Adoption of New Capital and Remuneration Rules for EU Investment Firms

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On 23 October 2019, the European Council adopted the new legislative package revising the prudential framework for EU investment firms, taking the form of the Investment Firm Regulation (the "IFR") and the Investment Firm Directive (the "IFD"). The regime encompasses new regulatory capital, staff remuneration and risk management requirements for all firms authorised under the EU's Markets in Financial Instruments Directive ("MiFID").

The new requirements are likely to take effect in EU member states in mid-2021 (18 months after the entry-into-force date, which is 20 days after the forthcoming publication in the *Official Journal*). Notwithstanding Brexit, it is currently expected that the United Kingdom will adopt the regime, and the FCA is likely to publish a consultation paper before the end of the year.

Key Changes under the Regime

EU firms authorised under MiFID—including EU brokers, broker-dealers, corporate finance advisers, investment advisers and portfolio managers—currently have regulatory capital requirements that are set by reference to the investment services and activities for which they are authorised as well as to their ability to hold client money or securities. As a result, some MiFID firms that are broker-dealers follow capital requirements under the bank-directed Capital Requirements Directive IV and Capital Requirements Regulation (CRD IV/CRR), whilst others (such as portfolio managers) follow the rules in its predecessor, Capital Requirements Directive III, whilst those with simpler business models (notably firms with "adviser-arranger" authorisation) follow simple fixed initial capital requirements.

This application of different regimes will change. Going forward, all firms authorised under MiFID will follow the new regime in the IFR/IFD package, save for those firms that are bank-like in nature by virtue of their size and activities. The IFR/IFD package creates a prudential framework that is tailored to a firm's business lines—including the size of their assets under management or under advisory arrangements. In addition, the

IFR/IFD imposes a new remuneration framework on investment firms, capturing many firms that are currently not subject to such rules.

The new framework includes an amendment to the Markets in Financial Instruments Regulation (MiFIR) to ensure that third-country "equivalence" decisions take into account the new IFR/IFD prudential framework—noting that many third countries have no such equivalent requirements for investment managers, at least in relation to regulatory capital.

Investment Firms in Scope

The IFR/IFD package captures EU investment firms that are authorised under MiFID.

In relation to **investment managers**, the rules capture those that provide individual portfolio management services—fund managers continue to be governed by the Alternative Investment Fund Managers Directive (AIFMD) or the UCITS Directive. However, it is expected that member states will apply the regime to managers that are authorised under the AIFMD but have "top-up" MiFID permissions, which may entail in practice, application of the regime across the firm's entire business lines.

In relation to **investment advisers** (those firms that are only authorised to give non-binding investment recommendations and assist on the execution of deals—known as "adviser-arrangers" in the United Kingdom), the package captures all advisers that are authorised under MiFID—noting that some advisers, particularly outside the United Kingdom, are authorised "locally" under an exemption from MiFID and, as such, are not subject to the IFR/IFD package.

Scope—Classes of Investment Firms

The IFR/IFD regime divides investment firms into three classes:

	Systemically Important Investment Firms	Non-Systemically Important Investment Firms	Small and Non-Interconnected Investment Firms
Scope	Very large firms (assets over €15 billion and deal on own account or underwrite). In the UK, this is a similar class to firms designated for supervision by the Prudential Regulatory	Large firms above specific thresholds (such as assets under management, balance sheet and revenues).	Smaller, non-interconnected firms **(SNIF)**.

	Systemically Important Investment Firms	Non-Systemically Important Investment Firms	Small and Non-Interconnected Investment Firms
	Authority.		
Key Changes to Capital and Remuneration Requirements	Not within IFD/IFR and will remain subject to CRR/CRD IV prudential requirements.	Capital requirements that apply to SNIFs, with additional capital potentially required tailored to business lines. One third of fixed overhead capital requirement to be held in liquid assets. New remuneration, governance and risk-management requirements.	Capital requirements set at higher of initial capital or fixed overheads of previous year, without additional capital tailored to business lines. Competent authorities can dis-apply liquid capital requirement. Remuneration, governance and risk management requirements do not apply.

Systemically Important Investment Firms

A systemically important investment firm is a firm that engages in underwriting services or deals on its own account (trades with its own capital) and where the total value of its assets exceeds **€15 billion** (or is part of a consolidation group in which firms carrying on these activities exceed this threshold). Alternatively, a firm is within this class if the total value of its assets exceeds **€5 billion** and, at the discretion of supervisors, classification in this class is necessary to address financial stability or market risks or because the firm is a clearing member of a central counterparty.

These firms are considered bank-like in nature because their activities expose them to credit risk, by reference to the counterparties they face, and market risk, by reference to the positions taken on their own account. These firms will be required to seek authorisation as credit institutions under CRD IV, becoming directly subject to the prudential requirements under the CRD IV (and, prospectively, CRD V) framework. As these firms must "deal on own account", investment managers that manage only their clients' assets, rather than their own, will not typically fall within this class.

Non-Systemically Important Investment Firms

A firm will fall in this class where it falls above any of the following thresholds. This class is likely to be relevant for many investment managers, including adviser-arrangers, with the assets under management threshold (see below) the most relevant in practice.

Threshold or Condition	Commentary
Assets under management (AuM) under both discretionary portfolio management and non-discretionary arrangements (constituting investment advice of an on-going nature[1]) **higher than €1.2 billion**.	The test applies on a **combined basis** for all investment firms that are part of a **group**. The AuM calculation **excludes** any assets the management of which has been delegated to the investment firm by another financial entity and **includes** the assets the management of which the firm has delegated to another financial entity.
Client orders handled (COH) (through execution or "reception and transmission" of orders) of at least €100 million per day for cash trades and/or at least €1 billion per day for derivatives.	The test applies on a combined basis for all investment firms that are part of a group. The COH calculation **includes** transactions executed by firms providing portfolio management services on behalf of investment funds and transactions which arise from investment advice in respect of which a firm does not calculate AuM. It **excludes** transactions handled by the investment firm that arise from servicing of a client's investment portfolio where the investment firm already calculates AuM in respect of that client's investment or where this activity relates to the delegation of management of assets to the investment firm by another financial entity.
The firm safeguards and administers any client assets.	The test applies on an individual, not group, basis.
The firm holds any client money.	The test applies on an individual, not group, basis.
The firm has any exposure to risks from trading financial instruments (measured by daily trading flow or, more broadly, execution activity not reflecting in client orders handled).	The test applies on an individual, not group, basis.
The firm has trading-book positions or posts margin as a clearing member.	The test applies on an individual, not group, basis.
The firm has counterparty credit risk arising from non-centrally cleared over-the-counter derivatives transactions.	The test applies on an individual, not group, basis.
On- and off-balance sheet total for the firm higher than €100 million.	The test is calculated on a combined basis for all investment firms that are part of a group.
Total gross revenues higher than €30 million calculated as average on basis of annual figures from two immediately preceding financial years.	The test is calculated on a combined basis for all investment firms that are part of a group (excluding any double counting arising in respect of gross revenues generated within the group).

[1] Defined as the "recurring provision of investment advice as well as continuous or periodic assessment and monitoring or review of a client portfolio of financial instruments including the investments undertaken by the client on the basis of a contractual arrangement."

Small and Non-Interconnected Investment Firms

Any firm not meeting the above thresholds will be a SNIF. The designation determines whether some significant parts of the IFD/IFR package—described in greater detail below—apply:

Requirement	Application to Small and Non-Interconnected Investment Firms
Application of IFR/IFD requirements on an individual basis	Competent authorities may waive the requirement to comply with the IFR's requirements relating to: own funds composition, the calculation of capital requirements, concentration risk, liquidity requirements, disclosure and reporting on a solo basis where the firm is, broadly speaking, within a consolidation group, subject to the satisfaction of a number of conditions.
Remuneration	The remuneration provisions do not apply, although SNIFs will continue to be subject to the MiFID remuneration rules (focussed on conduct towards clients).
Own funds requirement	A SNIF will be required to have own funds at least equal to the highest of its (i) fixed overheads requirement and (ii) permanent minimum requirement. SNIFs are not subject to the K-factor requirements (see below) when calculating regulatory capital.
Liquidity requirements	Competent authorities can exempt a SNIF from the liquidity requirements.
Internal capital adequacy assessment process	The requirement to carry out an internal capital adequacy assessment process does not apply to SNIFs, although supervisors have the discretion to require SNIFs to do so if they deem it appropriate.
Public disclosures on capital and risk	SNIFs are only required to make public disclosures where they issue "Additional Tier 1" instruments in relation to their capital requirements.
Reporting to competent authorities	SNIFs will report regulatory capital information to their competent authorities on an annual, rather than quarterly, basis.

Regulatory Capital Requirements

Prudential and specifically regulatory capital requirements deal with the stability of a firm as a "going concern" and are designed to provide sufficient time to wind down a firm (as a "gone concern"). For all firms, capital requirements will be set by reference to an "initial capital" requirement and their annual fixed overheads.

Initial capital requirements are:

- €750,000 for firms that deal on own account or underwrite and/or place financial instruments on a firm commitment basis.

- €75,000 for firms performing reception and transmission of orders, execution of orders, portfolio management, investment advice or placing without a firm commitment basis.

- €150,000 for any other firm.

The fixed overheads requirement is one quarter of the firm's fixed overheads of the preceding year—on the assumption that three months is a sufficient period for the firm to deal with its and its clients-affairs before closing its doors. Staff bonuses (to the extent they depend on the firm making a net profit) and partner profit share and other appropriations of profits and other variable remuneration, if fully discretionary, are not counted in fixed overheads. Non recurring expenses from non-ordinary activities are also not counted.

Adviser-arrangers (as "exempt CAD" firms) are currently required to hold initial capital of €50,000, and the requirement to hold additional capital by reference to fixed overheads is new.

The own funds requirement for a non-systemically important investment firm is the higher of:

- Base capital requirement;

- Fixed overheads requirement; and

- A new "K-factor" for measuring risks.

The K-factors target the business lines likely to generate risks to a firm, to its clients and to the market and largely correspond to the factors used to determine whether a firm is a SNIF (such as AuM and COH). The K-factor requirement is the sum of each K-factor multiplied by the relevant factor prescribed by the IFR. For AuM, the factor is 0.02% - €200,000 per €1 billion of AuM.

Any firm other than a SNIF must also have an internal capital adequacy assessment process (ICAAP) to assess and maintain, on an ongoing basis, the amounts, types and distribution of internal capital and liquid assets that it considers adequate to cover its risks.

Liquidity Requirements

Firms must maintain one third of the fixed overhead requirement as liquid assets, although competent authorities may exempt SNIFs from this requirement. The definition of liquid assets broadly includes cash on short-term bank deposit, claims on governments and high-quality covered bonds and corporate debt securities and, potentially, trade receivables and fees or commissions receivable within 30 days (covering up to one third of minimum liquidity requirements).

Governance and Remuneration Requirements

The IFD includes remuneration and governance rules, largely based on CRR/CRD IV. These rules do not apply SNIFs.

Governance

Firms must have robust governance arrangements, including a clear organisational structure, to identify and manage risks, and adequate internal control mechanisms. The management body must approve and review the firm's policy on its risk appetite and on managing, monitoring and mitigating the risks the firm may be exposed to, taking into account the macro economic environment and firm's business cycle. There are also general risk management obligations which require firms to have policies to address: risks to clients, risks to market, risks to the firm and liquidity risk proportionate to the complexity, risk profile and scope of the firm. Firms that do not meet the "simple firm" criteria for the purpose of the remuneration rules (see below) must establish a risk committee of members from the management body who do not perform any executive function in the firm.

Remuneration

The IFD remuneration rules will apply to senior managers, risk-takers, staff engaged in control functions and certain other highly paid roles. The IFD does not include a cap on "variable remuneration" (essentially bonuses), but firms will need to set (and publicly disclose) "appropriate" fixed-to-variable remuneration ratios. In addition, variable remuneration will be subject to certain restrictions, including:

- Non cash element—At least 50% of variable remuneration must be awarded in shares, share-linked instruments or non cash instruments which reflect the portfolios managed by the firm or certain capital instruments of the firm (or alternative instruments approved by competent authorities for firms that do not issue such instruments) and be subject to an appropriate long term retention policy.

- Deferral—Payment of at least 40% of variable remuneration (60% with particularly high remuneration) must be deferred over a three- to five-year period.

- Malus and clawback—Up to 100% of variable remuneration must be subject to malus (which would prevent vesting due to the firm's subsequent poor performance) and clawback (which would clawback remuneration already paid) arrangements.

Under the "proportionality" principle of existing remuneration frameworks, remuneration policies should be proportionate to the size, internal organization and nature, as well as to the scope and complexity, of the activities of the investment firm. Additionally, the non-cash element and deferral rules above (but not the malus and clawback rules) do not generally apply to:

- An investment firm with on- and off- balance sheet asset values of €100 million or below (based on a four-year look-back)[2]; or

- An individual whose annual variable remuneration does not exceed €50,000 (and this amount does not represent more than a quarter of the individual's total remuneration).

Firms with on- and off-balance sheet assets over €100 million over a four-year period will need to establish a remuneration committee. This can be established at group level.

In accordance with existing remuneration guidelines, variable remuneration is likely to include carried interest paid to private equity executives. To avoid re-structuring of carried interest arrangements, private equity advisors will need to argue, on the grounds of proportionality, that carried interest is already well aligned to investors' interests and addresses undue risk-taking, such that strict compliance with the requirements on non-cash element, deferral and malus and clawback need not apply. Firms will also need to disclose publicly the aggregate amounts of carried interest paid to staff.

Disclosure and Reporting

A firm, other than a SNIF, at the same time as it publishes its annual financial statements, must publicly disclose:

[2] It is thought that this test only applies on an individual (as opposed to consolidated) basis, but this may be subject to further guidance.

- Information about its risk-management objectives and policies with a risk statement approved by the management body describing the firm's overall risk profile associated with the business strategy.

- Information about governance, including the number of directorships held by members of the management body, the firm's policy on diversity in relation to selection of the management body and whether the firm has set up a separate risk committee and the number of times it has met.

- Information about the firm's own funds to meet minimum capital requirements.

- Information on the K- factor capital requirements (in aggregate form).

- Information on compliance with the fixed overheads requirement.

All investment firms with on- and off-balance sheet assets over €100 million over a four-year period will also have to disclose their investment policies. This should include detail on voting rights attached to shares which are admitted to trading on a regulated market, held directly or indirectly by the firm, where the proportion of voting rights held exceeds 5% of all voting rights attached to the shares, and a complete description of related voting behaviour by the firm.

Firms will be required to make public information on remuneration in more detail than under current remuneration frameworks. This should include information on the ratios the firm has set between fixed and variable remuneration, amounts of severance payments, amounts of deferred remuneration and information on any gender pay gap. Firms will also need to provide competent authorities with information on the number of individuals who are remunerated €1 million or more per year in pay brackets of €1 million. This information should include their job responsibilities, their business area and the elements of their salary, bonus, long-term award and pension contribution.

Firms will also need to publish reports on environmental, social and governance risks, related to the transition into a more sustainable economy. This requirement is subject to a three-year phase-in period.

Separately, all firms will need to report to their competent authorities information on their own funds, available capital, levels of activity and, for firms other than SNIFs, concentration risk and, where applicable, liquidity risk. Reports are required quarterly for all firms, other than SNIFs, which must report annually.

Group Consolidation

Investment firms belonging to a group where there is a parent financial holding company in the European Union must comply with the requirements in IFR on a consolidated basis. The consolidation group will include the relevant parent and its worldwide direct and indirect subsidiaries which fall within the EU definitions of investment firm, financial institution, ancillary services undertaking or tied agent. This is a new requirement for adviser-arrangers, which are not currently subject to prudential consolidation.

Competent authorities can apply a simpler and lighter touch “group capital test” to group structures which they deem to be “sufficiently simple” and in respect of which no significant risks to clients or to the market will arise from not applying consolidated supervision.

Transitional Provisions

The IFD/IFR includes transitional arrangements for the new capital requirements. Broadly, firms can limit the initial capital requirements to their minimum capital requirement under the CRD IV/CRR for five years, subject to annual increase of at least €5,000 over the course of five years.

In practice, the capital requirement calculated by reference to a firm’s fixed overheads and K-factors will almost always exceed a firm’s initial capital requirement. By way of derogation from the fixed overheads and K-factors requirements, firms may limit their capital requirement for five years from the date of application of the IFR to twice the firm’s existing capital requirement under the CRR or, for firms not in existence before the application date of IFR, twice the applicable fixed overhead requirement in IFR. There is currently some doubt on the application of the transitional provisions for firms (such as adviser-arrangers) that are currently only subject to an “initial capital” and not subject to a fixed overhead capital requirement, although the IFR indicates that such firms should be able to limit their capital requirement to twice their initial capital requirement.

The transitional arrangements are framed to apply only to the capital requirements. It is not currently clear whether they apply to the related requirements on liquidity, disclosure and reporting to competent authorities.

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