Client Update

European Commission Proposes More Appropriate Capital Requirements for Smaller EU Investment Firms

On 20 December 2017, the European Commission adopted proposals which aim to amend the current prudential framework for investment firms set out in the Capital Requirements Directive and Regulation (CRD IV/CRR) and in the Markets in Financial Instruments Directive and Regulation (MiFID II/MiFIR) and to introduce more proportionate and risk-sensitive rules.

Under these proposals, the vast majority of EU investment firms (including investment advisors, placement agents, portfolio managers and other financial intermediaries that provide regulated financial services) would be subject to a completely new regime of capital and prudential requirements. This approach would replace the current regime, under which investment firms are subject to rules that were originally designed for banks, but which provide for numerous exceptions.

NEW CLASSIFICATION OF INVESTMENT FIRMS

The proposals distinguish between three classes of investment firms.

- **Class 1**: investment firms with total assets above EUR 30 billion and which provide bank-like activities (i.e. underwriting services and dealing on own account).
- **Class 2**: investment firms exceeding any of the following thresholds:
  - assets under management under both discretionary portfolio management and non-discretionary (advisory) arrangements above EUR 1.2 billion;
  - client orders handled of at least EUR 100 million/day for cash trades and/or at least EUR 1 billion/day for derivatives;
  - balance sheet total higher than EUR 100 million;
  - total gross revenues higher than EUR 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.
- **Class 3**: all other investment firms that do not qualify as Class 1 or Class 2 firms.

NEW PRUDENTIAL REGIMES

Class 1 firms are considered systemic and will therefore remain under the regime for banks (CRD IV/CRR) and will be regulated like banks "in all respects". In addition, the European Central Bank (ECB) will directly supervise Class 1 firms under the Single Supervisory Mechanism. This represents another step in the shift from national to central European supervision.

A new prudential regime will be introduced for Class 2 and Class 3 firms, neither of which are considered systemic.

- **Capital requirements**: Class 3 firms will be subject to simpler capital requirements. The minimum capital will be the higher of the initial capital and 1/4 of the overheads of the previous year.

  The capital requirements for Class 2 firms will depend on the investment services provided, and the assets under management held by the firm (with the Class 3 capital requirements being the minimum). It is determined by the K-factor formula which means the sum of risk to customers (RtC), risk to market (RtM) and risk to the firm itself (RtF). This "K-factor" approach means, for example, that an asset manager or investment advisor will be subject to a capital requirement of 0.02% of its assets under management or advice.

- **Corporate governance and remuneration**: Class 3 firms will be subject to the corporate governance and remuneration rules of MiFID II only. This means that the bonus cap and deferral rules introduced by CRD IV will not apply to Class 3 firms.

  Class 2 firms will have to apply the CRD IV rules, but in a more proportionate manner than currently. In particular, the proposals do not set a specific limit on the ratio between variable and fixed components of remuneration (the so called bonus cap), but they require investment firms to set appropriate ratios themselves. Furthermore, Class 2 firms with total assets below EUR 100 million will not be subject to the deferral and payout instrument restrictions.

IMPACT ON PASSPORT FOR THIRD COUNTRY FIRMS

The proposals will also have an impact on third country firms. MiFID II introduces a "passport regime" for third country firms. This passport will give them access to EU clients on a cross-border basis if (among other things) the home jurisdiction of the third country firm meets certain equivalence standards. As the proposals intend to change the regulatory standards applicable to EU investment firms, third country firms will have to comply with these new standards in order to meet the equivalence test.

NEXT STEPS

As the Commission's proposals require agreement by the European Parliament and the Council, the EU legislators will now negotiate and publish drafts for discussion. After adoption by the EU legislators, an implementation period of 18 months is envisaged before the new regime goes into effect.

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Please do not hesitate to contact us with any questions.

LONDON

Patricia Volhard
pvolhard@debevoise.com

Simon Witney
switney@debevoise.com

FRANKFURT

Jin-Hyuk Jang
jhjang@debevoise.com

Lennart Lorenz
llorenz@debevoise.com

Eric Olmesdahl
eolmesdahl@debevoise.com