

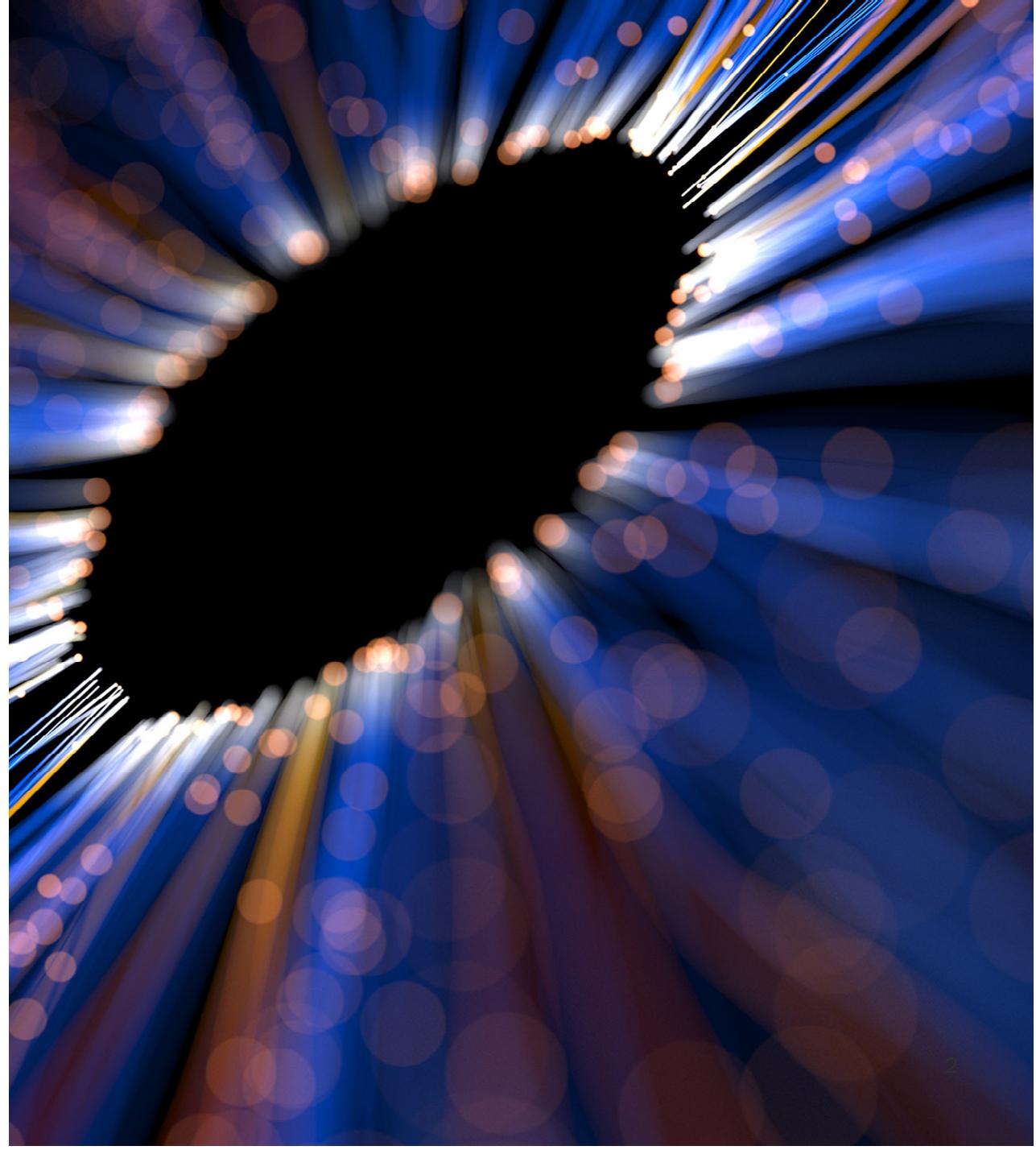
IFD / IFR – a new EU investment firm prudential regime

Financial Markets Legal
Update – the webinar series

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Agenda

- 1 **Introduction** on IFD/IFR: scope & timeline
- 2 **Categorisation**: classes and levels of application
- 3 **Capital**: K-Factors
- 4 **Remuneration**: bonus cap & proportionality
- 5 **Restructuring** : qualifying for class 3
- 6 **To do**: things to start thinking about



Introduction



What is the new EU investment firm prudential regime?



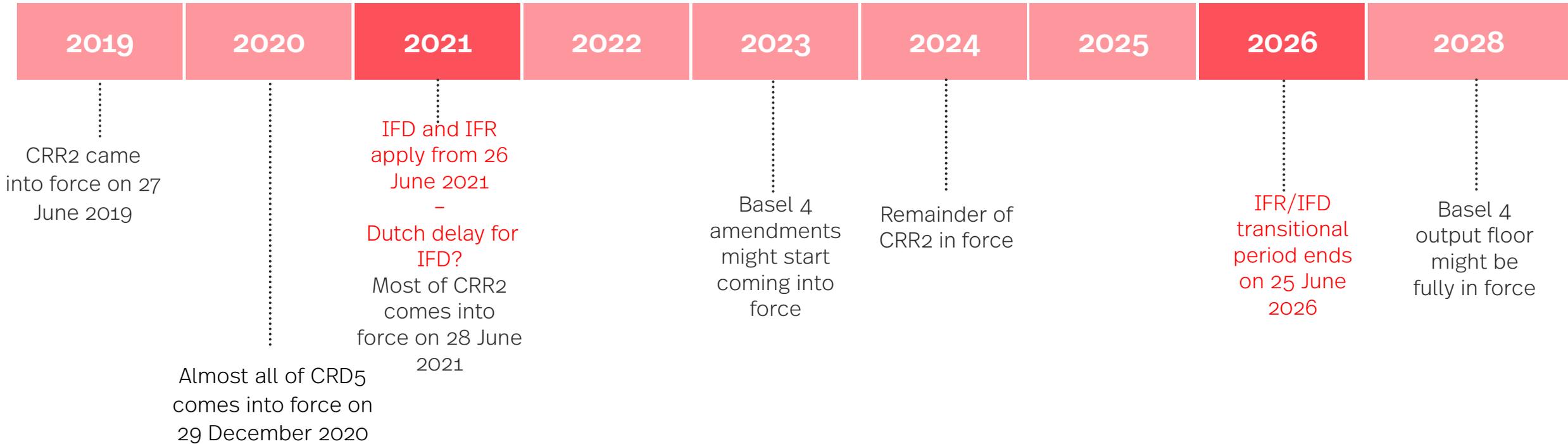
A new approach to the prudential regulation of investment firms in the EU

Comprises a regulation (the Investment Firm Regulation or IFR) and a directive (the Investment Firm Directive or IFD)

Final text published in the OJ on 5 December 2019.

EBA takes the lead with 29(!) documents

When does it apply?



Who does it apply to?



- The IFD/IFR applies to investment firms authorised and supervised under MIFID 2
 - Proprietary traders
 - What about AIFMs or UCITS Mancos with MIFID top-up?

AIFMs/UCITS Mancos with MIFID top-ups



Current Dutch position

Where AIFMs and UCITS Mancos have MIFID top-ups, they must comply with:

- AIFMD / UCITSD requirements
- ICAAP requirements



Options

1. Do nothing – maintain current approach
2. Goldplate IFD / IFR



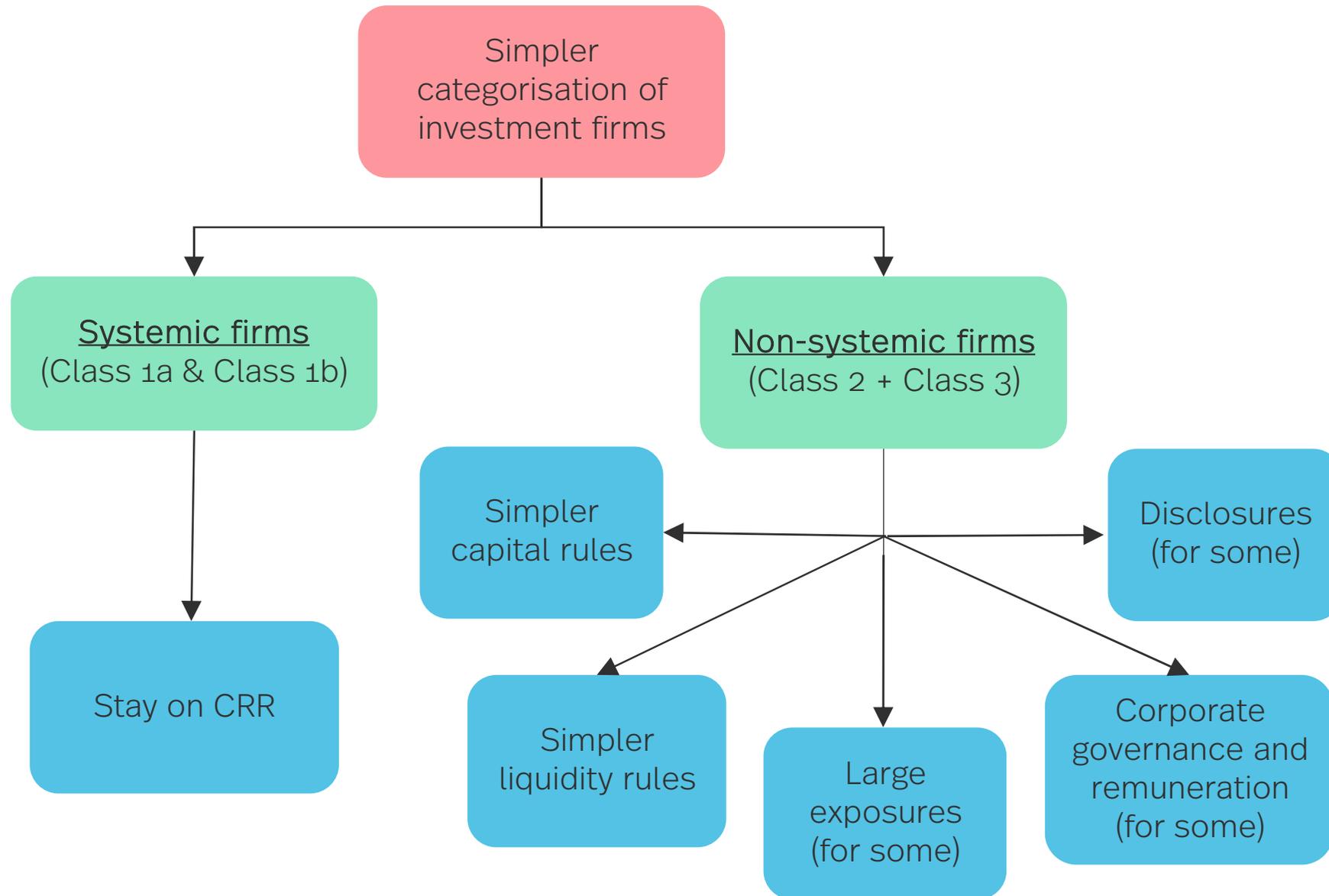
Dutch draft legislation

- Determine scope
- Consultation expected shortly
- “Urgent legislative proposal”

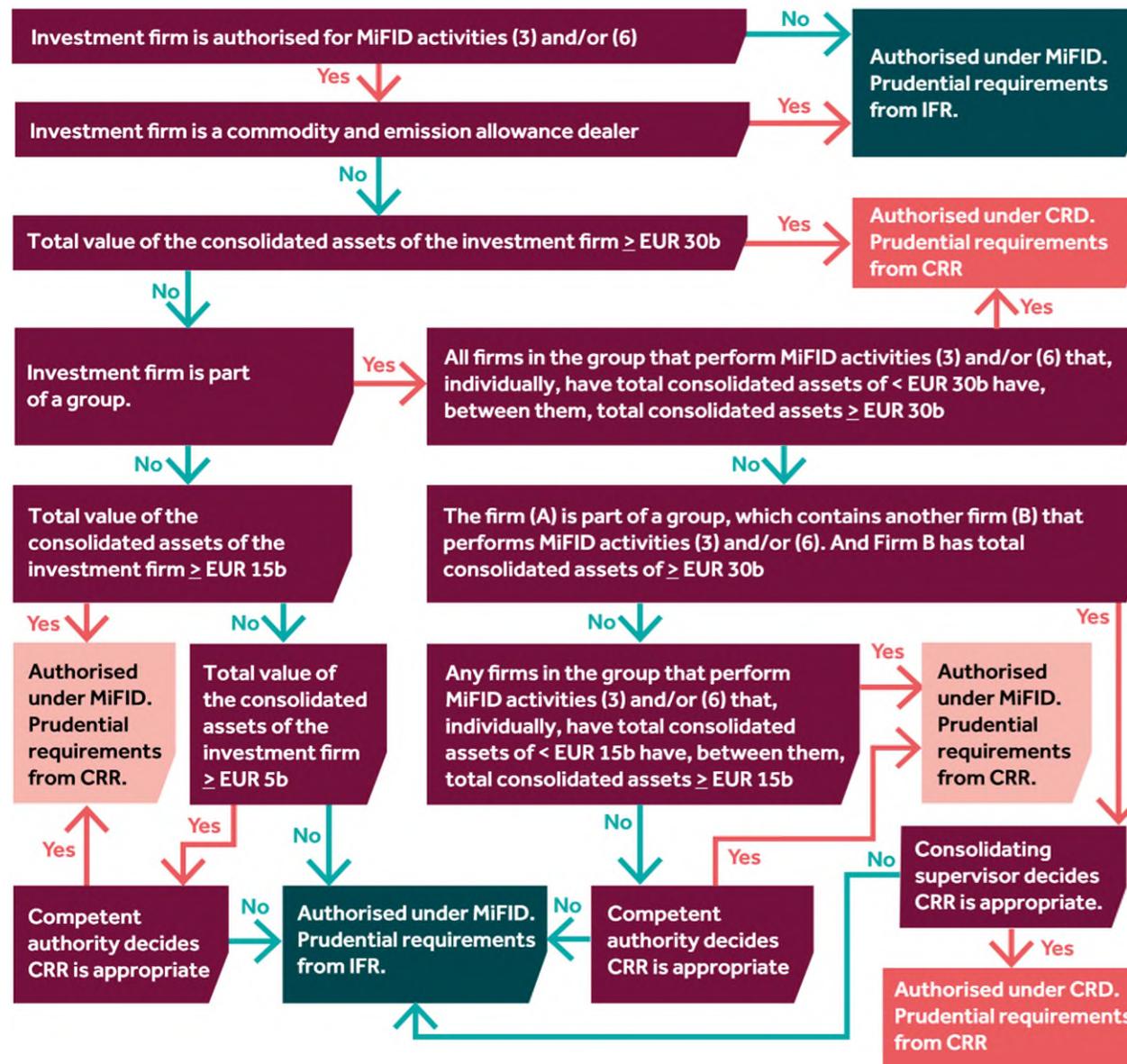
Categorisation



Simpler categorisation



Identifying Class 1 firm



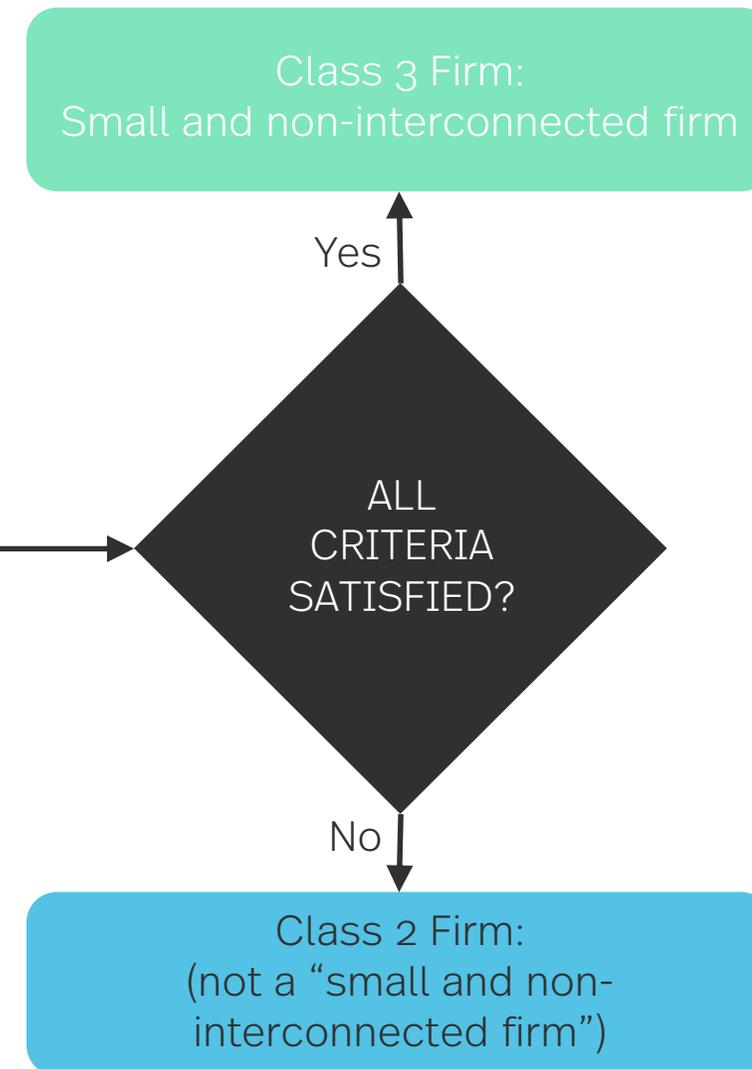
Source: FCA DP 20/2 - a new UK prudential regime for MiFID investment firms

Class 2 and Class 3 Firms



CRITERIA	THRESHOLD
Assets under management*	€1.2 billion
Client orders handled each day*	€100m (cash trades) or €1bn (derivatives)
Assets safeguarded and administered	0
Client money held	0
Daily trading flow	0
Net position risk	0
Trading counterparty default	0
Balance sheet total*	€100m
Annual gross revenue from investment services*	€30m

* apply on combined basis for group



K-Factors



Type	K-Factor		Description
Risk to Consumers	Assets Under Management	AUM	Captures the value of assets managed under discretionary portfolio management arrangements or in accordance with <u>non-discretionary investment advice of an ongoing nature.</u>
	Client Orders Handled	COH	Captures the value of client orders handled through the receipt and transmission of client orders or the execution of client orders.
	Client Moneys Held	CMH	Captures the value of client money held by the firm.
	Assets Safeguarded and Administered	ASA	Captures the value of client assets administered and safeguarded by the firm.

Type	K-Factor		Description
Risk to Markets	Net Position Risk	NPR	Measures FX and commodities risk and position risk in the trading book.
	Clearing Margin Given	CMG	Alternative to NPR for cleared positions. Requires permission from regulator.
Risk to Firm	Trading Counterparty Default	TCD	Captures counterparty credit risk arising from derivatives and SFT-type transactions in the trading book.
	Daily Trading Flow	DTF	Captures value of daily trades in trading book.
	Concentration risk	CON	Captures concentration risk in the trading book.

Why it matters?

- Class 3 firms are **exempt** from:
 - K-Factor requirement
 - ICAAP requirements
 - Pillar 3 disclosures (unless they issue Additional Tier 1 Capital)
 - IFD/IFR remuneration requirements
 - Requirement to have a risk committee staffed by non-exec

Levels of application



In general, the IFD/IFR applies on both a solo and consolidated basis

Exemption from application on solo basis

- Exemptions apply to Class 3 firms (small and non-interconnected firms)
- Firms must be part of prudential consolidation group under CRD 4, IFR or Solvency II
- Requires regulatory approval
- Other conditions apply

Exemption from application on consolidated basis

- The “group capital test”
- For simple and low-risk group structures
- Requires regulatory approval
- Holding companies must hold enough capital to cover holdings in and other exposures to certain subsidiaries
- With supervisory approval, may be reduced further

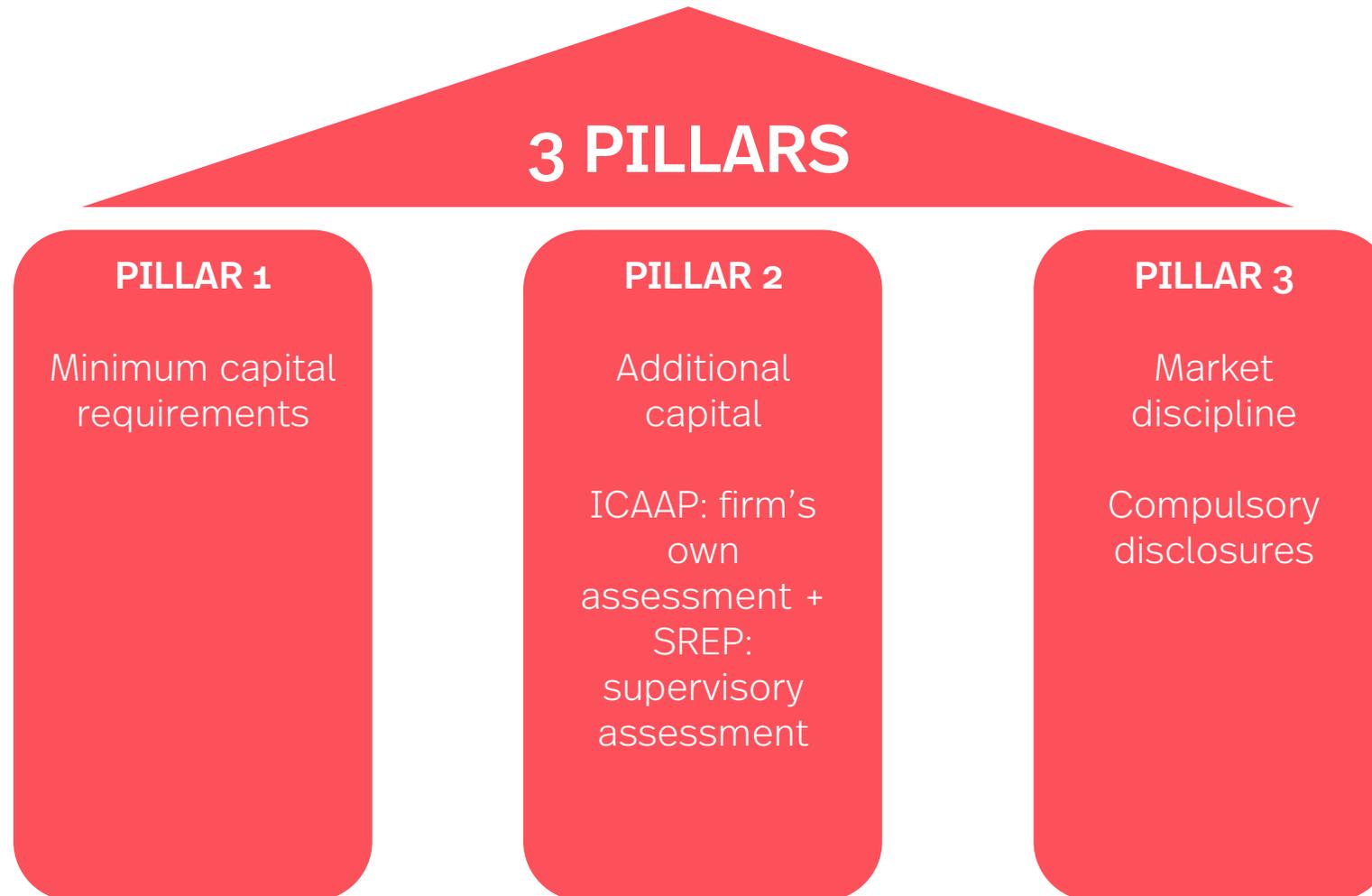
Capital



How is the capital requirement calculated?



Essentially based on a 3 pillar structure



Minimum capital requirement (Pillar 1)



Minimum capital requirement =

Greatest of:

- Fixed overheads requirement – 25% of fixed overheads in previous year
- Permanent minimum requirement – between €75k and €750k depending on the investment services and activities provided
- “K-factor” requirement - K-factors are proxies or metrics for types of risk. But not apply to Class 3 firms



Calculating the K-Factor requirement

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K-Factor requirement

=

Risk-to-Consumer K-Factors + Risk-to-Markets K-Factors + Risk-to-Firm K-Factors

K-AUM + K-COH + K-CMH + K-ASA

+

K-NPR and/or K-CMG

+

K-TCD + K-DTF + K-CON

Calculating the K-Factor requirement

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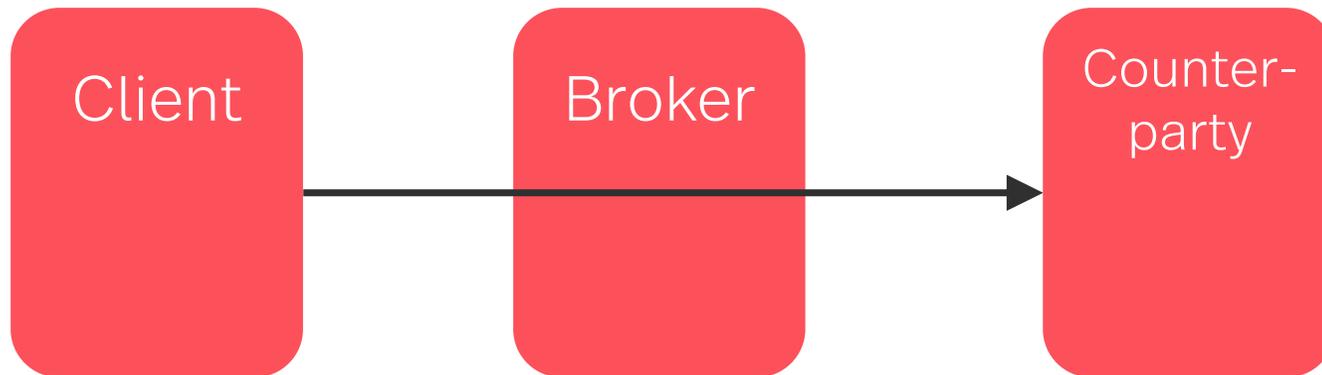
Type	K-Factor		Calculation
Risk to Consumers	Assets Under Management	K-AUM	AUM x 0.02%
	Client Orders Handled	K-COH	0.1% of value of cash trades 0.01% of notional for derivatives (maturity adjustment for interest rate derivatives)
	Client Moneys Held	K-CMH	0.4% of money in segregated accounts
			0.5% of money in non-segregated accounts
Assets Safeguarded and Administered	K-ASA	0.04% of value of assets	

Type	K-Factor		Calculation
Risk to Markets	Net Position Risk	K-NPR	Apply market risk provisions in CRR (as amended in due course by CRR2 to implement the FRTB).
	Clearing Margin Given	K-CMG	3rd highest amount of total margin posted over last 3 months x 1.3
Risk to Firm	Trading Counterparty Default	K-TCD	Effectively a simplified version of new standardised approach to counterparty credit risk in CRR. Includes simple CVA risk factor.
	Daily Trading Flow	K-DTF	0.1% of cash trades + 0.01% of derivatives (maturity adjustment for interest rate derivatives).
	Concentration risk	K-CON	Where K-CON applies, it is based on excess exposure over a limit, a scalar depending on excess and duration, the capital requirement for the exposure in question and the exposure value.

Trading book – equity trade on behalf of client

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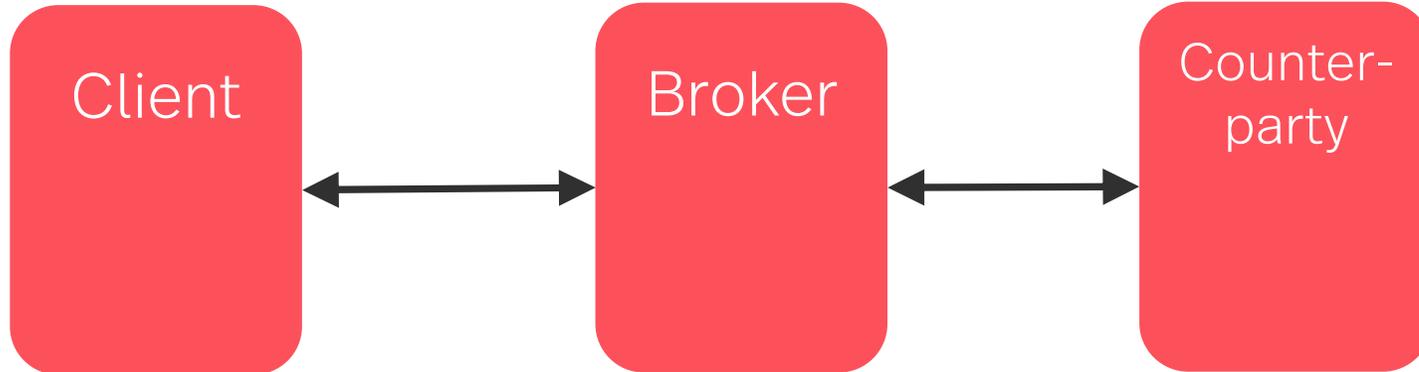
Assume a broker enters into a long position in equities as an agent of the client. The position is valued at EUR 100k.



IFR K-Factor	Value (x1000)
K-COH	0.1
K-NPR	0
K-DTF	0
K-TCD	0
Total	0.1

Trading book – equity trade on behalf of client

Assume a broker enters into a long position in equities on behalf of a client but in its own name (ie back-to-back). The position is valued at EUR 100k.

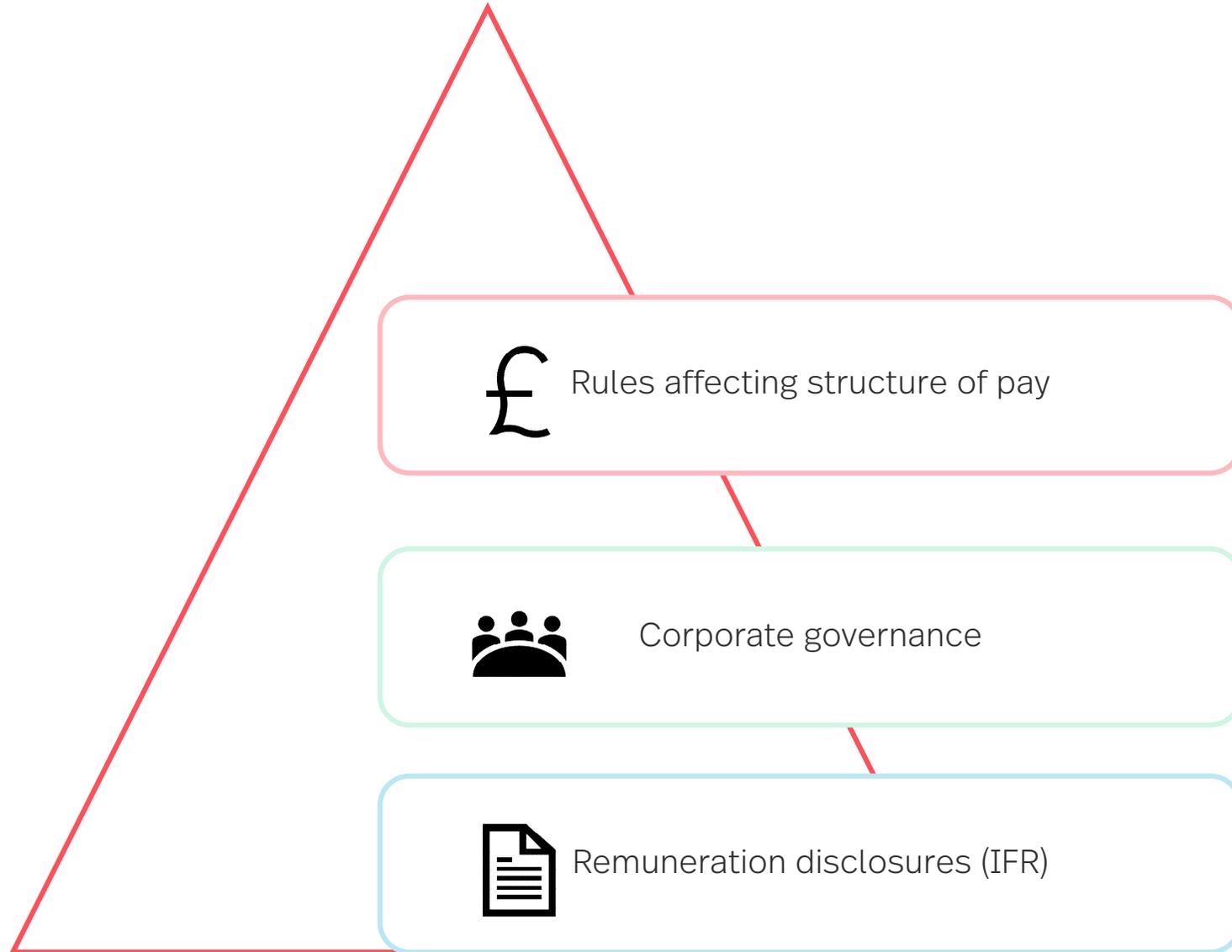


IFR K-Factor	Value (x1000)
K-COH	0
K-NPR	0
K-DTF	0.1
K-TCD	0
Total	0.1

Remuneration



Remuneration requirements



Rules impacting pay



Fixed/variable ratio	<ul style="list-style-type: none">• No bonus cap; firms must set an “appropriate ratio” between fixed and variable remuneration• What about Dutch bonus cap (20%) on variable pay?
Deferral*	<ul style="list-style-type: none">• 40-60% variable remuneration deferred over 3 to 5 years• 60% deferral for remuneration that is “particularly high”
Instruments*	<ul style="list-style-type: none">• At least 50% variable remuneration must consist of:<ul style="list-style-type: none">• shares or equivalent ownership interests, subject to legal structure of firm;• share-linked instruments or equivalent non-cash instruments, subject to legal structure of firm;• Additional Tier 1, Tier 2 instruments or other instruments fully convertible to Common Equity Tier 1 instruments or written down adequately reflecting credit quality of firm as going concern; or• non-cash instruments reflecting instruments of portfolios managed
Retention period*	<ul style="list-style-type: none">• Instruments must be subject to “appropriate” retention policy
Malus or clawback	<ul style="list-style-type: none">• Variable remuneration should be subject to malus <u>or</u> clawback arrangements where financial performance of firm subdued or negative, particularly covering situations where individual: (i) participated in / was responsible for conduct causing significant losses for firm; and (ii) no longer considered fit and proper.

* Can be disapplied on basis of proportionality

Firm proportionality

- Deferral, payment in instruments and retention requirements can be disapplied if firm's on- and off-balance sheet assets on average \leq **€100 million** over prior four years
- Applies on solo and consolidated basis where firm must apply full consolidation
- Member States may decrease or **increase up to €300 million**, subject to certain conditions
- What is an “off-balance sheet asset”?

De minimis exemption

- Deferral, payment in instruments and retention requirements can be disapplied if individual's annual variable remuneration \leq €50,000 and not more than $\frac{1}{4}$ of total remuneration
- Derogation available based on national market specificities on remuneration practices or responsibilities and job profile of affected staff

- More detailed disclosures, including:
 - Information on **gender neutrality** and any **gender pay** gap
 - Fixed/variable remuneration ratio
 - Aggregate quantitative information broken down for senior management and MRTs, including:
 - amounts of remuneration for year (fixed/variable and number of individuals)
 - amounts and forms of variable remuneration
 - amounts of outstanding deferred remuneration
 - amounts of outstanding deferred remuneration reduced through performance adjustments
 - guaranteed variable remuneration and number of individuals
 - severance payments (upfront/deferred, number of individuals and highest payment)
 - Information on whether firm applies proportionality because it has < EUR 100 million on-and-off balance sheet assets

Restructuring



Qualifying for Class 3



- AUM delegated by another financial entity
- Balance sheet total
- Gross revenue

To do?



Start thinking about



- Categorisation
- Prudential consolidation
- What drives your capital requirements
- Remuneration
- Restructuring

Thank you for joining

For further information, please contact us or visit our website simmons-simmons.com.



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