Revised EU Capital and Remuneration Framework for Investment Firms – Proposal

Introduction
On December 20, 2017, the European Commission (EC) published draft legislative proposals for a revised prudential framework for EU investment firms. The proposals are the outcome of a review mandated by the current Capital Requirements Regulation (CRR) and the Fourth Capital Requirements Directive (CRD IV), which, in conjunction with MiFID II, constitute the current prudential framework for investment firms as well as credit institutions (banks).

Core Features of the Proposal
The EC proposals rely heavily on an Opinion published by the European Banking Authority (EBA) in September 2017, and take the form of a new Investment Firm Regulation (IFR) and accompanying Investment Firm Directive (IFD).

The IFR/IFD proposals aim to create a common prudential framework that is more sensitive to the particular risks faced by investment firms, and are intended to apply on a consolidated group basis. The proposed requirements are calibrated depending on the size and nature of the firm and, if adopted, will result in systemically important investment firms needing to be reauthorised as credit institutions under CFR/CRD IV, while other investment firms will be subject to tailored capital requirements, including some based on new “K-factors.”

In addition, the proposals seek to revise the existing remuneration framework for investment firms, which may result in more firms being captured, and to a greater extent, than under the existing remuneration rules.

Finally, the proposals introduce an amendment to MiFID II to ensure that third country “equivalence” decisions will have to take into account the new IFR/IFD prudential framework.

2 See this Sidley Update.
What is an “Investment Firm?”

An “investment firm” is defined in the draft IFR/IFD to mean an investment firm as defined in MiFID II. Accordingly, “investment firm” would exclude banks, but would include securities firms, broker dealers, custodians and also investment managers.

In respect of investment managers, MiFID II only captures those investment managers that provide individual, as opposed to collective, portfolio management services. Accordingly, investment management firms that are authorised as alternative investment fund managers (AIFMs) under the EU Alternative Investment Fund Managers Directive (AIFMD), or as UCITS management companies (ManCos) under the UCITS Directive, fall outside the scope of the proposals. However, each EU member state can exercise discretion to extend the proposals to capture AIFMs and UCITS ManCos (in the same way the UK Financial Conduct Authority (FCA) has extended the application of certain provisions in MiFID II to UK AIFMs and UCITS ManCos, in addition to UK MiFID firms).

Scope

The new framework set out in the draft IFR/IFD would effectively result in investment firms being divided into three classes, each class capturing different risk profiles:4

- **Class 1** – systemically important investment firms;
- **Class 2** – non-systemically important investment firms above certain thresholds; and
- **Class 3** – small and non-interconnected investment firms below the Class 1 and Class 2 thresholds.

A specific group capital requirement would apply to groups containing only investment firms, with the parent company required to ensure sufficient capital to support its holdings in its investment firm subsidiaries.

**Class 1 Firms – Systemically Important Investment Firms**

A Class 1 firm is an investment firm that engages in underwriting services and deals on own account, and that meets the following criteria:

- the total value of its assets exceeds €30 billion;
- it is part of a group in which the combined total value of assets of group entities trading on own account or underwriting are individually below €30 billion but collectively exceed €30 billion; or
- at the discretion of supervisors, authorisation as a credit institution has been deemed necessary to address risks of circumvention or financial stability.

Given Class 1 firms must “deal on own account” (i.e., trade using proprietary capital), typical investment managers that only manage their clients’ (rather than their own) assets would not be Class 1 firms.

In essence, the EC considers that Class 1 firms are “bank-like” in nature (even though such firms might not be engaging in deposit-taking activities); accordingly, the IFR/IFD amends the definition of “credit institution” in CRR/CRD IV to include the €30 billion threshold above. This means that Class 1 firms would be required to seek

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4 Note that the legislative proposals in the draft IFR/IFD do not refer to “classes” of firms as such, but the EBA Opinion and European Commission FAQ on the proposed framework refer to such classes, and the proposals are easier to follow by using this classification.
authorisation as credit institutions under CRR/CRD IV, becoming directly subject to the CRR/CRD IV capital framework, including supervision under the EU banking supervisory framework.

The EC notes in its FAQ accompanying the proposals that most systemically important investment firms are currently located in the UK, and those that move their operations to the EU as a result of Brexit would be affected by this new classification.

Given that Class 1 firms will be subject to the CRR/CRD IV framework, the rest of this Update will focus on Class 2 and Class 3 firms.

**Class 2 Firms – Non-systemically Important Investment Firms Above Certain Thresholds**

A firm would be a Class 2 firm where it falls above any of the following thresholds:

- assets under management under both discretionary portfolio management and non-discretionary (advisory) arrangements higher than €1.2 billion;
- client orders handled of at least €100 million per day for cash trades and/or at least €1 billion per day for derivatives;
- balance sheet total higher than €100 million;
- total gross revenues higher than €30 million;
- exposure to risks from trading financial instruments higher than zero;
- client assets safeguarded and administered higher than zero; and
- client money held higher than zero.

Class 2 is likely to be relevant for many investment managers, although note that Class 2 would also include firms that deal on own account or engage in underwriting activities, but are below the Class 1 thresholds.

In respect of the above final Class 2 criterion above on “client money held,” it is important to note that the EC proposes to define client money “held” so as to include not only money actually held by a firm, but also money controlled by a firm. Under existing rules, the UK FCA, for example, distinguishes between the two concepts, with an investment management firm being considered to control, but not hold, client money. Extending the concept of client money “held” to include client money “controlled” could result in even very small investment managers being classified as Class 2 firms, since they might have “client money held higher than zero” under this criterion.

The minimum capital requirement for Class 2 firms would be set either as for Class 3 firms (see below), or according to the new “K-factor” approach for measuring their risks, whichever is higher. The K-factors specifically target the services and business practices that are most likely to generate risks to the firm, to its customers and to counterparties, and include:

- K-AUM – Assets under management
- K-CMH – Client money held
- K-ASA – Assets safeguarded and administered
- K-COH – Client orders handled
- K-DTF – Daily trading flow
- K-NPR – Net position risk
- K-CMG – Clearing member guarantee

**Class 3 Firms – Small and Non-interconnected Investment Firms Below the Class 1 and Class 2 Thresholds**

As noted above, a Class 3 firm would be any firm not meeting the above Class 1 and Class 2 thresholds.

The minimum capital requirement for Class 3 firms would be the higher of: (i) the level of initial capital required for authorisation; and (ii) a quarter of fixed costs (overheads) for the previous year.

**Summary of Classes of Investment Firms**

The above may be summarised as follows:5

<table>
<thead>
<tr>
<th>Systemic</th>
<th>Non-systemic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Class 1</strong></td>
<td><strong>Class 2</strong></td>
</tr>
<tr>
<td>- Largest firms (with assets over €30 billion)</td>
<td>- Large firms, above specific thresholds (e.g., assets under management, balance sheet, revenues, etc.)</td>
</tr>
<tr>
<td>- Carry out risky, bank-like activities</td>
<td>- New risk assessment tailored to their business</td>
</tr>
<tr>
<td>- Will remain under CRR/CRD and subject to banking supervision</td>
<td>- Simplified version of existing rules (if they trade financial instruments)</td>
</tr>
</tbody>
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**Remuneration and Governance**

The EC proposals include remuneration and governance rules based on CRR/CRD IV and MiFID II. However, unlike under the CRR/CRD IV framework (which will apply to Class 1 firms), the IFR/IFD does not include any requirement for a “bonus cap”6 for Class 2 and Class 3 firms.

**Remuneration – Class 2 Firms**

The proposed remuneration framework for Class 2 firms follows, broadly, the framework set out in CRR/CRD IV. That is, for senior managers and those in risk-taking and control functions (and certain other highly-paid

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6 Under the CRR/CRD IV bonus cap rules, a firm is required to limit variable compensation to 100 percent of fixed compensation (or 200 percent with specific shareholder approval).
roles), Class 2 firms will need to implement policies with clear criteria for determining “appropriate” fixed to variable remuneration ratios. In addition, variable remuneration would be subject to certain restrictions, including:

- **Non-cash element** – at least 50 percent of variable compensation must consist of shares, share-linked instruments or certain capital instruments of the firm;
- **Deferral** – at least 40-60 percent of variable compensation must be deferred over a three- to five-year period; and
- **Malus/clawback** – up to 100 percent of variable compensation must be subject to malus/clawback arrangements.

These restrictions, which are similar to those in the AIFMD and UCITS Directive, are sometimes referred to as “pay-out process” rules (although not referred to as such in the IFR/IFD). In addition, there are specific restrictions regarding discretionary pension benefits, including that benefits must be in the form of shares or share-like/convertible instruments and subject to a five-year retention period.

Under the fairly broad “proportionality” principle of the existing remuneration framework applicable to investment firms (and indeed under the AIFMD and UCITS Directive), member state regulators such as the UK FCA have had broad discretion to disapply the pay-out process rules for smaller, non-complex firms. The EC’s proposals in the IFR/IFD, however, appear to remove this broad discretion by specifying what the threshold for small/non-complex firms should be. In particular, it is proposed that the non-cash element, deferral and discretionary pension benefits rules above (but not the malus/clawback rules) should not apply to:

- an investment firm with an “asset value” of €100 million and below (based on a four-year lookback); and
- an individual whose annual variable remuneration does not exceed €50,000 (and does not represent more than a quarter of the individual’s annual total remuneration).

Member state regulators do have the discretion nonetheless to impose the non-cash, deferral and discretionary pension benefits rules even where the above factors apply.

Other proposals include:

- significant Class 2 firms will need to establish a remuneration committee;
- investment firms will need to publicly disclose detailed remuneration information – see Disclosure and reporting below; and
- member state regulators will be able to require an investment firm to limit variable compensation as a percentage of net revenues where that remuneration is inconsistent with the maintenance of a sound capital base.

Finally, note that Class 2 firms will continue to be subject to the remuneration framework set out in MiFID II, since MiFID II applies to all investment firms. The remuneration framework under MiFID II is aimed at ensuring that remuneration structures for sales staff do not incentivise them to recommend products that do not reflect clients’ needs.

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7 Following the amendments introduced by UCITS V.
**Remuneration – Class 3 Firms**

Under the proposals, Class 3 firms would not be subject to the IFR/IFD remuneration framework applicable to Class 2 firms. Rather, they would be subject solely to the existing MiFID II remuneration framework.

**Other Prudential Requirements**

The proposed IFR/IFD also contains other rules for Class 2 firms relating to risk management, liquidity risk and concentration risk.

Member states will also be required to put in place a more detailed supervisory framework in respect of investigatory powers, administrative penalties for breaches and a detailed supervisory review and evaluation process.

**Disclosure and Reporting**

It is proposed that Class 2 firms will have to make public details on capital, returns on assets (net profits divided by total balance sheet), risk management objectives and policies, governance arrangements and information on remuneration of staff.

In particular, the remuneration information required to be published is much more granular than under the current investment firm, AIFMD and UCITS remuneration frameworks. Notably, it is proposed that a Class 2 firm must make public the number of individuals who have been remunerated €1 million or more per financial year and, upon demand from its member state regulator, the total remuneration of each member of the management body or senior management of the firm. The requirement to make such public disclosures is expressed to be without prejudice to the new EU General Data Protection Regulation (GDPR), which applies in all EU member states from May 25, 2018. However, it remains to be seen how and whether firms will be able to rely on the GDPR to avoid having to make such disclosures.

Separately, it is proposed that investment firms report annually to their competent authorities on their own funds, capital, levels of activity and, for Class 2 firms, concentration and liquidity risk.

**Equivalence for Third Country Firms – The Brexit Angle**

As explained in our Update on MiFID II, MiFID II introduces a new “third country” regime applying to non-EU (or “third country”) investment firms seeking to provide investment services to EU clients – see in particular Article 47 of MiFIR. The ability to provide such services to EU professional clients depends on an “equivalence” determination having been made by the EC in relation to the non-EU firm’s home country.

The proposed IFR amends the MiFIR equivalence process, so as to additionally require equivalence between the third country’s prudential regime and IFR/IFD. In particular, where the services provided or activities performed by third country firms are “likely to be of systemic importance” for the EU, the equivalence determination by the EC shall be based on a “detailed and granular assessment.”

It is fairly clear that the purpose of the above provision is to ensure that, following Brexit, the UK will be subjected to a rigorous assessment in order to be determined to be “equivalent”. If the UK’s local prudential...
framework deviates from that in the IFR/IFD, the EC could decide that the UK should not be granted such equivalent status. Indeed, the EC pointedly notes in the FAQ accompanying its proposals that “[t]he Commission is never obliged to consider a third country’s rules and standards as equivalent.”

It will be interesting to see whether the reference to third country firms’ services/activities being “likely to be of systemic importance” will also be extended to firms from other major third countries such as the United States.

**Next Steps and Timeline**

The EC’s proposals must now be reviewed by the European Parliament and the Council of the European Union before a final version is adopted.

Timelines are difficult to predict, as much will depend on whether the proposals are prioritised for discussion by the Parliament and Council. However, it is likely to be at least several months before the review process is completed and several more months before a compromise is reached. This would mean that adoption of the IFR/IFD is unlikely before the end of 2018. Once adopted, an implementation period of 18 months is envisaged before the new regime starts to apply (with a five-year phase-in period for the amount of capital required to be held by investment firms under the new framework). It is likely, therefore, that by the time the IFR/IFD is implemented, the UK should have completed its exit from the EU.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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