July 2021

FCA Policy Statement PS21/9 on the Investment Firm Prudential Regime

The Financial Conduct Authority (FCA) has published its second Policy Statement (PS21/9) on the introduction of the Investment Firm Prudential Regime (IFPR) following up on its earlier consultation paper, CP21/7. This Policy Statement contains feedback on the issues raised by respondents, including AIMA, ACC and MFA, with respect to CP21/7 and a set of related "near-final" rules on the aspects of IFPR covered in that consultation paper. CP21/7 consulted on (i) the application of the IFPR rules; (ii) own funds requirements; (iii) basic liquid assets requirements; (iv) risk management, ICARA and SREP; (v) governance; (vi) remuneration; and (vii) regulatory reporting. As with the previous Policy Statement (PS21/6), the FCA has, in general, implemented their proposals as consulted on, with only a few amendments and clarifications made. A summary of PS21/6 can be found here. A detailed summary of PS21/9 can be found below. In short, the key amendments/clarifications made by the FCA in PS21/9 are:

Application of IFPR rules to CPMIs: New transitional provisions (TPs) have been introduced for collective portfolio management investment firms (CPMIs) to meet the fixed overheads requirement (FOR), K-factor requirements (KFR), and the permanent minimum requirement (PMR).

Remuneration: CPMIs will have to apply the remuneration codes applicable to the types of business they conduct. If multiple remuneration codes apply, it must comply with the most stringent of the relevant provisions. In addition, the IFPR remuneration code will apply to carried interest arrangements which must be valued at the time of its award. A new rule is introduced that provides that the requirements on pay-out, deferral, retention and ex-post risk adjustment do not apply if certain conditions are met. The FCA has amended the application provision in the rules to refer to 'performance periods' rather than 'performance years' to allow for the fact that some firms have, e.g., quarterly performance periods rather than performance years. Guidance has been included indicating that a 3-year clawback period will be the appropriate starting period for all firms. Investment firm groups will now also be able to set up a remuneration committee at group level, dependent on whether certain conditions are met.

Own funds: An amendment has been made to clarify that LLP members' shares in profits are deductible provided they are fully discretionary and have been included in total expenditure. Several clarifications have been made with regards to the calculation of assets under management (AUM), client orders held (COH), and initial calculation of KFR. The FCA has also addressed the gap that arose in the way that its draft rules for K-COH and K-DTF applied.

Basic liquid assets requirement (BLAR): The FCA clarifies that where a firm benefits from transitional relief using an alternative requirement for their FOR, it may also reduce the amount of the BLAR that is based upon the FOR accordingly.

ICARA: Large non-SNIs will no longer be required to conduct an Internal Capital and Risk Assessment (ICARA) on a twice-yearly basis. These firms will now only be required to review their ICARA processes once a year unless there are material changes to their business model. The FCA expects firms to make their best efforts to comply with the new ICARA, which includes a requirement for firms to undertake their ICARA reports during 2021 on a 'best efforts' basis. The FCA has also introduced TPs for firms with individual capital guidance or individual liquidity guidance.

Application of IFPR rules

The FCA has provided clarifications on the application of the IFPR rules to CPMIs. Firstly, a minor change has been made to the definition of an SNI firm by amending the definition of the daily trading flow (DTF) so that it now also applies to firms that trade in their own name on an agency basis. With regards to own funds and liquid assets requirements, the FCA notes that the definitions of these differ between the IFPR and AIFMD/UCITS and that they will "address this in the future".

In addition, the FCA has amended the FOR/KFR TPs to make clear that these can also be used by CPMIs. They have also now added a TP for the PMR for CPMIs. This will be relevant to CPMIs that will have a PMR of £150,000 and will allow them to gradually increase their PMR from €125,000, the base own funds requirement under IPRU-INV 11.3.1R, to £150,000 over 5 years. CPMIs that would have a PMR of £75,000 do not need a TP as the base own funds requirement is already higher.

Own funds requirements

The FCA clarifies that relevant expenditure is to be calculated before, not after, distribution of profits which it believes is a more natural way to reflect how items of expenditure are recorded in financial statements. It has also clarified its rules around deducting partners' shares in profits from total expenditure for the purposes of calculating the relevant expenditure for the FOR, which may be deducted provided these are fully discretionary.

Amendments have been made to clarify that following a material increase in the projected relevant expenditure of a firm for the current year, the firm must immediately substitute the updated FOR calculation for its original FOR, and must immediately substitute the updated basic liquid assets requirement (BLAR) (based on the updated FOR) for its original BLAR.

The FCA has made several minor amendments and clarifications to specific provisions on the calculation of AUM, COH, and initial calculation of KFR. On AUM, the FCA has provided some clarificatory amendments with regards to the TPs that apply to firms with missing data points together with detailed guidance on what may or may not be included when measuring AUM. With regards to COH, the FCA has provided clarification of the intention that generally a transaction that the firm has executed should fall under either COH or DTF and there should not be a gap between them.

In a change from its original proposal in CP21/7, the FCA has addressed the gap that arose in the way that its draft rules for K-COH and K-DTF applied. Initially, K-DTF only applied to firms that deal on own account and, as a result, firms that execute orders on behalf of clients in their own name, but without dealing on own account, would not have been caught by either K-COH or K-DTF. PS21/9 now clarifies that K-DTF is not limited to firms that deal on own account and will extend to firms that execute orders on behalf of clients in their own name. To reflect this, the FCA has amended the definition of SNI firm which now explicitly states that any firm that trades in its own name on an agency basis cannot be an SNI.

Basic liquid assets requirement

The FCA will continue to require all firms to comply with the BLAR as they believe it is prudent for all FCA investment firms to hold a minimum amount of core liquid assets as this will allow firms to fund the initial stages of an orderly wind-down.

In a change from its original proposals, the FCA now clarifies that where a firm benefits from transitional relief using an alternative requirement for their FOR, it may also reduce the amount of the BLAR that is based upon the FOR accordingly. The FCA also extends the existing own funds TPs for former IFPRU and BIPRU firms to CPMIs.

Risk management, ICARA and SREP

The FCA recognises that the introduction of the ICARA process will be a new exercise for many firms, in particularly to those who were not previously subject to the Internal Capital Adequacy Assessment Process (ICAAP) requirement. While a TP will not be introduced, the FCA notes that it expects firms to make their best efforts to comply and that it may consider providing firms with feedback to support them in the implementation of the ICARA process or the transition from ICAAP to ICARA. Note that the FCA expects to adopt a proportionate and risk-based approach to supervise the ICARA requirements at the beginning of the IFPR's implementation.

The FCA is introducing a new TP for firms which currently have individual capital guidance (ICG) and/or individual liquidity guidance (ILG). These amounts act as a minimum floor to a firm's threshold requirements to ensure that they do not apply an inappropriately low requirement at the outset of the IFPR before having been able to properly consider the outcome of the ICARA process. In brief, the TP for the own funds threshold requirement will be calculated by reference to the ICG amount averaged over the 12 months covered by the firm's last own funds reports submitted before 1 January 2022. The TP for the liquid assets threshold requirement will be determined by the methodology used to determine their current ILG, as applied on an ongoing basis. Firms with a current ICG/ILG will need to submit MIF007 for the first time by 31 March 2023 at the latest.

In addition, the FCA has clarified its provisions on using an early warning indicator as its original proposal implied that firms were expected to hold an additional 10% capital to avoid having to provide the FCA with continuous notifications. PS21/9 notes that it is acceptable and appropriate that a firm is within the 110% boundary for the threshold requirement for a substantial period of time if this is part of its agreed capital planning and reflective of its wider business strategy. More importantly, the FCA stresses that while it expects to be made aware of the reasons for a firm triggering the early warning notification, it will not be necessary for a firm to provide continuous updates to the FCA if they remain below the notification point. Once the relevant information has been provided, no further notifications are expected unless the next notification point is met (i.e., a breach of the own funds threshold requirement). Firms are able to set internal early warning indicators at levels appropriate to their business model.

The FCA has revised its rules for calculating the threshold for when large non-SNIs need to establish a risk, remuneration and nomination committee (i.e., £300 million on- and off-balance sheet) by, among others, drawing a cleared distinction between on-balance sheet assets and off-balance sheet assets, explaining that the value of on-balance sheet assets must be calculated in accordance with the applicable accounting framework, and explaining what firms should do if they have missing data points and when the FCA expects this to arise. They have removed the inclusion of guidance stating that large and more complex firms should assess the adequacy of their ICARA process more regularly than on an annual basis. A firm will only be expected to carry out a formal review of its ICARA process on an annual basis, unless there is a material change in the firm's business or operating model, in which case the ICARA process will need to be reviewed again to take into account the impact of that change.

With regards to a group application of ICARA, the FCA has provided additional guidance to clarify that it may also impose a requirement on a group to operate a consolidated ICARA process (i.e., as if the overall financial adequacy rule applied to the consolidated situation, so that the entire group were treated as a single firm) if the FCA believes this to be necessary. The FCA, however, stresses that this will only arise in exceptional situations.

The FCA notes that it would not normally require entities that conduct only non-MiFID business to be included in a group ICARA but it may use its consolidation powers to require the inclusion of these specific entities in some cases where it has concerns.

Governance

While the FCA continues to believe that firms should apply to the FCA to establish the nomination and risk committees at a group level, it will now allow groups to set up a remuneration committee at group level (see 'extended remuneration requirements' below for more information). PS21/9 confirms the FCA's views that it will not allow firms to combine their remuneration and nomination committees as it argues that the role of these committees is separate and distinct, so combining these would not be appropriate.

The FCA also provides clarification on the committees requirement that applies to large non-SNIs and how it replaces the current requirements for significant IFPRU firms to have risk, remuneration and nomination committees. This follows queries from stakeholders asking what this means for the future of the term 'significant IFPRU firm' and what the consequences are for firms which are enhanced scope Senior Managers and Certification Regime (SMCR) firms due to being significant IFPRU firms. The FCA clarifies that these firms will continue to be enhanced SMCR firms when the IFPR comes into effect and that it will not change the substantive thresholds that underpin the term – it will only change the name, which it will consult on in the final consultation. Significant IFPRU firms that currently have a waiver or modification of the existing requirements to establish committees must apply to the FCA to extend these (if they expire on or before 31 December 2021) or the FCA will automatically renew them (if they expire after 31 December 2021).

Scope and application of remuneration requirements

The FCA has clarified which remuneration code would apply where (i) the variable remuneration is based on performance in 2021 but is awarded after the firm has started to apply the new IFPR remuneration code; and (ii) the variable remuneration is awarded in 2021 but is paid out by the firm after the firm has started to apply the new IFPR remuneration code. PS21/9 notes that the new remuneration code applies to performance periods beginning on or after 1 January 2022. It is the performance period, rather than the date on which the remuneration is awarded or paid out, which is relevant. This means that firms subject to the existing IFPRU and BIPRU remuneration codes should continue to apply those rules when awarding and paying out remuneration where the remuneration in question is for performance or services provided during a period which started before 1 January 2022.

In addition, the FCA has amended the application provision to refer to 'performance periods' instead of 'performance years' following feedback that some firms use performance periods shorter than 1 year. This means that a firm with quarterly performance periods should apply the new code from the beginning of its next performance period beginning on or after 1 January 2022.

With regards to calculating the average on- and off-balance sheet assets to determine the threshold for applying the extended remuneration requirements, and in line with the above, the FCA provides additional guidance on the frequency of the values to be used which is now set at a monthly basis as it argues this is the most appropriate frequency to use over the 4-year period. Note that firms have discretion to decide which date of the month to use but once chosen, it may only change it for "genuine business reasons". If firms do not have the (full 4-year) data, they are expected to use data points it does have in a way that paints the most representative picture of the period in question. CPMIs should not calculate their on-balance sheet assets and off-balance sheet items based only on their MiFID business. To ensure a level playing field, all firms in scope of the IFPR remuneration code should use their total on-balance sheet assets and off-balance sheet items.

If a firm is in scope of multiple remuneration codes, it is required to comply with all the relevant requirements from all applicable codes as it argues that different remuneration codes contain the same requirements. Only where it is not possible to comply with both provisions because there is a conflict is there a need to decide which provision to apply. In these situations, the stricter of the provisions should be applied. Guidance has been added to clarify that the FCA expects firms to determine which rules are stricter on a provision-by-provision basis rather than by applying all or none of a remuneration code to an individual. They have also provided illustrative examples of situations in which multiple requirements may apply to a single material risk taker (MRT) (please refer to 19G.1.21 G).

The FCA confirms it will proceed with its list of categories of staff that must be identified as MRTs and with the accompanying guidance. However, it has clarified a number of points in relation to the identification process: (i) the name of the function or role is not decisive but rather the authority and responsibility held by the individual. This may mean that individuals in relatively junior roles are not identified as MRTs if they do not hold an appropriate level of authority and responsibility; (ii) the process should identify those with managerial responsibilities rather than all those members of staff with operational responsibilities in a certain field; and (iii) any individual who has a material impact on the risk profile of the firm, or of the assets it manages, should be identified as an MRT. This includes individuals employed or contracted by the solo entity or (where the rules apply on a consolidated basis) another firm in the consolidation group. This is irrespective of whether the individual is located in the UK or abroad, and whether or not they have responsibilities for MiFID business.

Basic remuneration requirements

The FCA will largely proceed with is initial proposals as outlined in CP21/7. However, a few helpful clarifications have been made. In response to partnerships and LLPs' comments on the remuneration and profit-sharing guidance, the FCA clarifies that it would expect 'a reasonable portion' of the profit share of a partner (or member of an LLP) to be considered remuneration where that partner or member works full-time for the firm.

With regards to carried interest, the FCA notes that it was not their intention to propose rules that would require large scale changes to existing carried interest arrangements as under its initial proposal it considered carried interest to be remuneration. While the FCA continues to believe that the MIFIDPRU remuneration code should apply to carried interest and that carried interest must be valued at the time of its award, it has added a new rule which means that the requirements on pay-out in instruments, deferral, retention and ex-post risk adjustment do not apply to carried interest arrangements where: (i) the value of the carried interest is determined by the performance of the fund in which the carried interest is held; (ii) the period between award and payment of the carried interest is at least 4 years; and (iii) there are provisions for the forfeiture or cancellation of carried interest that include at least situations in which the MRT participated in or was responsible for conduct which resulted in significant losses to the firm, and situations in which the MRT failed to meet appropriate standards of fitness and propriety.

Finally, the FCA clarifies that it would consider the returns on a co-investment arrangement to be remuneration only where the investment was made using a loan provided by the firm or a member of the group to which the firm belongs, and that loan: (i) was not provided to the individual on commercial terms; or (ii) had not been repaid in full by the time the return on the investment was paid.

Standard remuneration requirements

While the FCA has largely implemented its proposals as consulted on in CP21/7, several amendments/clarifications have been made. For example, the FCA does not think that defining appropriate ratios between fixed and variable remuneration is useful. A firm should consider all potential scenarios when setting its ratio or ratios for the coming year, including that the firm exceeds its financial objectives. The maximum ratio should reflect the highest amount of variable remuneration that can be awarded to the category of MRT in the most positive scenario. A firm should be satisfied that it has taken into account all relevant factors and be able to explain its decision to the FCA upon request. It has clarified these expectations in a new guidance provision. In general terms, it considers a ratio not to be appropriate where the fixed element of the remuneration is so small as to require the payment of variable remuneration to ensure basic living costs can be met. Note that the third and final CP will consult on remuneration disclosure.

With regards to performance assessment on a multi-year period, the FCA has amended its rule to expressly clarify that the IFPR requires non-SNIs to take a longer-term approach, which includes setting some aspects of the assessment process in a multi-year period which reflects the firm's business cycle, or the redemption policy of the funds managed, and/or using appropriate ex-ante and ex-post adjustments.

The FCA has made amendments to the requirement to annually review the remuneration policy by control functions. It has removed the reference to using a firm's internal audit function, added guidance to provide more details of what it expects the review to include, clarified that the review may be outsourced in whole or in part, and amended the rule to clarify that the independent internal review relates to the implementation of the remuneration policy and practices, and whether they comply with the policy framework and procedures laid down by the management body in its supervisory function.

In addition, the FCA has clarified its provisions on non-standard forms of variable remuneration. On severance pay, if a firm has to make a severance payment as a result of a legal obligation and, as a consequence, the non-SNI exceeds its ratio, the firm should exclude from the variable component the difference between the maximum severance pay foreseen in its remuneration policy and the severance pay it has become obliged to pay. On retention awards, by making the payment of a retention award dependent on the MRT meeting certain defined performance criteria, the FCA considers that the alignment of risk and reward is further strengthened. It clarifies that a firm may (but does not have to) link a retention award to performance criteria. Finally, with regards to buy-out awards, the FCA has changed the relevant rule to require the duration of the retention, deferral, vesting and ex-post risk adjustment arrangements to be 'no shorter' than the duration applied, and remaining, under the previous employer. The only requirement in relation to the non-duration aspects of the pay-out, malus and clawback arrangements is that these must be aligned with the long-term interests of the firm.

Extended remuneration requirements

The FCA confirms it will largely proceed with the proposals as outlined in CP21/7. However, with regards to pay-out in shares, other instruments or using alternative arrangements, the FCA has clarified that using notional units which track the performance of units in the underlying portfolio and are settled in cash falls within the category of non-cash instruments which reflect the instruments of the portfolios managed. The FCA also asks firms to contact them should they wish to carry over 'alternative arrangements' which have been agreed with the FCA previously.

The FCA clarifies that it may be appropriate (rather than it being an expectation in all instances) to apply a deferral period longer than 3 years to the most senior MRTs.

With regards to interest and dividends, MRTs are now permitted to accrue interest and dividends during the deferral period, but firms will not be permitted to pay them to MRTs until the point of vesting. This will apply on the condition that the interest rate or level of dividends paid is not higher than that which would have been paid to an ordinary holder of the instrument. Where this condition is not met, the accrued interest or dividends may not be paid out to the MRT.

The FCA has amended its rules by permitting a non-SNI firm to rely on a group level remuneration committee where the firm is part of an FCA investment firm group to which prudential consolidation applies and where the UK parent entity has a remuneration committee that (i) meets the composition requirements (where they apply); (ii) has the necessary powers to comply with the other obligations in MIFIDPRU 7.3 on behalf of the non-SNI firm; and (iii) has members with the appropriate level of the UK parent entity's knowledge, skills and expertise in relation to the non-SNI firm. Where these criteria are met, a firm may rely on the group level remuneration committee without needing to apply for a modification.

Reporting

Several amendments have been made to firms' ICARA reporting requirements, including a requirement for firms to undertake their ICARA reports during 2021 on a 'best efforts' basis, and that it does not expect firms to submit MIF007 before they have completed their ICARA process. A small number of changes have been made to MIF007 to provide the FCA with a better understanding of firms' business models for supervisory purposes.

Finally, several minor amendments have been made to the metric monitoring requirements (MIF003), related to DTF and average K-factor metrics.

Next steps

The FCA will publish its third and final consultation on the introduction of the IFPR during the summer. The IFPR is effective as of 1 January 2022. AIMA will publish an IFPR implementation guide in the summer to assist members in transitioning to the new regime.