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FSbriefing

Investment firms legislation

Introduction

Following the investment firms review, final legislation (consisting of a Directive on the prudential supervision of investment firms and a Regulation on the prudential requirements of investment firms (IFD, IFR, together IF legislation)) has been published in the Official Journal of the EU.

At present the regulatory framework for investment firms consists of (i) the amended Markets in Financial Instruments Directive and associated Regulation (MiFID 2/MiFIR) which set the conditions for authorisation and organisational and business conduct requirements; and (ii) the prudential framework contained in the amended Capital Requirements Directive and for certain investment firms Regulation (CRD and CRR, together CRD 4).

In December 2017 the European Commission published proposals to review the prudential framework for investment firms to provide a specific regime tailored to investment firms rather than to continue to try to fit investment firms within the CRD framework which was developed for banks (credit institutions) and has been amended to transpose the Basel standards for internationally active banks. Investment firms were originally brought within the CRD framework to level the playing field since the larger investment firms compete with banks in performing investment services (which banks may offer under a banking licence). However given that credit institutions and investment firms have different business models, some investment firms were exempted entirely from the full CRD requirements. As the framework has become more complex, further exemptions have been introduced leading to a piecemeal system of categorisation for investment firms. Further impetus for reform arose due to the CRD framework being calibrated to ensure the protection of depositors through economic cycles, and therefore not capturing the core business models and actual risks faced by the majority of investment firms.

The IF legislation will introduce a regime tailored for investment firms, which aims to provide "risk-sensitive prudential requirements" depending upon the type of investment services a firm carries out. In addition there are tailored requirements on remuneration and governance that reflect the investment firms' activities, business models and remuneration structures.

In its review the Commission stated that for "investment firms in aggregate, capital levels should not necessarily change significantly, but the distribution of capital across firms should correspond better to actual risks". However, for some investment firms (particularly those that are exempt from the CRD framework currently), the legislation will lead to large increases in regulatory capital due to the calibrations used to measure risks and the application of a fixed overhead requirement to firms if these are currently subject to a fixed requirement of €50,000. Although the IFR provides for transitional measures for 5 years from the date of application (26 June 2021), firms will need to start planning now to ensure they are sufficiently capitalised to undertake business under the new regime.

The revised texts also amend the provisions in MiFIR that deal with third-country rules for investment firms to provide that such firms need to supply the European Securities and Markets Authority (ESMA) with detailed information in respect of investment services provided in EU Member States. Where a third country firm provides services which are of systemic importance for the EU, a detailed and granular assessment will need to be undertaken before the third country requirements may be considered to have equivalent effect and specific operational conditions may be attached to an equivalence decision by the Commission.

The date by which the Directive must be transposed into national laws and the Regulation will apply is 26 June 2021. Although the UK left the EU prior to the implementation date (and it is not currently envisaged the transition period will be extended beyond 31 December 2020), HM Treasury has stated that it is "supportive of its intended outcomes" and targeted deviations from the EU prudential regime will only be implemented where they are necessary to reflect either the number, size and nature of UK investment firms or the structure of the UK market.

Categorisation of investment firms

There will be three main categories of investment firms:

Class 1: systemic firms that remain subject to the CRD framework;

Class 2: those firms that deal on own account, underwrite, safeguard and administer client assets or that are above certain size thresholds that will be subject to a new capital regime with the capital requirement being the highest of initial capital, a fixed overhead requirement or a requirement based upon "K factors" correlating to the risks they are subject to; and

Class 3: small and non-connected firms with lesser requirements based upon new initial capital or fixed overheads requirements. Such firms are exempted from the new capital regime by the competent authority subject to meeting certain conditions.

The final legislation draws upon a report from the European Banking Authority (EBA) and ESMA (December 2015) recommending a revised prudential regime for non-systemic investment firms (with systemic firms remaining subject to the CRD requirements); and final EBA advice containing a bespoke prudential regime (November 2016).

The EBA recommended three new categories of investment firm as set out above and this approach has been carried through into the legislation, with minor amendments.

Class 1 firms

This category covers systemic investment firms that operate in the same manner as credit institutions and it is proposed such firms would remain subject to the CRD framework.

The EBA had suggested two different methods of including systemic investment firms within the CRD framework and the Commission considered that of the two, amending the definition of a "credit institution" to capture systemic investment firms would be the best option for minimising the scope of regulatory arbitrage, as well as the most straightforward drafting option. The final text of the IFR amends the credit institution definition in Article 4(1) of the CRR to include those investment firms which either deal on own account or underwrite issues of securities (excluding commodity and emissions dealers, collective investment undertakings or insurers) and where one of the following applies:

(i) the total value of consolidated assets of the undertaking exceeds €30 billion;

(ii) the undertaking has assets below €30 billion but is part of a group in which the total value of consolidated assets of all of the undertakings in that group which carry out such activities and with assets below €30 billion, exceeds €30 billion; or

(iii) the undertaking has assets below €30 billion but is part of a group in which the total value of the consolidated assets of all undertakings in the group which carry out such activities is equal to or exceeds €30 billion, where the consolidating supervisor in consultation with the supervisory college decides it should be included to avoid risks of circumvention of rules and potential risks for EU financial stability.

For the purposes of (ii) and (iii) when the undertaking is part of a third country group, the total assets of each branch of the third country group authorised in the EU are included in the combined total value of the assets of all undertakings in the group.

Where an investment firm fulfils these tests, it will be a credit institution. An investment firm which crosses these size thresholds will be required to apply for re-authorisation as a credit institution and is required to submit an application for re-authorisation on the day when the monthly average of total assets, calculated over a period of 12 consecutive months, crosses the relevant threshold. For investment firms meeting these criteria on 24 December 2019, the authorisation must be made by 27 December 2020. Where an investment firm which crosses the relevant size threshold is located in the eurozone, as a credit institution it will be subject to supervision by the European Central Bank (ECB) under the Single Supervision Mechanism (SSM). Therefore systemic investment firms will be subject to a change in supervisor as a result of this categorisation.

HM Treasury, in the only derogation from the EU regime identified, has stated that it will not require UK systemic investment firms to obtain re-authorisation as credit institutions, since such firms are already prudentially regulated and supervised under CRD 4 by the PRA, the UK banking regulator. The Treasury and the regulators consider that the existing PRA designation framework achieves the same outcomes sought by the IFR.

There is a further category of class 1 firms subject to the CRD framework but such firms are not required to become credit institutions. These firms which either deal on own account or underwrite issues of securities and are of a particular size where the competent authorities decide to apply the CRD framework. The size criteria are where the total value of consolidated assets of the investment firm exceeds €15 billion. Competent authorities may also apply the CRD framework where (i) activities are carried out on such a scale that the failure or distress of the firm could lead to systemic risk; (ii) the investment firm is a clearing member; or (iii) the competent authority considers it justified in light of the size, nature, scale and complexity of the activities with regard to the importance for the EU economy or the relevant Member State economy, the significance of its cross-border activities or the interconnectedness of the firm with the financial system. This does not apply to commodity and emissions allowance dealers, collective investment schemes or insurance undertakings.

A smaller investment firm that deals or underwrites but which does not meet the size criteria may apply the CRD framework where it is a subsidiary and included in a banking consolidation group, the firm notifies the competent authority (and the consolidating supervisor, if applicable) and the competent authority is satisfied that the application of the CRR own funds requirements to the firm on an individual basis and to the group on a consolidated basis does not result in a reduction of the own funds requirements of the investment firm and is not undertaken for the purpose of regulatory arbitrage.

Class 2 firms

This category comprises all other investment firms that are not either class 1 firms nor small and non-interconnected firms (class 3 firms).

The thresholds above which an investment firm is not considered small or non-interconnected are set out in the table. Only one threshold needs to be exceeded so a firm which holds any client money, for example, will not be a small and non-interconnected firm.

Category		**Threshold**
Assets under management (AuM)		**€1.2 billion**
Client orders handled (COH)	**- cash trades**	**€100 million per day**
	- derivatives	**€1 billion per day**

Assets safeguarded and administered (ASA)		**Zero**
Client money held (CMH)		**Zero**
Daily trading flow (DTF)		**Zero**
Net position risk (NPR) or Clearing member guarantee (CMG)		**Zero**
Trading counterparty default (TCD)		**Zero**
On- and off- balance sheet total		**€100 million**
Annual gross revenue from investment services		**€30 million**

Class 3 firms

This category comprises small and non-interconnected firms which fall below the above thresholds. These firms are subject to lesser requirements.

Initial capital

All investment firms will be required to hold a minimum level of capital. The amount will be based upon the type of activities carried out.

Activity	Initial capital €
Dealing, underwriting, placing on a firm commitment basis, operating an OTF when dealing on own account	750,000
Reception and transmission of orders, execution of orders on behalf of clients, portfolio management, investment advice and placing without a firm commitment basis provided the firm cannothold client money or securities	75,000
All other firms	150,000

Own funds

An investment firms must at all times have own funds which amounts to the higher of:

- a fixed overheads requirement being one quarter of the fixed overheads of the previous year;
- the permanent minimum capital requirement (initial capital); and
- (and for class 2 firms only) a K-factor requirement (see below).

Own funds are described by reference to the banking definition of own funds set out in the CRR. The following conditions must be met at all times:

- common equity tier 1 (CET 1) capital must be 56% or more of total own funds; and
- CET 1 and additional tier 1 (AT 1) capital must be 75% or more of total own funds.

The bespoke prudential regime for class 2 firms

The range of activities offered by investment firms is wide but in general their activities seek returns from taking on risks either for own account or for their clients by investing in different types of financial instrument. Some firms will act as principals to trades and may hold client money or assets. Capital requirements seek to cover any risks arising from such investments or the operation of other parts of the investment firm.

The new bespoke regime, taken from the EBA final advice, calculates capital requirements on a new set of factors which seek to measure risks to customers, markets and the firms themselves, the "K factors".

For the risk to customer K factors (and also for the risk to the firm from the daily trading flow) each K factor is given a co-efficient to be multiplied by a given metric. The risk to market and risk to firm K factors which seek to capture trading book type risks (position, counterparty and concentration risk) are calculated using a simplified form of the corresponding CRR requirement set out in the IFR.

Where a firm does not carry on the type of activity envisaged by the K factor, the amount for that K factor sum is zero. The capital requirement is the sum of these K amounts.

K FACTORS

Risk type	K Factor	Co-efficient %	Metric
Risk to customer	K-AuM	0.02	Assets under management
(RtC)	K-CMH (segregated)	0.4	Client money held in segregated accounts
	K- CMH (non-segregated)	0.5	Client money held in non-segregated accounts)
	K-ASA	0.04	Assets safeguarded and administered
	K-COH	Cash 0.1 Derivatives 0.01	Customer orders handled
Risk to market	K-NPR	CRR calculation for own funds requirement for the trading book positions	Net position risk
(RtM)	or		
	K-CMG	130	Third highest amount of total margin posted with a clearing member against trading risks
Risk to firm	K-TCD	Article 26 calculation	Trading counterparty default

(RtF)	K-CON	Article 39 calculation	Concentration risk
	K-DTF	Cash 0.1 Derivatives 0.01	Daily trading flow (gross value of settled cash/notional value of derivatives)

Assets under Management (AuM)

AuM is measured as the rolling average of the value of the total monthly assets under management, measured on the last business day of each of the previous 15 months converted into the entities' functional currency at that time. The three most recent monthly values are excluded and the AuM is the arithmetic mean of the remaining 12 monthly values.

The formal delegation of management of assets by an investment firm does not exclude the assets from the AuM total for that investment firm. However, the delegate would exclude the assets from its AuM to avoid double counting.

AuM (as well as CMH, ASA, COH and DTF) is calculated on the first business day of each month.

Client money held and assets segregated and administered (CMH/ASA)

CMH and ASA are to be measured as the rolling average of the value of total daily client money held/client assets safeguarded and administered, measured at the end of each business day for the previous nine months, excluding the three most recent months. CMH and ASA are the arithmetic mean of the daily values from the remaining six months.

The CMH co-efficient is lower where assets are held in segregated accounts rather than non-segregated accounts (see table).

Client orders handled (COH)

COH is to be measured as the rolling average of the value of total daily client orders handled measured throughout each business day for the previous six months, excluding the three most recent months. CMH is the arithmetic mean of the daily measurements from the remaining three months. COH shall be measured as the sum of the absolute value of buys and the absolute value of sells. For cash trades, the value is the amount paid or received on each trade. For derivatives, the value is the notional amount of the contract, scaled for the time to maturity (in years) of the contract over ten years i.e. a five year contract would be valued at 50 per cent of the notional.

COH includes transactions (i) executed by investment firms providing portfolio management services on behalf of investment funds; and (ii) which arise from investment advice in respect of which an investment firm does not calculate K-AuM.

COH excludes (i) transactions that arise from servicing a client's portfolio where the firm already calculates K-AuM in respect of the client's investments or where the firm is a delegate managing assets for another firm; (ii) transactions executed by the investment firm in its own name either for itself or on behalf of a client; and (iii) orders which have not been executed due to the timely cancellation of the order by the client.

Net position risk (K-NPR)

A firm has a choice of how to calculate K-NPR (the capital requirement for the trading book positions for a firm dealing on own account) based upon the different methods available to under the CRR:

(i) the simplified standardised approach set out in CRR;

(ii) the alternative standardised approach as will be amended by CRR 2; or

(iii) the alternative internal model approach as will be amended by CRR 2.

Clearing member guarantee (K-CMG)

Competent authorities may permit investment firms to use this K factor for all positions subject to clearing or on a portfolio basis, where the whole portfolio is subject to clearing or margining, subject to the following conditions (i) the investment firm in not part of a group containing a credit institution; (ii) the clearing and settlement of the transactions takes place through a qualifying central counterparty clearing member (which is a credit institution, including a class 1 investment firm) and the transactions are either centrally cleared or otherwise settled on a DvP basis under the responsibility of this clearing member; (iii) the calculation of total margin is based upon a margin model of the clearing member; (iv) the investment firm justifies this choice to the competent authority; and (v) the competent authority assesses that the choice of the portfolios subject to this K factor has not been made with a view to engaging in regulatory arbitrage of the own funds requirements. In addition there are certain set requirements with regard to the assessment of the clearing member's margin model and sufficiency of coverage of the margin requirements.

K-CMG is the third highest amount of total margin required on a daily basis over the preceding three months multiplied by a factor of 1.3.

Trading counterparty default (K-TCD)

Firms calculate this K factor using a simple formula (being exposure value multiplied by a risk factor for counterparty type, a credit valuation adjustment and 1.2). When calculating the exposure value, potential future exposure is added to the replacement cost for derivatives and allowance is made for collateral, subject to haircuts. The risk factor is 1.6% for central governments, central banks, public sector entities, credit institutions and investment firms and 8% for all other counterparties. The CVA is 1.5 for all transactions subject to certain exemptions where the CVA is 1; or

A single exposure value at netting level is permitted subject for all transactions covered by a contractual netting agreement, subject to certain conditions.

Concentration (K-CON)

An investment firm's limit to concentration risk of an exposure to an individual client (or group of connected clients) is 25% of own funds (or the higher of 25% of own funds and 150 million if the client is a credit institution, investment firm or where the group includes such an institution, provided the limit with regard to concentration risk does not exceed 100% of the investment firm's own funds). If this limit is exceeded this needs to be both notified to the competent authority and K-CON calculated. K-CON applies increasing multiplication factors to the aggregate amount of the capital requirement for that client/group. Where the excess has not persisted for more than 10 days, the requirement is doubled. For excesses persisting for longer than 10 days, a multiplication factor between 200-900% is applied to the amount of the exposure value excess as a percentage of own funds (the higher the excess as a percentage of own funds, the higher the multiplication factor).

Daily trading flow (K-DTF)

DTF is the rolling average of the value of the total daily trading flow, measured throughout each business day over the previous nine months, excluding the three most recent months. DTF is the arithmetic mean of the daily measurements from the remaining six months. DTF is measured on the same basis as COH (i.e. sum of the absolute value of buys and sells and the notional amount of derivatives). DTF excludes transactions executed by investment firms providing portfolio management services on behalf of investment funds; and includes transactions executed by an investment firm in its own name either for itself or on behalf of a client.

Consolidated supervision

The IFD widens the scope of consolidated supervision in respect of EU groups containing investment firms: EU parent investment firms, parent investment holding companies and parent mixed financial holding companies are required to comply with the obligations in respect of own funds, capital requirements, concentration risk, disclosure and reporting on the basis of their consolidated situation. In addition the requirements in respect of liquidity must be complied with by the parent undertaking unless the competent authority exempts the parent undertaking from this requirement, taking into account the nature, scale and complexity of the group. An investment holding company is defined as a financial institution, the subsidiaries of which are exclusively or mainly investment firms or financial institutions, at least one of which is an investment firm and which is not a financial holding company as defined under the CRR.

The full consolidation requirements do not apply if the competent authority considers the group structure to be sufficiently simple, provided that there are no significant risks to clients or to markets stemming from the investment firm group that would otherwise require supervision on a consolidated basis. Instead the competent authority will require the parent undertaking to have sufficient capital to support the book value of its holdings in the subsidiaries. Capital is required to be held by the parent undertaking to cover the (i) full book value of holdings; (ii) any subordinated claims; (iii) any direct, indirect or synthetic CET 1, AT 1 or tier 2 instruments holdings in investment firms, financial institutions, ancillary services undertakings and tied agents in the investment firm group; and (iv) any contingent liability in favour of investment firms, financial institutions, ancillary services undertakings and tied agents in the investment firm group.

Competent authorities are required to notify EBA that they have permitted the use of this method.

Liquidity

Investment firms will be required to hold an amount of liquid assets equivalent to at least one third of the fixed overhead requirement. Class 3 investment firms may be exempted from this requirement by their competent authority.

Liquid assets are defined by reference to the Delegated Regulation supplementing the CRR with regard to the liquidity coverage ratio (i.e. the banking definition of liquid assets). For many firms the liquidity requirements will be met by holding cash rather than the high quality liquid assets (such as certain government bonds) permitted by the banking rules. Client monies or assets held are excluded from liquid assets, even if held in the investment firm's own name.

Remuneration

The legislation introduces new rules with regard to remuneration for investment firms. However, some small and non-interconnected firms (class 3 firms) are exempted from the remuneration rules. In addition the rules on deferred and claw-back of variable remuneration are disapplied for firms with a balance sheet of less than €100 million (which may be adjusted up or down by regulators). They are also disapplied for any employee whose variable remuneration is less than €50,000 and is less than a quarter of that person's total remuneration (although the exemption may be disapplied by national regulators).

The new remuneration rules include:

- investment firms should have a remuneration policy that is clearly documented and proportionate to the size, internal organisation and structure of the firm, as well as to the scope and complexity of its activities;
- investment firms will need to set appropriate ratios between fixed and variable pay. However, there is no bonus cap as there is under the CRD regime;
- at least 40 per cent of variable remuneration for (60% where the variable remuneration is of a particularly high amount) will need to be deferred over a period of three to five years. This is in line with the current CRD 4 regime. The CRD 5 Directive will introduce a minimum of four year deferral period for at least 40% of variable remuneration (60 per cent for "particularly high amounts");
- the payment of at least half of variable remuneration will have to be paid in shares, share-linked instruments, non-cash instruments subject to the legal structure of the firm concerned or non-cash instruments which reflect the instruments of the portfolios managed. In addition, tier 1, tier 2 or other instruments that can be fully converted to CET 1 instruments or written down and that adequately reflect the credit quality of the investment firm as a going concern may be used;
- malus or clawback provisions will apply; and
- firms will be required to establish a gender-neutral remuneration policy and have gender balanced remuneration committees.

Equivalence

The IFR amends the articles in MiFIR dealing with the rules relating to third-country investment firms. However, the final rules do not give as much power to the Commission as was originally mooted.

As currently, third-country investment firms may provide services or perform activities (in respect of eligible counterparties and professional clients only) in the EU following an equivalence decision in respect of that third country. However, the IFR makes some significant changes to the regime. In particular, the equivalence assessment will depend upon the relationship between the third country and the EU.

Where the scale and scope of the services provided and activities performed by a third-country firm in the EU is likely to be of systemic importance in the EU, the legally binding prudential, organisational and conduct of business rules of that third country will need to be subjected to a detailed and granular assessment by the Commission which takes account of the level of supervisory convergence between the third country and the EU. The Commission may attach specific operational conditions to an equivalence decision that would ensure that ESMA and the national competent authorities have the necessary tools to prevent regulatory arbitrage and to monitor the activities of third-country firms in respect of their EU activities.

On an annual basis ESMA is given the power to monitor the regulatory and supervisory developments, enforcement practices and other relevant market developments in third countries benefitting from an equivalence decision under MiFIR in order to check that the conditions upon which equivalence has been granted continue to apply. ESMA will produce a confidential report addressed to the Commission which will use this to report to the Council and to the European Parliament.

Furthermore, in addition to the existing requirement to register with ESMA, third country investment firms will have to inform ESMA annually of certain information including the scale of services or activities, geographical distribution, exposures to EU counterparties, total value of financial instruments originating from EU counterparties underwritten or placed on a firm commitment basis, turnover, investment protection arrangements and risk management and governance arrangements. ESMA may request "any other information necessary" to carry out its tasks under the IFR.

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