Latest on the prudential supervision of investment firms

Introduction and scope

On 20 December 2017, the EU Commission published a proposal for a directive and a regulation (together with a staff working document) "on the prudential requirements of investment firms". This follows the publication on 29 September 2017 of the European Banking Authority's (EBA) opinion on the framework.

The new regime will likely take effect in late 2019 or early 2020. It will apply to all MiFID firms, including those that will be brought into scope by MiFID II[1]. The purpose of the new framework is to implement capital and liquidity requirements for investment firms, but in a way that is more proportionate and risk-sensitive for non-bank institutions. Broadly, the principle of 'home state' regulation applies[2], although host state supervisors can intervene if required to 'avert or remedy potential problems and risks…to the protection of clients or the stability of the financial system' in their jurisdiction. A dispute resolution process to resolve differences between home state and host state regulators will be created and will involve the EBA.[3] Foreign branches may be subject to on-the-spot inspections by both host state and home state regulators[4].

A summary of the EU Commission proposal is provided below. It considers six main areas of the proposed framework:

1. Classification;
2. Capital requirements;
3. Concentration risk;
4. Liquidity risk;
5. Reporting; and
6. Public disclosure requirements.

Classification

General

There are three 'classes' of investment firm defined under the proposal:

1. Class 1: systemically important investment firms which are exposed to the same types of risk as credit institutions;
2. Class 2: non-systemic investment firms above specific thresholds, including larger investment firms, trading firms and firms that hold client money/assets; and
3. Class 3: Small and non-interconnected investment firms providing limited services in terms of number and size, which would have a lower impact if they failed.

Class 1 firms will continue to be subject to provisions of CRD IV[5]. Class 2 firms will be subject to all of the provisions of the new prudential framework. Class 3 firms will be subject to a sub-set of the new provisions.

[1] Directive, Article 2(1)
[2] Directive, Article 10
[3] Directive, Article 11
[4] Directive, Article 12(1) and (2)
[5] Directive 2013/36/EU and Regulation (EU) No 575/2013

Effect of classification

Investment firms must assess, on an annual basis, whether they meet the conditions to classification as "small and non-interconnected"[6] (i.e. a "Class 3" firm). To be classified as such, a firm must meet all of the conditions detailed in schedule 2[7]. Where an investment firm no longer meets all of the above conditions, it will cease to be regarded as 'Class 3' with immediate effect[8]. However, if the only reason why the firm has ceased to maintain its 'Class 3' status is because it has breach either the K-AUM or the K-COH thresholds (see below for more detail), it will cease to be regarded as 'Class 3' three months after the relevant threshold was breached.[9] An investment firm which previously did not meet all of the above conditions, must meet them for a minimum of six months before it can be regarded as 'Class 3'[10].

In addition, any firm which does not satisfy all of the 'Class 3 conditions' must - as of the financial year after the year on which it assumed 'Class 2' status[11] – comply with a number of additional provisions under the Directive[12], as set out below.

Internal governance

Class 2 firms must have "robust governance arrangements" in place. This includes clear organisational structure, effective processes to manage risk, adequate internal control mechanisms and remuneration policies which promote sound and effective risk management[13].

Country-by-country reporting

Class 2 firms must provide country reporting for each subsidiary and branch. This must be audited, annexed to financial statements and address a number of issues: (i) name, nature of activities and location; (ii) turnover; (iii) number of full-time equivalent employees; (iv) profit or loss before tax; (v) tax on profit or loss; and (vi) public subsidies received[14].

Treatment of risks[15]

Class 2 firms must periodically review their risk management policies. They must devote sufficient time and adequate resources to the management of risk and establish reporting lines to the board in relation to all risks. "Significant" investment firms will be required to establish a dedicated risk committee composed of suitably experienced non-executive directors. In contrast, a 'non-significant' firm may allow its audit committee to perform a dual function as a risk committee.[16]

Risk-to-customers, risk-to-market, risk-to-firm[17]

Investment firms must have "robust strategies, policies, processes and systems" for the identification, measurement, management and monitoring of a number of risks to their business, as specified in the table below. 'Risk to Customers', 'Risk to Market' and 'Risk to Firm' are defined by reference to a number of 'K-factors', more details of which are also provided in Schedule 2.

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[6] Directive, Article 23(1)
[7] Regulation, Article 12(1)
[8] Regulation, Article 12(2)
[9] Regulation, Article 12(3)
[10] Regulation, Article 12(4)
[11] Directive, Article 23(3)
[12] Directive, Article 23(3)
[13] Directive, Article 24
[14] Directive, Article 25
[15] Directive, Article 26
[16] Directive, Article 26(4)
[17] Directive, Article 27

Classification	Risk to Customers	Risk To Market	Risk to Firm		Liquidity Risk
			Trading Activities	Concentration Risk	
Class 2	Yes	Yes	Yes	Yes	Yes
Class 3[18]	Yes	No	No	Yes	Yes

Remuneration policies[19]

Class 2 firms must implement a "clear and documented" remuneration policy which, broadly, applies to all senior management and risk takers. The remuneration policy must set appropriate ratios between basic fixed remuneration and variable remuneration, promote sound and effective risk management, avoid conflicts of interest and be subject to periodic review. "Significant" investment firms must go further and establish a remuneration committee consisting of non-executive board members[20]. Information regarding the remuneration of 'material risk takers'[21] as well as 'million plus' earners[22] must be disclosed.

Whilst the proposals do not include an outright 'bonus cap' (i.e. they do not limit the ratio between variable and fixed remuneration), to the extent that a firm pays performance-related variable remuneration,[23] it must:

1. Take account of the performance of the individual, the business unit and the overall firm;
2. Take account of both financial and non-financial criteria;
3. Be assessed over a multi-year period which takes into account the business cycle of the firm;
4. Not affect the firm's ability to ensure a sound capital base;
5. Not be guaranteed (there is an exception for new staff, but only for the first year of employment);
6. Take into account all types of current and future risks facing the firm with respect to the way in which it is allocated; and
7. Be subject to clawback provisions in its entirety.

Where Qualifying Firms[24] and Qualifying Individuals[25] are concerned, at least 50% of variable remuneration must comprise equity, equity-instruments or instruments convertible into equity and at least 40% must be deferred over a 3 to 5 year period. More generally, the size of the overall pool of variable remuneration must take into account the risk, cost of capital and liquidity requirements of the firm. Class 2 firms which benefit from extraordinary public financial support may also be required to limit:

1. the payment of variable remuneration of all staff to a portion of net revenue, and
2. the remuneration of members of the board[26].

In addition:

1. Early termination payments must reflect actual performance of the individual and not reward an individual's failure or misconduct;

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[18] Directive, Article 27(2)
[19] Directive, Article 28
[20] Directive, Article 31
[21] Regulation, Article 51
[22] Directive, Article 32
[23] Directive, Article 30
[24] Firms with an average asset value greater than EUR 100 million as calculated over the previous 4-years
[25] Individuals whose annual variable remuneration exceeds EUR 50,000 or represents more than 25% of the individual's total annual remuneration
[26] Directive, Article 29

2. Compensation packages generally must be aligned with the long-term interests of the firm; and
3. Discretionary pension benefits must be in line with the business strategy, objectives and long-term interests of the firm (and, with respect to Qualifying Firms and Qualifying Individuals, will be subject to a 5-year retention period).

Capital Requirements

General

Investment firms must have in place "sound, effective and comprehensive strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of risks to which they are or might be exposed"[27]. These processes must be subject to "regular internal review"[28]. Levels of capital must be sufficient to ensure that[29]:

1. Cyclical economic fluctuations do not lead to a breach of the Directive or Regulation; and
2. Firms can absorb the potential losses and risks identified by supervisory review.

Initial capital requirements

The initial capital requirements[30] for investment firms have remain unchanged from the EBA opinion of September 2017[31], and are summarised in Schedule 3. Firms will have five years to bring their initial capital levels up to the required minimum by annual increases of EUR 5,000[32]. However, during this five-year period they may limit their capital requirements to:

1. Twice the relevant capital requirement under the Capital Requirements Regulation[33] (had the firm continued to be subject to that Regulation);
2. Twice the applicable fixed overhead requirement (where the firm was not in existence at the time the new requirements came into force); or
3. Twice the initial capital requirement specified under the Capital Requirements Directive[34] (where the firm in question was only subject to an initial capital requirement until the new regulations came into force).

If, at the end of the five-year period, capital levels have not met the new requirements, another transitional period of up to five years can be granted. Commodity dealers must comply with initial capital requirements within five years of entry into force of the framework.

Ongoing capital requirements

Class 3 firms

Small and non-interconnected investment firms must at all times have capital equal to:

Max (fixed overheads, permanent minimum capital requirements)[35]

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[27] Directive, Article 22(1)
[28] Directive, Article 22(2)
[29] Directive, Article 38
[30] Directive, Article 8
[31] See Recommendation 20
[32] Directive, Article 59(1)
[33] Regulation (EU) No 575/2013
[34] Directive 2013/36/EU
[35] Regulation, Article 11(2)

where:

"*Fixed overheads*" equals one-quarter of the fixed overheads of the preceding year[36] (or its projected first-year overheads – where the firm is in its first year of operation)[37]; and

"*Permanent minimum capital requirements*" must be no less than the amount of initial capital required (see Schedule 3).[38]

Class 2 firms

All other investment firms must at all times have capital equal to:

Max (fixed overheads, permanent minimum capital requirements, Σ K-factor requirements)[39]

where:

"*K-factor requirements*" equals the 'K-factor Capital Requirement' as detailed in, and calculated in accordance with, Schedule 2.

Capital composition

In terms of composition, own-funds must meet the following requirements:

1. At least 56% must consist of Tier 1 capital;
2. Up to 44% may consist of additional Tier 1 capital; and
3. Up to 25% may consist of Tier 2 capital[40].

K-Factors

General

Broadly, K-factors measure different areas of risk to which an investment firm may be exposed. K-factors must be monitored and firms must notify regulators of any trends that could result in materially different capital requirements.[41] Regulators have the ability to increase K-factors where there has been a material change in the business activities of a firm[42]. Each of the different K-factors is discussed in more detail below:

K-AUM

K-AUM refers to assets managed under both discretionary and non-discretionary arrangements, as well as assets delegated to another undertaking[43]. However, assets delegated to the firm in question are excluded[44].

K-CMH

K-CMH is a measure of the amount of client money that an investment firm hold or controls[45].

[36] Regulation, Article 13(1)
[37] Regulation, Article 13(3)
[38] Regulation, Article 14 and Directive, Article 8
[39] Regulation, Article 11(1)
[40] Regulation, Article 9(1)
[41] Regulation, Article 15(3)
[42] Regulation, Article 15(4)
[43] Regulation, Article 17(2)
[44] Regulation, Article 4(25)
[45] Regulation, Article 4(26)

K-ASA

K-ASA refers to the value of assets that an investment firm safeguards and administers for clients, including assets delegated to another undertaking and assets that another undertaking has delegated to the investment firm (irrespective of whether they appear on the firm's own balance sheet)[46].

K-COH

K-COH refers to the value of client orders that an investment firm handles[47].

K-CON

K-CON measure the trading book exposure of an investment firm to a client or group of connected clients[48].

K-CMG

K-CMG is a reference to the amount of initial margin posted with a clearing member[49].

K-DTF

K-DTF is a measure of the daily value of transactions that an investment firm executes on own account or on behalf of clients in its own name[50].

K-NPR

K-NPR refers to the value of transactions recorded in the trading book of an investment firm (the 'net position risk')[51].

K-TCD

K-TCD is a measure of the risk assumed by an investment firm in relation to trading counterparty default[52]. Broadly, it requires firms to factor in the risk arising from:

1. Non-cleared derivatives (other than those executed with governments and central banks or executed for hedging purposes);
2. Long settlement transactions;
3. Repurchase transactions;
4. Securities or commodities lending/borrowing transactions; and
5. Margin lending transactions.

Expressed as a formula, K-TCD:

= Exposure value * RF[53]

= Max (0, RC + PFE – C) * RF

[46] Regulation, Article 4(27)
[47] Regulation, Article 4(28)
[48] Regulation, Article 4(29)
[49] Regulation, Article 4(30)
[50] Regulation, Article 4(31)
[51] Regulation, Article 4(32)
[52] Regulation, Article 4(33)
[53] Regulation, Article 26

where:

RC: is the "Replacement Cost" of the relevant transactions[54];

PFE: is the potential future exposure. This is only applicable to derivatives and long settlement transactions. It is calculated by reference to the 'Effective Notional'[55] of the transaction, multiplied by a "Supervisory Factor" (a factor which ranges between 0.5% and 32%, depending on asset class[56]), multiplied by a "Maturity Factor" (which is, broadly, the square root of the remaining time to maturity as a proportion of one year – floored at 10 days and capped at one year[57]));

C: refers to the amount of posted collateral (subject to haircuts depending on asset class, remaining maturity and whether the underlying transaction is a repo or not, and with an additional 8% haircut for currency mismatches)[58]; and

RF: is 1.6% for credit institutions and investment firms and 8% otherwise.

Concentration Risk

Unless a firm qualifies as 'Class 3' it must report annually to its National Competent Authority (NCA) on the concentration risk:

1. associated with the default of counterparties;
2. towards entities holding the firm's client assets;
3. towards entities holding the firm's own money; and
4. from earnings.[59]

An Investment firm must limit its exposure to a client or group of connected clients to 25% or less of its regulatory capital unless:

1. It notifies its competent authority of any limit breach "without delay"[60]; and
2. It meets the additional K-CON capital requirements detailed in Schedule 4[61]; and
3. The exposure does not exceed 500% of the investment firm's regulatory capital (where 10 days or less have elapsed since the excess occurred)[62]; and
4. <u>Excess</u> exposure does not exceed 600% of the investment firm's regulatory capital (where more than 10 days have elapsed since the excess occurred).

However, where the client in question is a credit institution or investment firm, or where the group of clients includes a credit institution or investment firm, exposure must be limited to:

Max [25% of regulatory capital, Min (100% of regulatory capital, EUR 150 million)][63]

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[54] See Regulation, Article 28 for more detail on the "Replacement Cost" for different types of underlying transaction
[55] See Regulation, Article 29. Broadly, this is the notional of the transaction multiplied by the duration (for IRS and CDS) or the delta (for options). A method is also specified for determining the 'notional' for different transaction types
[56] Regulation, Article 29(7)
[57] Regulation, Article 29(8)
[58] Regulation, Article 30
[59] Regulation, Article 34
[60] Regulation, Article 37
[61] Regulation, Article 38
[62] Regulation, Article 36(2)(b) – not that this provision does not seem to refer to "Excess" exposure, but to 'absolute' exposure
[63] Regulation, Article 36

Liquidity Risk

Investment firms must hold liquid assets equivalent to at least one-third of their fixed overhead requirements.[64] Firms can fall below this level provided that they notify their NCA "without delay" and compliance is restored within 30 days.[65] 'Class 3' firms may include receivables from trade debtors and fees or commissions receivable within 30 days in their liquid asset calculations – up to a maximum of one-third of the requirement and subject to a haircut of 50%.[66] An investment firm must increase its liquid assets by 1.6% of the total amount of guarantees provided to customers.[67]

Reporting

Investment firms will have to provide NCAs with all information necessary for the assessment of compliance with the new regime. Internal control mechanisms and administrative procedures which enable authorities to check compliance "at all times" are specifically envisaged[68]. Investment firms will be expected to "register" their transactions and "document systems and processes" in such a manner as will enable NCAs to assess compliance with the new framework[69]. Specifically, they must submit an annual report to their NCA including all of the following information[70]:

Information to be reported	'Class 3' firm	'Class 2' firm
Level and composition of own funds	Yes	Yes
Capital requirements	Yes	Yes
Capital requirement calculations	Yes	Yes
The level of activity for determining whether the firm qualifies as 'Class 3'	Yes	Yes
Concentration risk	No	Yes
Liquidity requirements	No	Yes

[64] Regulation, Article 42(1)
[65] Regulation Article 43
[66] Regulation, Article 42(2)
[67] Regulation, Article 44
[68] Directive, Article 4(5)
[69] Directive, Article 4(6)
[70] Regulation, Article 52(1)

In addition, 'Class 2' firms which deal on own account or underwrite/place financial instruments on a firm commitment basis must verify the size of their total assets on a monthly basis and report that information on a quarterly basis to both their NCA and the EBA.[71]

NCAs will have wide-ranging powers of enforcement[72], including the power to:

1. require an investment firm to hold additional capital (provided that certain conditions are satisfied[73]);
2. restrict the business or operations of an investment firm;
3. require an investment firm to reduce risk;
4. limit variable remuneration as a percentage of net revenues;
5. restrict dividend payments; and
6. impose additional reporting, disclosure or liquidity requirements

Auditors will also be under a duty to report promptly to competent authorities any fact or decision concerning the investment firm which:

1. Constitutes a material breach of the directive;
2. May affect the continuous functioning of the investment firm; or
3. May lead to a refusal to certify the accounts or can lead to the expression of reservations.[74]

Public Disclosure Requirements

Public disclosure requirements apply to investment firms, as detailed in the table below[75]:

Information to be disclosed	'Class 3' firms	'Class 3' firms issuing Additional Tier 1 capital	'Class 2' firms
Risk Management Objectives and Policies	No	Yes	Yes
Internal Governance Arrangements	Yes	No	Yes
Own Funds	No	Yes	Yes
Capital Requirements	No	Yes	Yes
Return on Assets[76]	No	Yes	Yes
Remuneration policy and practices for material risk takers	Yes	No	Yes

[71] Regulation, Article 53(1)
[72] Directive, Article 36
[73] Directive, Article 37
[74] Directive, Article 15
[75] Regulation, Articles 45 to 51
[76] Net profit divided by total balance sheet

Schedule 1: Small and non-interconnected investment firms[77]

An investment firm will be regarded as "small and non-interconnected" (i.e. 'Class 3') where it meets **all** of the following conditions:

Classification	Condition	Threshold	Observation Time(s)	Observation Period	Sole/Combined Basis?
RtC	Assets under management (AUM)	< EUR 1.2 billion	End of day	Average calculated on previous 2-year period	Combined
RtC	Client orders handled (COH)	< EUR 100 million p/d (cash trades); OR < EUR 1 billion p/d (derivatives)	End of day	Average calculated on previous 2-year period	Combined
RtC	Assets safeguarded or administered (ASA)	= Zero	End of day	Any point in previous 2-year period	Sole
RtC	Client money held (CMH)	= Zero	Intra-day	Any point in previous 2-year period	Sole
RtM	Net Position Risk (NPR)	= Zero	End of day	Any point in previous 2-year period	Sole
RtM	Clearing Member Guarantee (CMG)	= Zero	End of day	Any point in previous 2-year period	Sole
RtF	Daily trading flow (DTF)	= Zero	End of day	Any point in previous 2-year period	Sole
RtF	Trading counterparty default (TCD)	= Zero	End of day	Any point in previous 2-year period	Sole
RtF	Trading book exposure to connected clients (CON)	Not specified	Not specified	Not specified	Not specified
-	Balance sheet	< EUR 100 million	End of previous financial year	Average calculated on previous 2-year period	Combined
-	Total gross revenues from investment services and activities	< EUR 30 million	End of previous financial year	Average calculated on previous 2-year period	Combined

[77] See test in Article 12(1) of the Regulation

Schedule 2: K-factors

	K-factor Capital Requirement (KFCR)										
	KFCR = RtC + RtM + RtF[78]										
	KFCR = {($C_{K\text{-}AUM}$ x K-AUM) + ($C_{K\text{-}CMH}$ x K-CMH) + ($C_{K\text{-}ASA}$ x K-ASA) + ($C_{K\text{-}COH}$ x K-COH)} + {Max (K-NPR, K-CMG)} + {($C_{K\text{-}DTF}$ x K-DTF) + ($C_{K\text{-}TCD}$ x K-TCD) + ($C_{K\text{-}CON}$ x K-CON)}										
	K-Factors									'Other' Factors	
	K-AUM	K-COH	K-ASA	K-CMH	K-NPR	K-CMG	K-DTF	K-TCD	K-CON	Balance Sheet	Total Gross Revenues
K-factor coefficient (C_K)[79]	0.02%	Cash: 0.1% Derivs: 0.01%	0.04%	0.45%	None	None	Cash: 0.1% Derivs: 0.01%	None[80]	None specified	Not applicable	Not applicable
Deferral Period[81]	3m	3m	3m	No lag	No lag	Not specified	3m	No lag	No lag	Not applicable	Not applicable
Averaging	15m Average (excluding 3 most recent months)[82]	6m Average (excluding 3 most recent months)[83]	6m Average (excluding 3 most recent months)[84]	3m Average[85]	No Averaging	Not specified	6m Average (excluding 3 most recent months)[86]	No Averaging	No Averaging	Not applicable	Not applicable
Observation Point	Last day of month	Daily trading flow	End of day[87]	End of day	End of day	Not specified	End of day[88]	End of day	End of day	Not applicable	Not applicable
No of Observations	12	No working days in relevant month	No working days in relevant month	No working days in relevant month	N/A	Not specified	No working days in relevant month	N/A	N/A	Not applicable	Not applicable

[78] Regulation, Article 15(1)
[79] Regulation, Article 15(2)
[80] The capital requirement is calculated as Exposure* CRR risk factor
[81] "Deferral" refers to the timelag between the date of the calculation of capital requirements and the date on which the capital requirements take effect
[82] Regulation, Article 17(1)
[83] Regulation, Article 20(1)
[84] Regulation, Article 19(1)
[85] Regulation, Article 18(1)
[86] Regulation, Article 32(1)
[87] Regulation, Article 18(1)
[88] Regulation, Article 32(1)

Schedule 3: Initial Capital Requirements

Investment Services and Activities undertaken[89]	Capital Requirement (EUR)	
	Holding client money or assets	Not holding client money or assets
Reception and transmission of orders in relation to one or more financial instruments;	150,000	75,000
Execution of orders on behalf of clients	150,000	75,000
Dealing on own account	750,000	750,000
Portfolio management	150,000	75,000
Investment advice	150,000	75,000
Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis	750,000	750,000
Placing of financial instruments without a firm commitment basis	150,000	75,000
Operation of an MTF	750,000	750,000
Operation of an OTF	750,000	750,000

[89] Taken from Section A of Annex I to MiFID II (Directive 2014/65/EU)

Schedule 4: Additional K-CON Capital Requirements

Additional K-CON Capital Requirement = Excess * Factor		
Excess (Excess Exposure over concentration limits (as a % of regulatory capital))	Factor (where excess existed <= 10 days)	Factor (where excess existed > 10 days)
Excess <=40%	200%	200%
40% < Excess <= 60%	200%	300%
60% < Excess <= 80%	200%	400%
80% < Excess <= 100%	200%	500%
100% < Excess <= 250%	200%	600%
Excess > 250%	200%	900%