

Specific prudential framework for investment firms

Introduction

The European Commission is undertaking a fundamental review on the prudential regime for (MiFID) investment firms. This is relevant for all non-bank firms undertaking investment services and activities. The current prudential regime has its origin in 1993, when banks and investment firms became subject to uniform prudential requirements. Because of this investment firms have been subject to the same EU prudential rules as banks which however do not always do justice to the specific business model of investment firms. Therefore the European Commission has undertaken a fundamental review of the overall prudential framework for investment firms in consultation with the European Banking Authority (EBA).¹ The proposals are comprised of a Regulation on the prudential requirements of investment firms and a Directive on the prudential supervision of investment firms. It is important to note that although the proposal is meant to ease the burden for investment firms, as the proposals currently stand for some investment firms the capital requirements will increase.



Is this proposed regime relevant for you?

The proposed regime is relevant for:

Type of business	Which relevant MiFID services do they undertake?
Proprietary traders	Dealing on own account
Wealth managers	Portfolio management and investment advice
Commodity traders with a MiFID license	Dealing on own account
MTFs and OTFs	Operation of multilateral trading facilities (MTFs) or organised trading facilities (OTFs)
Broker/dealers	Dealing on own account and/or execution of orders
Corporate finance boutiques	Placing of financial instruments
Fund managers	Fund managers often conduct portfolio management next to their fund management activities. Given that their activities are similar to investment firms it is likely that supervisors will continue their current practice of equating fund managers with investment firms for prudential purposes.

¹ See EBA's Report on investment firms in response to the European Commission's Call for Advice of December 2014, EBA/Op/2015/20 and Proposal for a Regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014, COM (2017) 790 final, 20 December 2017 and (EU) No 1093/2010 and Proposal for a Directive of the European Parliament and of the Council on the prudential supervision of investment firms and amending Directives 2013/36/EU and 2014/65/EU, COM (2017) 791 final, 20 December 2017.



The proposed regime introduces three classes of investment firms

There will be three classes of investment firms:

Class 1

Bank-like systemic investment firms (with balance sheet over €30 billion). This group of 8 firms are established in the UK. These are the securities arms of big investment banks. They will be treated like banks. Because of the limited number, we did not discuss these firms in this document.

Class 2

Non-systemic investment firms which cross particular sizes or perform specific activities.





Class 3

The smallest and non-interconnected firms which are subject to a simplified regime and may only perform a limited set of MIFID services.

	Class 2	Class 3
 <p>Size thresholds</p>	<p>Firms in excess of any of the following size thresholds:</p> <ul style="list-style-type: none"> ▶ Assets under management above €1.2 billion; ▶ Client orders handled of at least €100 million a day for cash transfers or €1 billion a day notional for derivatives; ▶ Balance sheet total above €100 million; or Total gross revenues above €30 million. 	<p>Firms below all of the following size thresholds:</p> <ul style="list-style-type: none"> ▶ €1.2 billion assets under management; ▶ Client orders handled below €100 million a day for cash transfers or €1 billion a day notional for derivatives; ▶ Balance sheet total below €100 million; or ▶ Total gross revenues below €30 million from investment services.
 <p>Performed services/activities</p>	<ul style="list-style-type: none"> ▶ All investment services and ancillary services; ▶ A firm undertaking another activity then listed on the box to the right 	<ul style="list-style-type: none"> ▶ Reception and transmission of orders in relation to one or more financial instruments; ▶ Execution of orders on behalf of clients; ▶ Portfolio management; ▶ Investment advice; ▶ Placing without firm commitment; and ▶ All ancillary activities except custody of assets; ▶ If undertaking any other investment service or activity a firm is classed 2.



The new rules have impact on capital, reporting, governance, remuneration and liquidity

	Class 2	Class 3
 <p>Capital required</p>	<p>The highest of</p> <ul style="list-style-type: none"> ▶ Fixed overheads requirement (FOR); ▶ Permanent minimum requirement (= Initial Capital); ▶ K-factors; <ul style="list-style-type: none"> ▶ Risk to customer ▶ Risk to market ▶ Risk to firm 	<p>The highest of</p> <ul style="list-style-type: none"> ▶ Fixed overheads requirement (FOR); ▶ € 75.000 CRDIV minimum capital is initial capital.
 <p>Annual reporting to authorities</p>	<ul style="list-style-type: none"> ▶ level and composition of own funds; ▶ capital requirements; ▶ capital requirement calculations; ▶ the level of activity, including the balance sheet and revenue breakdown by investment service and applicable K-factor; ▶ concentration risk;and ▶ liquidity requirements. 	<ul style="list-style-type: none"> ▶ level and composition of own funds; ▶ capital requirements; ▶ capital requirement calculations; and ▶ the level of activity, including the balance sheet and revenue breakdown by investment service and applicable K-factor.
 <p>Governance and Remuneration</p>	<p>Apply CRD IV like governance rules and remuneration rules, but no bonus cap. Disclose the following information:</p> <ul style="list-style-type: none"> ▶ Information regarding risk management objectives and policies, internal governance arrangements, own funds, ICAAP, K-factors and remuneration policy; ▶ Return on assets calculated as its net profit divided by its total balance sheet; and ▶ CRD IV like Country by country reporting of turnover, headcount and taxes paid. 	<ul style="list-style-type: none"> ▶ Apply simplified governance rules and remuneration rules (based on MiFid II) by exempting small and non-interconnected investment firms from the current governance and remuneration rules as laid down under the current CRD IV/CRR; ▶ A small and non-interconnected investment firm shall not be subject to public disclosure requirements, except where they issue Additional Tier 1 instruments.
 <p>Liquidity requirements</p>	<ul style="list-style-type: none"> ▶ To hold at least one-third of their fixed overheads requirements in liquid assets (i.e. 1/12 of the fixed overheads of the preceding year); ▶ Additional liquid asset to cover an amount equal to 1.6% of the total amount of guarantees provided to customers. 	<ul style="list-style-type: none"> ▶ To hold at least one-third of their fixed overheads requirements in liquid assets (i.e. 1/12 of the fixed overheads of the preceding year); ▶ Additional liquid asset to cover an amount equal to 1.6% of the total amount of guarantees provided to customers; ▶ Able to include receivables from trade debts and fees or commissions receivable within 30 days, but only to satisfy one third of their liquidity requirement and subject to a 50% haircut.



What is meant with Fixed overheads requirement (FOR), Initial capital and K-factors?



Fixed overheads requirement (FOR)

The fixed overheads requirement shall amount to at least one quarter of the fixed overheads of the preceding year (basically 3 months of turnover).



Permanent minimum requirement (Initial Capital)

- ▶ €750.000 (now: €730k): for investment firms that deal on own account, underwrite, or operate an MTF or OTF.
- ▶ €150.000 (now: €125k): for investment firms that do not perform the services activities listed above, but do hold client assets.
- ▶ €75.000 (now: €50k): for all other investment firms.



K-factors

K-factors are the capital requirements set out in the proposed Regulation for risks that an investment firm poses to customers, markets and to itself.

K-factors are designed to capture that the activities and the services of the investment firm pose to customer (RtC), to market counterparties (RtM), and risks that the firm is subject to itself because of mistakes or defaults of others (RtF).



Zoom in on K-factors

Risk to customer factors; the four factors below must be added up

K-AUM	The capital requirement relative to the value of assets that an investment firm manages for its clients under both discretionary portfolio management and non-discretionary arrangements constituting investment advice, including assets delegated to another undertaking and excluding assets that another undertaking has delegated to the investment firm.	0.02% of assets under management
K-CMH	The capital requirement relative to the amount of client money that an investment firm holds or controls, regardless of any legal arrangements in relation to asset segregation and irrespective of the national accounting regime applicable to client money held by the investment firm.	0.45% of client money held
K-ASA	The capital requirement relative 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 assets appear on the investment firm's own balance sheet or are segregated in other accounts.	0.04% of assets under administration
K-COH	The capital requirement relative to the value of orders that an investment firm handles for clients, through the reception and transmission of client orders and through the execution of orders on behalf of clients.	0.1% of the nominal of cash trades 0.01% of the nominal for derivative trades

Risk to market factors; Highest of the two must be used:

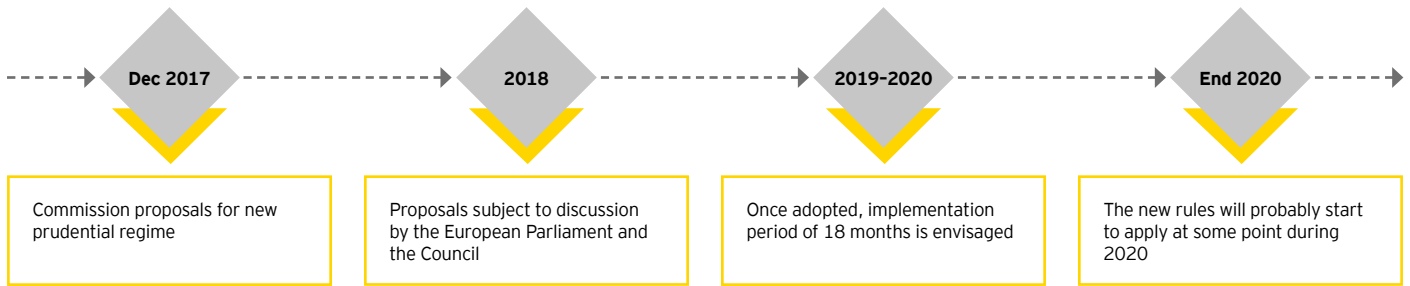
K-NPR	The capital requirement relative to the value of transactions recorded in the trading book of an investment firm.	This is calculated according to the current market risk calculations set out in the CRR
K-CMG	The capital requirement equal to the amount of initial margins posted with a clearing member, where the execution and settlement of transactions of an investment firm dealing on own account take place under the responsibility of a general clearing member.	This is equal to the amount of margin that must be posted with the clearing member who is himself subject to CRD IV CRR

Risk to firm factors; the three factors below must be added up

K-TCDD	The capital requirement relative to the exposures in the trading book of an investment firm in instruments and transactions giving rise to the risk of trading counterparty default	Depends on (i) the type of counterparty (ii) maturity of the instrument, (iii) the asset class and (iv) the collateral received.
K-CON	The capital requirement relative to the exposures in the trading book of an investment firm to a client or a group of connected clients the value of which exceeds certain preset limits;	For exposures above 25% the capital requirement can become as high as 900%
K-DTF	The capital requirement relative to the daily value of transactions that an investment firm enters through dealing on own account or the execution of orders on behalf of clients in its own name	0.1% of the nominal of cash trades 0.01% of the nominal for derivative trades



As of when will you need to comply with the new rules?



The exact transitional rules after entry into force of the new regime will differ on a case-by-case basis, depending on the firm-specific required increase to regulatory capital. For example, firms whose capital requirement would more than double under the new rules would be able to initially limit that increase to double their current capital requirement for a period of five years after the new regime takes effect.

Important: even though the proposal only apply once final, regulators may already expect that you take the proposal into account with your Internal Capital Adequacy Assessment Process (ICAAP).



How can HVG Law help you?

We can assist you by

- 1** Determining whether the draft investment firm regulation (IFR) capital rules actually apply to you.
- 2** Determining which parts of the IFR are relevant based on your group structure.
- 3** Analyzing which parts of the IFR are relevant for you based on your activities.
- 4** Checking whether the required capital is available. This means checking the liability parts of their balance sheet against the minimum capital requirement.
- 5** In the unfortunate case the current capital is not enough (which of course we do not hope), assisting you in bringing the message to the regulator.
- 6** Advising you and assist you with implementing the new governance requirements.



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