposed UK regime, please see this Client Alert.

The first consultation (CP20/24) was published in December 2020 and covered a number of topics, including the categorisation of investment firms under the IFPR, prudential consolidation, own funds requirements, and transitional arrangements for how firms will progress to meeting their new capital requirements. The second consultation covers, amongst other topics, remuneration, risk management and governance, and liquidity requirements, and consults on own funds requirements not covered in CP20/24. Comments are requested by 28 May 2021, so firms should note that they do not have long to respond.

The FCA plans to issue a third consultation in Q3 2021, which will cover residual matters such as disclosure and consequential amendments to the FCA Handbook. The FCA intends to publish a Policy Statement and near final rules for each consultation throughout the year (with the Policy Statement to CP20/24 due in "late spring", and the Policy Statement for CP21/7 expected in the summer), but will not publish its final rules until the Financial Services Bill (which makes the legislative changes necessary for the regime to take effect) has been passed and all three consultations are complete. The IFPR is set to take effect on 1 January 2022.

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in France, Hong Kong, Italy, Singapore, and the United Kingdom and as an affiliated partnership conducting the practice in Japan. Latham & Watkins operates in South Korea as a Foreign Legal Consultant Office. Latham & Watkins works in cooperation with the Law Office of Salman M. Al-Sudairi in the Kingdom of Saudi Arabia. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2021 Latham & Watkins. All Rights Reserved.

Remuneration

CP21/7 sets out the FCA's proposed remuneration rules for firms within the IFPR. The FCA is proposing that there will be a single MIFIDPRU Remuneration Code for all IFPR firms, with differently sized firms subject to different rules within this code. Remuneration has historically been an area in which the UK has taken a different view from the EU, and so it is no surprise that the FCA is taking a slightly different approach to proportionality.

The FCA splits firms into three categories under the code: Small Non-Interconnected firms (SNIs), and smaller and larger non-SNIs. Whereas some FCA investment firms currently are subject to very minimal remuneration requirements, the FCA is proposing that all IFPR firms will have to comply with certain basic requirements, including SNIs. All firms will need to have a clearly documented remuneration policy and comply with at least a small number of basic principles (such as ensuring that fixed and variable remuneration elements are appropriately balanced) in respect of all their staff. This differs from the EU approach, which exempts the smallest firms from the remuneration requirements entirely.

A firm will be classed as a larger non-SNI if: (i) the value of its on-and off-balance sheet assets over the preceding four-year period is a rolling average of more than £300 million; or (ii) the value of its on-and off-balance sheet assets over the preceding four-year period is a rolling average of more than £100 million (but less than £300 million), and it has trading book business of over £150 million, and/or derivatives business of over £100 million. This is more generous than the EU approach, which sets a lower threshold (although Member States are permitted to raise the threshold to a comparable level to what the FCA is proposing, at their own discretion).

All non-SNI firms must comply with more detailed requirements over and above the basic rules. This includes identifying material risk takers, setting appropriate ratios between fixed and variable remuneration, applying requirements on performance assessment and risk adjustment, and applying rules on the use of guaranteed variable remuneration, retention awards, buy-out awards, and severance pay for material risk takers. Larger non-SNIs will also need to apply rules on deferral and pay-out of variable remuneration for material risk takers, and will be required to have a remuneration committee.

Like the EU, the FCA intends to include an exemption from the rules on deferral and pay-out when a material risk taker's remuneration falls below a certain threshold. The FCA proposes to calibrate the threshold so that an individual would need to have annual variable remuneration of £167,000 or less and which makes up one-third or less of their total remuneration to fall within the exemption. Under the EU rules, only an individual whose annual variable remuneration does not exceed EUR 50,000 and does not represent more than a quarter of that individual's total remuneration will meet the exemption. However, the FCA notes that it will keep this threshold under review and may need to revisit its approach in light of potential developments, "including those regarding market access". As such, it seems the FCA may consider reverting to alignment with the EU rules if this were the gateway to an equivalence decision.

The FCA does not consider it appropriate to set a bonus cap for any IFPR firms. The regulator expects non-SNI firms to set their own ratios between fixed and variable remuneration, also affording them the flexibility to set different ratios for different categories of staff.

Risk management

The FCA states that it is using the introduction of the IFPR as an opportunity to reset its expectations of firms' internal governance and risk management. A key expectation will be that firms consider the potential harm they could cause to consumers and markets, as well as risks to their own safety and soundness.

The FCA plans to introduce an internal capital and risk assessment (ICARA) process for all FCA investment firms. Firms will be expected to meet an Overall Financial Adequacy Rule (OFAR), which will be used to determine whether or not a firm has adequate financial resources (and, in turn, whether it continues to meet the threshold conditions). Firms will need to use the ICARA process to determine their own funds threshold requirement and liquid assets threshold requirement. The former will be set at the higher of: (i) the permanent minimum requirement; (ii) own funds necessary to cover harms from ongoing operations; or (iii) own funds necessary for wind-down. The latter will be the sum of the basic liquid assets requirement, plus the higher of: (i) the additional liquid assets necessary at any given point in time to fund ongoing operations, taking into account potential periods of financial stress during the economic cycle; or (ii) the additional liquid assets required to begin its orderly wind-down, taking into account inflows of liquid assets that can be reasonably expected to occur during the wind-down period.

The ICARA process will consolidate FCA requirements in relation to business model analysis, stress-testing, recovery planning and actions, and wind-down planning. The regulator considers credible and accountable wind-down planning to be a critical feature of the internal risk assessment process under the new framework. The FCA also flags that it will re-orientate its prudential supervisory approach towards being harm-led, meaning that it will focus more on potential harm posed by firms to their clients and to the markets in which they operate. Linked to this, the regulator plans to move away from having a minimum Supervisory Review and Evaluation Process cycle for most firms and will instead use a “harm-led” approach.

There will be new expectations for Senior Managers in relation to the ICARA process. Senior Managers will be held responsible for ensuring that the firm recognises, monitors, controls, and mitigates the risks to which it is exposed, and will need to review and sign off on the firm’s ICARA documentation.

The FCA plans to provide specific guidance on what it expects from firms at certain intervention points when they run into difficulties, and what they can expect from the regulator. This includes setting standard intervention points and related notifications that the firm must make to the FCA.

Governance

The FCA plans to set general high-level requirements for all firms to have robust governance arrangements in place. These requirements are intended to ensure that all firms meet minimum standards of internal governance. The expectation is that firms will then develop and maintain arrangements tailored to their specific business model and operations. The largest non-SNI firms will be required to have risk, remuneration, and nomination committees. The threshold for this requirement will be set lower than at present (currently, only significant IFPRU firms must establish these committees), so more firms will find themselves needing to establish these committees. Generally, these committees must be established at individual entity level, although the FCA plans to permit firms to apply for a modification of this rule. Committees must be made up of at least 50% non-executives, and the chair must be a non-executive. However, the FCA does not plan to introduce requirements on diversity at this time (the EU rules specify that the remuneration committee should be gender balanced).

Own funds

In CP20/24, the FCA consulted on the permanent minimum requirement and the K-factors that only apply to firms with permission to deal as principal. The FCA is now consulting on the K-factors that may apply to any type of investment firm within the IFPR (based on assets safeguarded and administered, client money held, assets under management, and client orders handled). The FCA also sets out how firms should calculate an adjusted coefficient for use in times of stressed market conditions in relation to the daily trading flow own funds requirement (one of the K-factors consulted on in CP20/24).

Further, the FCA is proposing to introduce a fixed overheads requirement (FOR) that will apply to all firms within the IFPR. The FOR is intended to calculate a minimum amount of capital that a firm would need available to absorb losses if it has cause to wind-down or exit the market. The FCA proposes that the FOR will amount to one quarter of a firm's relevant expenditure in the previous year, based on the figures in its most recent audited annual financial statements. There will also be provision for firms to re-calculate the FOR in-year if there is a material increase (or decrease) in relevant expenditure. The FCA expects that firms will consider whether they need to hold any additional funds for a wind-down scenario as part of the ICARA process.

Further, the FCA sets out specific requirements for firms that are clearing members and for indirect clearing firms (a firm that is a client of a clearing member and also provides indirect clearing services to its clients). Specifically, the regulator explains how the daily trading flow K-factor will apply to clearing activities, and how the trading counterparty default K-factor will apply to central counterparty default fund exposures. The FCA clarifies that these firms will automatically be classed as non-SNI firms.

Liquidity requirements

The FCA is proposing that all firms within the IFPR have a basic liquid assets requirement, based on holding core liquid assets equivalent to at least one third of the amount of their FOR and 1.6% of the total amount of any guarantees provided to clients. This will be the first time that all FCA investment firms have a quantified liquid assets requirement. This requirement can apply on both an individual and a consolidated basis. Where it applies on an individual basis, the FCA would usually expect the firm to meet the requirements using assets it holds itself.

The FCA plans to set out a list of core liquid assets that firms can use to meet the basic liquid assets requirement. In general, core liquid assets will need to be denominated in pounds sterling. However, for overheads or guarantees that are in other currencies, the FCA proposes to allow firms to use comparable core liquid assets denominated in the relevant currency, in the same proportion as the relevant expenditure or guarantee.

Application to CPMIs and international firms

Collective Portfolio Management Investment Firms (CPMIs) are AIFMs or UCITS management companies with MiFID permissions, which allow them to perform certain MiFID business alongside their portfolio management business. The FCA is proposing that these firms will need to apply the IFPR methodology to calculate the FOR on behalf of the whole firm; many other IFPR requirements will only apply to the MiFID business of these firms, not to their collective portfolio management business.

In relation to international firms, the FCA is proposing that an international firm established overseas that is seeking UK authorisation (i.e., for a UK branch) will not be subject to the IFPR requirements directly. However, the FCA would need to be satisfied that the firm will be subject to broadly equivalent prudential supervision in its home jurisdiction. Otherwise, the firm will be required to establish a UK subsidiary, which would fall within the IFPR directly.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

David Berman
david.berman@lw.com
+44.20.7710.3080
London

Kishore Bhindi
kishore.bhindi@lw.com
+44.20.7710.4785
London

Sherryn Buehlmann
sherryn.buehlmann@lw.com
+44.20.7710.3043
London

Brett Carr
brett.carr@lw.com
+44.020.7710.4695
London

Charlotte Collins
Knowledge Management Lawyer
charlotte.collins@lw.com
+44.20.7710.1804
London

Becky Critchley
becky.critchley@lw.com
+44.20.7710.4519
London

Stuart Davis
stuart.davis@lw.com
+44.20.7710.1821
London

Carl Fernandes
carl.fernandes@lw.com
+44.20.7710.4777
London

Nicola Higgs
nicola.higgs@lw.com
+44.20.7710.1154
London

Gabriel Lakeman
gabriel.lakeman@lw.com
+44.020.7710.4645
London

Sidhartha Lal
sidhartha.lal@lw.com
+44.20.7710.4778
London

Anna Lewis-Martinez
Knowledge Management Lawyer
anna.lewis-martinez@lw.com
+44.20.7710.1025
London

Anne Mainwaring
anne.mainwaring@lw.com
+44.20.7710.1018
London

Sam Maxson
sam.maxson@lw.com
+44.20.7710.1823
London

Ella McGinn
ella.mcginn@lw.com
+44.20.7710.4649
London

Rob Moulton
rob.moulton@lw.com
+44.20.7710.4523
London

Denisa Odendaal
denisa.odendaal@lw.com
+44.20.7710.1845
London

Jonathan Ritson-Candler
jonathan.ritson-candler@lw.com
+44.20.7710.1815
London

Katy Sanders
katy.sanders@lw.com
+44.20.7710.4548
London

Sean Wells
sean.wells@lw.com
+44.20.7710.4662
London

You Might Also Be Interested In

ESG Disclosures Under the EU Taxonomy Regulation and CRR: Latest Developments

FCA Confirms Dates for Cessation of LIBOR Benchmarks

Independent Review Provides Recommendations for Improving UK Listing Regime

FCA Publishes Review of Asset Managers' Implementation of MiFID II Product Governance Rules

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham, visit our subscriber page.