



Thursday, 21 December 2017

## European Commission proposals for new prudential regime for EU investment firms

On 20 December 2017, before MiFID II has even entered into force, the European Commission published a [staff working document](#) and legislative proposal addressed to the European Parliament and the Council for a [new Directive](#) and [new Regulation](#) on prudential requirements for MiFID investment firms.

The Commission's proposed legislative package follows closely the earlier recommendations of the European Banking Authority (EBA) contained in its final report published on 29 September 2017. For a summary of the proposals in general terms, please refer to [our earlier briefing note](#) on the EBA's report. In this latest briefing, we highlight some of the most significant aspects of the proposals, including where the Commission has gone beyond the scope of the EBA's previous advice.

### PROCESS AND TIMING

The new legislative package will need to be agreed between the European Parliament and the Council before it can enter into force. Subject to the vagaries of that process, this means that the relevant legislation might not be passed before the next European Parliament elections in May or June 2019. If it has not been passed by then, the legislative process will need to begin again and therefore will be subject to further delays. With the fairest wind, the legislation might come into force at some point during 2020.

### SUMMARY

- Commission proposals largely follow advice contained in EBA's final report in September 2017
- Timeline for application of new regime still uncertain, but **potentially from 2020**
- Criteria for classification as Class 1 firm now clarified – in practice, only likely to be relevant to groups containing large investment banks
- Most asset managers likely to be Class 2 firms, as that category includes any firm that holds **or controls** client money
- Class 2 firms will be subject to remuneration rules, but without bonus cap
- Some firms entirely exempt from most onerous pay rules, but any whose **balance sheet is EUR 100m+** will have to change the way they pay staff
- EBA's proposed liquidity requirements will apply to Class 2 and Class 3 firms
- Requirements for third country equivalence assessments under MiFIR updated to include "detailed and granular" assessment of whether third country has equivalent prudential rules

## SIMPLIFICATION OF THE EXISTING RULES

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One of the original intentions behind the review of the existing prudential regime for MiFID investment firms was to simplify the current complex rulebook. However, the new Directive and Regulation make extensive cross-references to the current Fourth Capital Requirements Directive (**CRD IV**) and Capital Requirements Regulation (**CRR**), not least for the purposes of borrowing defined terms and concepts, including, for example, the definitions of the items that will qualify as eligible capital. In practice, this may mean that the new rules are not much simpler to apply.

## REVIEW OF THE OPERATION OF THE NEW REGIME

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Some of the proposals for the new regime are quite radical. The Commission will be required to review the operation of the new rules and report back to the European Parliament and the Council, particularly in relation to the calibration of the new regime, within 3 years of the new regime taking effect. This is not explicitly linked to the transitional provisions (described in more detail below), nor is the review clause as specific as some industry bodies had called for in light of the relatively poor data set that firms provided to the EBA, and concerns about very significant impacts on certain types of investment firm.

Any future review may result in further legislative amendments or new proposals. The current set of Commission legislative proposals is itself the result of the required review of the existing CRR.

## NEW CATEGORISATION OF FIRMS

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The Commission has adopted the EBA's proposed classification of MiFID investment firms according to three categories. Although the terminology is not used in the legislative proposals, we continue to refer to firms as Class 1, Class 2 or Class 3 firms in the remainder of this note, as detailed in our earlier briefing on the EBA proposals referenced above.

### **Class 1 firms**

The EBA had hovered over how to define Class 1 firms. The Commission's proposal now clarifies the scope of the Class 1 category (i.e. those firms which will continue to be subject to CRD IV and CRR and in due course, CRD V and CRR II). A firm will be a Class 1 firm if it has permission to deal on own account, underwrite or place on a firm commitment basis and:

- the firm has total balance sheet assets which exceed EUR 30 billion;
- the firm itself has balance sheet assets below EUR 30 billion, but is part of a group in which the combined total value of the balance sheet assets of all undertakings in that group that:
  - either deal on own account or carry out underwriting activities; and
  - each have assets below EUR 30 billion;in total exceeds EUR 30 billion; or
- the firm itself has balance sheet assets below EUR 30 billion, but is part of a group in which the combined total value of the balance sheet assets of all undertakings in that group that either deal on own account or carry out underwriting activities exceeds EUR 30 billion, where the relevant consolidating regulator decides it is necessary for the firm to be classified as a Class 1 firm in order to address potential financial stability risks or risks of the prudential rules otherwise being circumvented.

In practice, therefore, the Class 1 category is only likely to be relevant to firms that are large investment banks or are part of groups that contain such banks. This classification is being effected through an amendment to the definition of a "credit institution" under the CRR so that it includes firms meeting one of the above thresholds. This means that such firms will be re-classified as credit institutions and therefore will be subject

to all of the rules applicable to that type of entity under CRD IV and the CRR when the new regime enters into force. This is a rather odd concept, but it appears intended to reduce the risk of regulatory arbitrage and to subject those firms to full supervision by the European Central Bank under the Single Supervisory Mechanism. The Commission argues that it also reflects a growing international trend to align the supervisory treatment of systemically important investment firms with the rules applicable to credit institutions.

## **Class 3 firms**

These firms are intended to be the smallest and least interconnected firms. Amongst other criteria, any firm that holds (or is deemed to hold) client money cannot be a Class 3 firm. Unfortunately, the Commission has proposed that any firm which has a mandate over a bank account in the name of a client (an arrangement which, in the UK at least, is known as "controlling" – as opposed to "holding" – client money) will be deemed to hold client money for the purposes of the new rules. The EBA's position on this point had been unclear. In practice, this means that the vast majority of asset managers cannot be classified as Class 3 firms.

For the purposes of the Class 2/ Class 3 divide certain K-factors (as explained in our previous briefing) will apply on the basis of the aggregate position of all investment firms in a group (apparently on a worldwide basis, although the legislation is not explicit on this point).

For the purposes of the risk factor relating to assets under management (K-AUM), firms may disregard assets under management that have been formally delegated to them by another financial entity.

Otherwise, the relevant thresholds remain as proposed by the EBA and summarised in our earlier note, as do the relevant rules to which Class 3 firms will be subject.

## **Class 2 firms**

Any firm that is not a Class 1 or a Class 3 firm will be a Class 2 firm. As stated above, the vast majority of asset managers will fall into this category.

### **RULES APPLICABLE TO CLASS 2 FIRMS**

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#### **Pay regulation**

The Commission has decided not to extend the so-called "bankers' bonus cap" – i.e. the mandatory limit on the ratio of variable remuneration to fixed remuneration that may be paid to relevant staff – but firms will be required to set and publish appropriate ratios themselves.

The EBA originally proposed that Class 2 firms should otherwise be subject to pay regulation which broadly follows the format in the existing CRD IV Directive, including mandatory deferral of a significant proportion of variable pay, and payment of some variable pay in shares, share-linked instruments or equivalent non-cash instruments. It appears that such instruments must be linked to the employer group (as opposed to, for example, awarding units in a fund product).

The Commission has followed the EBA's advice but (partly as a result of lobbying by trade associations) has introduced an exemption for any firm "the asset value of which" (apparently a reference to its balance sheet assets, rather than AUM, for example) is on average no more than EUR 100 million over the four years preceding the date of assessment. Under the exemption, such firms would not be required to comply with the rules relating to payment of a certain minimum proportion of variable remuneration in certain specified instruments or requiring deferral of part of variable remuneration. On the face of it, the threshold for this exemption is applied on a solo basis only, although it may be disapplied by national regulators if they consider that it is not appropriate due to the nature and scope of an individual firm's activities or the characteristics of the group to which it belongs. In practice, this is likely to be useful to many firms, but may not be available to certain entities such as CLO collateral managers and other fund managers who make certain investments from the balance sheet of the regulated entity. Where the exemption is not available, firms should assume they cannot rely on the principle of proportionality and therefore will need to apply the relevant rules in full.

Firms must also consider how much of individuals' variable pay should be subject to malus or clawback arrangements.

Delegated legislation will specify which staff members must be subject to the applicable remuneration rules. Individual members of staff will be exempt if their annual variable remuneration: (i) does not exceed EUR 50,000; and (ii) does not represent more than 25% of their total annual remuneration. This is subject to the right of national regulators to disapply this exemption in relation to particular individuals based on the specificities of national remuneration practices in the relevant market or based on the nature of an individual's job profile or responsibilities.

Certain significant firms will be required to have a remuneration committee.

## **Mechanical capital requirements**

The Commission's proposed rules on capital requirements are broadly the same as those proposed by the EBA.

A transitional provision in the new Regulation is intended to smooth the impact on firms by allowing them to build up the new required amounts of initial capital over a longer period. For the first five years after the new legislation comes into force, the following modified arrangements will apply:

- where a firm was subject to the CRR prior to the entry into force of the new regime, its capital requirement will be limited to twice the requirement that would have applied had it continued to be subject to the CRR;
- for firms that were not in existence prior to the new regime entering into force, the capital requirement will be limited to twice their fixed overheads requirement under the new regime; and
- for firms that were only subject to an initial capital requirement under the CRR (e.g. exempt-CAD adviser-arranger firms), the capital requirement will be limited to twice that initial capital requirement.

Firms that were in existence prior to the entry into force of the new regime who have not met the required levels of initial capital under the new rules have five years to increase their capital to the necessary levels, but subject to achieving an increase of at least EUR 5,000 per year. If this has still proven insufficient after the first five years to meet the required initial capital under the new regime, individual Member States may apply a further transitional period, not exceeding another five years.

Commodity dealers must comply with the initial capital requirements within five years of the new regime entering into force.

## **Liquidity requirements**

The Commission's proposals follow the EBA's proposed liquidity requirements for Class 2 and Class 3 firms. Both categories of firms will be required to hold an amount of liquid assets equal to at least one third of their fixed overheads requirement (i.e. this equates to one month's fixed overheads).

As the EBA proposed, the new rules state that liquid assets for these purposes are certain assets specified in the delegated regulation on the liquidity coverage requirement under the CRR (e.g. claims on national governments, high quality covered bonds and corporate debt). Class 3 firms only will also be 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.

## **Internal capital adequacy assessment processes (ICAAPs)**

Class 2 firms will be required to conduct an internal capital adequacy assessment process and may be subject to supervisory review, on a solo or a group basis. This is the case under the existing rules for most – but not all – MiFID investment firms. The frequency and intensity of the review will be applied on a proportionate basis

and determined by the size, systemic importance, nature, scale and complexity of the activities carried out by the relevant firm.

## **Public reporting**

Class 2 firms will be obliged to make public disclosures about their capital, capital requirements, governance and remuneration policies and practices. The remuneration-related disclosures do not require individuals to be named, but will involve more granular disclosures than those with which firms are currently familiar. This will include disclosure of the number of individuals who receive remuneration of EUR 1 million or more per year, with remuneration between EUR 1 million and EUR 5 million broken down into bands of EUR 500,000, and remuneration of EUR 5 million or more broken down into bands of EUR 1 million.

Public country-by-country reporting rules currently applicable to firms caught by the CRR will be extended to all Class 2 firms. This will require them to disclose the following information annually in relation to *each* EU Member State and non-EU jurisdiction in which they have a branch or a subsidiary that meets the definition of a "financial institution":

- the name, nature of activities and location of any subsidiaries and branches;
- the turnover;
- the number of employees on a full-time equivalent basis;
- the profit or loss before tax;
- the tax on profit or loss; and
- any public subsidies received.

This information must be audited and where possible, annexed to the firm's individual or consolidated financial statements.

## **APPLICATION OF REQUIREMENTS ON A CONSOLIDATED BASIS**

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The general principle is that the proposals will apply to firms on a solo basis. Supervisors may waive the application of the new regime to firms on a solo basis if they form part of a banking consolidation group, subject to certain conditions being satisfied.

Broadly, however, where an investment firm is part of a group headed by an EU parent undertaking, the capital requirements will also apply on a group basis. There are a number of alternative group capital tests, with discretion in relation to their application left to national regulators. At the lowest, the group capital test will require the top EU parent undertaking to hold capital equal to the higher of the sum of the actual or notional solo capital requirements of financial firms in its group, plus contingent liabilities in favour of similar types of entity.

It does not appear that other rules – for example, those relating to governance, ICAAPs, remuneration or reporting – will apply on a group or consolidated basis.

## **THIRD COUNTRY FIRMS AND EQUIVALENCE ASSESSMENTS**

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The Commission's proposed legislation addresses a number of issues relating to third country (i.e. non-EU) investment firms.

Perhaps the most striking change is the proposed revision to the rules on assessing third countries for equivalence in relation to the provision of cross-border services by third country firms under MiFIR. The

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relevant provision in MiFIR is being amended to state that when carrying out any equivalence assessment in relation to a third country for those purposes, the Commission must take into account (amongst other factors):

- whether firms in that jurisdiction are subject to prudential requirements which are equivalent to those set out under the new Regulation and Directive (as well as the CRR and CRD IV Directive, depending on the relevant type of firm); and
- whether firms in that third country are subject to effective supervision and enforcement to ensure compliance with the prudential requirements.

The revised provision also states that the Commission may only conclude that a third country has the necessary equivalent measures after a "detailed and granular assessment" of whether the requirements set out under EU prudential legislation are met. It will be a significant challenge for some jurisdictions – such as the United States – to demonstrate that they have equivalent prudential rules at a detailed and granular level.

Until an equivalence decision has been issued in relation to a third country under MiFIR, investment firms that are established in that third country may only supply MiFID services into the EU on a cross-border basis in accordance with the national rules applicable in each Member State and there is no obligation on any EU Member State to provide access. This will be relevant to ongoing Brexit considerations, as structures which involve UK investment firms continuing to provide MiFID services on a cross-border basis into the EU will rely on an equivalence assessment under MiFIR having been issued, or will otherwise be subject to the national rules of the relevant EU Member State(s) concerned (with no guarantee of access). The Commission has emphasised in a separate "frequently asked questions" document relating to the new proposals that it is not under any obligation to carry out MiFIR equivalence assessments in relation to any particular third country.

There is also a new provision which addresses supervisory relationships with third countries, apparently for the purposes of facilitating the cross-border supervision of group capital tests where an EU investment firm has a parent entity in a third country. This provides for supervisory cooperation agreements, the use of which may eventually prompt a reconsideration of the prudential treatment of cross-border groups.

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