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CLIENT ALERT

Revised Prudential Framework for EU Investment Firms

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Background: The Investment Firm Review

The current EU framework governing the authorisation and conduct of investment firms is set out in the Markets in Financial Instruments Directive[1] ("MiFID") and Regulation[2] ("MiFIR") (together "MiFID II"). MiFID II applied as of 3 January 2018. In addition, EU investment firms are subject to prudential rules under the Capital Requirements Directive[3] and Regulation[4] ("CRR") (together "CRD IV"), designed to ensure that such firms have sufficient resources to face the risks they undertake.

Under the current prudential regime it is possible to identify at least 11 different prudential categories of investment firms. This categorisation largely depends on the services the particular firms provide and the kinds of clients they have. Such services may include simple reception and transmission of orders, or giving investment advice. In other cases they may extend to execution of orders and portfolio management. Other firms may engage in dealing on their own account. Some firms hold client funds/securities whilst others do not.

1 Directive 2014/65/EU.

2 Regulation 600/2014.

3 Directive 2013/36/EU.

4 Regulation 575/2013.

The existing regime is recognised as being too complex, not being tailored or risk-sensitive enough to different investment firm business models and imposing a disproportionate compliance burden on smaller firms. In addition, member states have implemented the existing rules inconsistently.

The European Banking Authority ("EBA") has reviewed the current regime and recommended the development of a consolidated single rulebook for all investment firms covered by MiFID II, except for systemic investment firms or investment firms that are exposed to the same types of risks as credit institutions (i.e. banks). This latter category (which the EBA termed "Class 1") would be subject to the full CRD IV requirements. The remainder—the vast majority of investment firms—would be divided into two classes. Class 2 would be for non-systemic investment firms meeting specific thresholds which should be subject to a more tailored prudential regime. Class 3 would be for small and non-interconnected investment firms providing limited services, which should be subject to a very simple regulatory regime. This will result in more appropriate and risk-sensitive requirements for investment firms that better target the risks posed across different business models.

Accordingly, the European Commission proposed on 20 December 2017 a revised framework consisting of a new regulation on the prudential requirements for investment firms[5] (the "Regulation") and a new directive on the prudential supervision of investment firms[6] (the "Directive") (together the "Investment Firm Prudential Regime").

The new Investment Firm Prudential Regime is due to take effect in member states either towards the end of 2019 or early in 2020.

The Changes

3 Classes of Investment Firms

Under the Regulation, investment firms are split into three broad categories:

- Class 1 – systemic investment firms, or firms that are exposed to the same types of risks as credit institutions (i.e. banks). This includes investment firms with total assets above €30 billion that provide underwriting services and/or deal on their own account. Only these firms will be subject to the full CRD IV requirements applicable to credit institutions (banks);

- Class 2 – non-systemic investment firms exceeding any of a number of specific thresholds (e.g. assets under management under both discretionary portfolio management and non-discretionary [advisory] arrangements higher than €1.2 billion; client orders handled of at least €100 million per day for cash trades and/or at least €1

5 The proposed regulation can be found here: http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017- 790-F1-EN-MAIN-PART-1.PDF.

6 The proposed directive can be found here: http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-791-F1-EN-MAIN-PART-1.PDF.

billion per day for derivatives; a balance sheet total higher than €100 million; total gross revenues higher than €30 million; exposure to risks from trading financial instruments higher than zero; client assets safeguarded and administered higher than zero; and client money held higher than zero);

Such firms would be subject to a more tailored prudential regime involving the use of so-called “K-factors”, which set capital requirements according to the volume of certain services and business practices that can generate risks to the firm, its customers and counterparties; and

- Class 3 – smaller and less complex firms, not passing the thresholds for Class 1 or 2, representing lower risk and subject to the least onerous regulation.

Class 1 Firm: Definition of credit institution

The draft Regulation (article 60) changes the definition of “credit institution” in Article 4(1)(1) of the CRR to bring those investment firms that meet the Class 1 criteria within it. Investment firms that meet these criteria would be authorised as credit institutions, be subject to CRD IV requirements and be overseen by banking supervisors. This will only affect the very largest investment firms currently operating in the UK but that might be relocating part of their operations to the EU due to Brexit. This alignment of regulatory and supervisory treatment of systemic investment firms with that of credit institutions is intended to ensure a level playing field given developments in the United States, Switzerland and Japan.

Class 2 Firm Prudential regime: K-Factors

For Class 2 firms—non-systemic firms that nonetheless exceed the thresholds to qualify as small and non-interconnected “Class 3” firms—a new approach to capital requirements determined by so-called K-factors is proposed. Essentially this sets a formula for determining an investment firm’s capital requirements in accordance with the volume of its services and business practices that are most likely to generate risks to the firm, to its customers and to counterparties. Metrics covering a range of risk factors are calculated in accordance with the terms of the Regulation to ensure consistency. These metrics can then be multiplied by specific coefficients to appropriately weigh each of the risks, producing the K-factor for that particular risk.

K-factors capture three types of risk: risks to the customer, risks to the market and risks to the firm.

The **risk to the customer** is comprised of the sum of four factors relating to (i) assets under management; (ii) client money held; (iii) assets under safekeeping and administration; and (iv) client orders handled, each on the basis of a rolling average over a defined period and each to be multiplied by a set coefficient.

The **risk to the market** is assessed by calculating the higher of the net position risk or the margins posted with clearing members.

The **risk to the firm** is the sum of factors relating to (i) counterparty credit risk; (ii) daily trading flow over a rolling average and (iii) concentration risk.

The sum of all these factors gives the overall K-factor requirement, i.e. the minimum capital requirement for the relevant Class 2 investment firm.

Class 3 Firm Prudential regime: Fixed overhead basis

For Class 3 investment firms, which are small and non-interconnected (as per the criteria set out in article 12), the minimum capital requirement will be set at the higher of their initial authorisation capital or a quarter of their fixed overheads for the previous year.

Remuneration

On remuneration, the aim is to ensure the orderly functioning of investment firms and prevent excessive risk-taking by their staff. However, the revised requirements recognise the different nature of investment firms and credit institutions, the need for some flexibility and that, for reasons of proportionality, small and non-interconnected firms should be exempted from the remuneration rules. Such Class 3 firms will of course still be covered by rules under MiFID, such as ensuring that sales staff are not incentivised through the remuneration structure to recommend unsuitable products, in order to protect investors and consumers.

Overall, for small investment firms, these new rules should result in lower compliance costs and more appropriate prudential standards tailored to the specific risks of their activities.

Changes to the third country regime under MIFID II

The EU has taken the opportunity in this proposal to tighten the equivalence rules for third country investment firms, which it considered necessary in order to level the playing field between third country and EU investment firms. It is clear Brexit has influenced the changes as the EU anticipates the UK being a third country.

Under Articles 46 and 47 of MiFIR, an investment firm from outside the EU can provide investment services to professional clients and eligible counterparties in the EU without establishing a branch in the EU where it is registered with ESMA[7]. The draft Regulation amends these provisions in MiFIR to strengthen the equivalence determination process and the assessment criteria. ESMA will require additional information from investment firms applying for equivalence. The detailed technical standards for this have not yet been published. For third country firms performing investment services and activities in the EU that are likely to be of systemic importance, the draft Regulation requires ESMA to conduct a

[7] ESMA = European Securities and Markets Authority.

"detailed and granular assessment" of the firms' prudential and business conduct requirements. There is also a new requirement that the legal framework of the third country provide for an effective equivalent system for the recognition of investment firms under third country legal regimes.

The draft Regulation introduces new annual reporting requirements for third country firms relating to the scale and scope of services provided in the EU, including disclosure of details as to turnover and assets, investor protection arrangements and the risk policy applied by the firm to the services and activities provided.

This Regulation does not affect the third country provisions in EU financial services legislation for other sectors such as under the EU Alternative Investment Fund Managers Directive or EMIR[8].

Brexit: Will the UK implement the Investment Firm Prudential Regime?

This new regime is due to be implemented in member states later in 2019 or early in 2020. It is not known at the date of this briefing the exact date on which the UK may leave the EU. However, this new regime is still of interest to UK investment firms as it is likely that it will be implemented in the UK. There are two alternative bases for this. If the UK Government were to approve the Withdrawal Agreement[9] with the EU, the UK will continue to comply with European legislation until the end of the implementation period, currently scheduled for 31 December 2020. In that case the UK is obliged to implement new European legislation taking effect during the implementation period.

If the UK were to leave the EU without approving the Withdrawal Agreement—on the basis of "no deal"—the UK has established a mechanism in the Financial Services (Implementation of Legislation) Bill 2017-2019 under which EU financial services legislation that is currently in the pipeline (so-called "in-flight" legislation) is to be implemented for a period of two years after the UK leaves the EU. This legislation is included in the list of in-flight legislation to be implemented.

UK and EU investment firms should therefore consider the provisions of the new Investment Firm Prudential Regime and start to assess implications for their capital requirements in due course.

8 EMIR = European Market Infrastructure Regulation.

9 The draft agreement on the withdrawal of the UK from the EU published on 14 November 2018.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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