FCA's New Prudential Rules for UK Private Equity Adviser-Arrangers

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The Financial Conduct Authority ("FCA") recently published a Discussion Paper on the new UK prudential regime—encompassing regulatory capital, staff remuneration and risk management requirements—for all firms authorised under the EU's Markets in Financial Instruments Directive ("MiFID"). The Discussion Paper covers the regime that the UK will adopt in place of implementing the EU Investment Firms Directive and Regulation ("IFD" and "IFR"), which come into force in June 2021, after the end of the current Brexit transitional period. The UK's regime is closely modelled on the IFD and IFR. We have published a separate briefing on the IFD and IFR.

EU private equity firms that are structured as "adviser-arrangers" are often (but not invariably) authorised under MiFID. Unless they are classified as "Non-Systemically Important Investment Firms" (i.e., sub-threshold firms) under the various tests in the IFD and IFR[1], they will need to consider the impact of many of the IFD and IFR's provisions. Despite representations by the private equity industry, the FCA gives no indication that it will introduce a tailored regime for private equity advisers. However, the FCA's Discussion Paper contains helpful guidance on the FCA's interpretation of various rules and points of uncertainty and indicates how the FCA will exercise various discretions in the IFD and IFR.

Of particular interest to private equity sponsors are the following points:

Remuneration. The FCA confirms that it will introduce a new remuneration code based on the rules in the IFD and IFR, which will apply to firms other than sub-threshold firms. Private equity advisors (currently classified as "CAD exempt" and largely outside the scope of remuneration rules) will be required to have a detailed policy on remuneration, set an appropriate ratio between the variable and fixed components of total remuneration and meet requirements on the structure of variable remuneration. In this regard, the FCA states that it may consider thresholds for the total annual remuneration paid to an individual at which certain rules (on pay-out and deferral) can

[1] The key tests that apply to determine whether an adviser-arranger is sub-threshold are: (i) value of assets under non-discretionary investment advisory arrangements exceeds €1.2 billion; (ii) balance sheet total higher than €100 million; and (iii) annual gross revenues higher than €30 million.

be disapplied that are lower than those set out in the IFD, and indicates that it will exercise a discretion to increase the test by reference to a firm's balance sheet that will allow firms to disapply the pay-out and deferral rules across the firm as a whole. Of particular note is that the FCA confirms that, whilst firms should adopt a proportionate approach to compliance with the remuneration provisions, the current broad discretion for UK firms to disapply certain rules on the basis of "proportionality" will not apply in the future, with the consequence that all firms (other than sub-threshold firms) will be required to apply the rules on "malus" (downward adjustment of a bonus award before it is payable) and "clawback" (repayment of bonuses already awarded).

UK AIFMs with Additional MiFID Permissions. The FCA confirms that firms authorised as AIFMs with additional MiFID "top-up" permissions will be subject to the same prudential requirements for their MiFID business. Firms will determine whether or not they are sub-threshold by reference to the firm's MiFID (as opposed to AIFMD) business, with the firm holding the higher of the AIFMD or MiFID regulatory capital requirements.

Environmental, Social and Governance ("ESG") Issues. From December 2022, larger investment firms (i.e., those with balance sheets exceeding €100,000,000) will need to disclose information on their exposures to activities associated with ESG risks. There is some lack of clarity as to what this will entail, although it appears to relate to consideration by the firm of environmental, social and governance factors in its own activities, and the European Commission may introduce ESG-related adjustments to the capital that firms are required to hold. The FCA confirms that it will ensure that firms integrate consideration of ESG-related risks and opportunities into the business, investment and risk decisions they make.

Transitional Arrangements. There has been uncertainty as to the ability of adviser-arrangers to take advantage of the transitional provisions in the IFR relating to "fixed overheads" and "k-factors" capital requirements (which would have the effect of allowing firms to defer implementation of potentially greatly increased capital requirements for up to five years). The FCA notes the uncertainty in this regard and indicates that it will consider this issue further.

As a next step, the FCA expects to publish a consultation paper in the third or fourth quarter of this year. The UK Treasury has separately confirmed that it intends to introduce the new regime by summer 2021, in line with the June 2021 application date of the IFR/IFD.

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