Investment Firms Directive and Regulation: An Introduction

February 2020
Agenda for today

- Background and timeline
- Overview and scope
- Group requirements
- Capital requirements
- Pay regulation
- Transparency and reporting
- SNIFs
- Your to do list
- Key messages for the board
Background

Updates EU “prudential regulation” of MiFID investment firms

Drivers for change:

- Existing regime adapts the ever more complex rules designed for banks (CRD I-V, CRR I &II)
- Investment firms require a tailored regime, simplicity, consistency

Applies to:

- UK/EU27 MiFID firms
- Likely some UK/EU27 AIFMs and UCITS Mancos with MiFID top-ups

UK currently expected to implement regardless of Brexit

- 2013 – Commission mandated to review existing framework
- 2016 – Commission call for advice, EBA discussion paper and public hearing
- 2017 – Legislative proposal, Parliament and Council work
- 2019 – Legislation published in the Official Journal

Trade associations such as AIMA (and Travers Smith) heavily involved throughout
Timeline

25 December 2019
IFD/IFR comes into force

26 June 2021
IFD/IFR applies from this date

26 December 2022
ESG risk disclosures for larger firms

25 December 2019
IFD/IFR comes into force

26 June 2021
IFD/IFR applies from this date

26 December 2022
ESG risk disclosures for larger firms

Q1 2020
FCA discussion paper expected

29 December 2020
CRD V/CRR II comes into effect for banks

26 December 2020
Draft regulatory technical standards on fixed overheads

25 June 2026
End of transitional relief
Which UK firms are covered by IFR/IFD?

- All firms licensed under MiFID
  - IFPRU firms, BIPRU firms, exempt-CAD advisor-arranger firms
  - Most investment banks, brokers, MTF and OTF operators, wealth managers, hedge fund managers, debt fund managers, CLO managers, PE, VC and RE advisor-arrangers
  - Not banks, insurers, service companies, OPS firms, AIFMs/UCITS Mancos without MiFID top-ups, UK domestic CIS operators, insurance or mortgage intermediaries, Article 3 MiFID-exempt firms, data reporting service providers
  - Appointed representative firms on hosting platforms may need to absorb the higher capital costs of their principals

- AIFMs and UCITS Mancos with MiFID top-up permissions?

- Some small and non-interconnected firms (SNIFs) will enjoy a lighter treatment

- The very largest (approximately eight) EU and UK investment banks will continue to be regulated under CRD V and CRR II

Changes most significant for these firms

Depending on national implementation
Consistent with current approach in the UK but varies by jurisdiction
Some firms will be required to hold more **capital** (some a great deal more); some perhaps less

- New **data points / processes** may be required to calculate capital requirements
- Impact of **deductions** will need to be assessed
- **Liquid assets** requirements
- Substantive rules on **concentration risk** for some firms; all firms may be required to monitor and report

- Firms will be subject to onerous **remuneration rules** (though not as tough as the rules for banks)
- New **regulatory reporting** requirements
- New **public transparency** requirements
- New **governance** requirements

Very importantly, some rules will apply on a **group-wide basis**

Groups and sub-groups...

...headed by an EU parent

- Capital, remuneration, transparency and regulatory reporting obligations will apply to the EU parent on the basis of its consolidated situation, broadly as now for IFPRU and BIPRU firms
- EU parents of “sufficiently simple" and low risk groups will be permitted instead to hold own funds sufficient to cover the full book value of holdings in subsidiaries plus contingent liabilities in favour of such firms

...headed by a non-EU parent

- If two or more EU MiFID investment firms are subsidiaries of a non-EU parent the relevant EU regulator may apply “appropriate supervisory techniques” if non-EU parent is not subject to equivalent supervision
- Could potentially require the group to establish an intermediate EU holding company – policy on this will need to be watched
- Brexit implications...
Groups and sub-groups – example structure

Prudential Consolidation Group

US LLC Top Co

EU Hold Co

EU Portfolio Manager
EU Tied Agent

US Hold Co

Non-EU Subsidiaries
Groups and sub-groups – post Brexit?

Prudential Consolidation Group

US Top Co

EU 27 Hold Co

UK Hold Co

EU 27 Portfolio Manager

UK Portfolio Manager

UK Tied Agent
Capital requirements

1. Black box calculation
   *Higher of:
   - Specified minimum € amount (€75k or €150k, unless prop trading); or
   - Fixed overheads requirement; or
   - New risk-based “K-factor” requirement

2. May be increased as a result of Individual Capital Adequacy Assessment Process (ICAAP)

3. Regulator may require increase following Supervisory Review and Evaluation Process (SREP)

Capital resources

Broadly:

1. Shareholder equity
   - Ordinary share capital
   - Eligible LLP members’ capital

2. Plus audited retained earnings

3. Less deductions
   - e.g. current year losses
# K-factors

<table>
<thead>
<tr>
<th>K-factor</th>
<th>Explanation</th>
<th>Coefficient</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>K-AUM</td>
<td>Assets under management</td>
<td>0.02%</td>
<td>Ignore assets delegated to the firm</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Some uncertainties about calculation of AUM and, in particular, AUA</td>
</tr>
<tr>
<td>K-CMH</td>
<td>Client money held</td>
<td>0.4% segregated accounts 0.5% otherwise</td>
<td>Client money “controlled” under a mandate is ignored</td>
</tr>
<tr>
<td>K-ASA</td>
<td>Assets in custody</td>
<td>0.04%</td>
<td></td>
</tr>
<tr>
<td>K-COH</td>
<td>Client orders handled</td>
<td>0.1% for cash trades 0.01% for derivatives trades</td>
<td>Includes RTO as well as dealing in the client’s name, but should not result in double counting from K-AUM</td>
</tr>
<tr>
<td>K-NPR</td>
<td>Net position risk</td>
<td>The position</td>
<td>Relevant to trading book positions of firms dealing on own account (for themselves or on behalf of clients)</td>
</tr>
<tr>
<td>K-CMG</td>
<td>Clearing margin given</td>
<td>The value</td>
<td>Also applies to non-trading book positions giving rise to FX or commodity risk (better view is that still confined to dealing on own account but unclear)</td>
</tr>
</tbody>
</table>
## K-factors (cont.)

<table>
<thead>
<tr>
<th>K-factor</th>
<th>Explanation</th>
<th>Coefficient</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>K-TCD</td>
<td>Trading counterparty default</td>
<td>The position</td>
<td>Only relevant to firms dealing on own account (for themselves or on behalf of clients) with trading book positions</td>
</tr>
<tr>
<td>K-DTF</td>
<td>Daily trading flow</td>
<td>0.1% for cash trades 0.01% for derivatives</td>
<td>As K-TCD in terms of firms caught but will also catch some agency transactions (e.g. for an undisclosed principal)</td>
</tr>
</tbody>
</table>
| K-CON    | Exposures which exceed new concentration limits | N/A | Application unclear but better view is that it is confined to firms dealing on own account or on matched principal basis  
Firms are subject to a limit on exposure to an individual client or group of connected clients of:  
• 25% of own funds; or  
• in the case of exposures to certain financial sector clients, the higher of 25% of own funds and €150m (or, if lower, 100% of own funds)  
All firms may be required to monitor and report on concentration risk |
Transitional relief

- Two **transitional reliefs** available for own funds requirements, but
  - Limited in scope
  - Unclear whether they apply only on a solo or also on a group basis
  - **Do not currently appear to benefit exempt-CAD advisor-arrangers**
- **Relief 1**: for 5 years, can substitute 2x existing own funds requirement under CRD IV/CRR for fixed overheads/K-factor requirements under IFD/IFR
- **Relief 2**: for 5 years, permanent minimum requirement may be scaled in small increments – but this is unlikely to be material
Liquid assets requirement

- Must hold at least one month’s fixed overheads in liquid assets
- Liquid assets tightly defined to include:
  - Cash
  - Gilts and other government bonds
  - Some other debt subject to specific eligibility criteria and haircuts
  - Shares or units in certain money market funds up to a cap of €50m
  - Other assets traded on a trading venue for which there is a liquid market (per MiFIR) subject to haircut of 55%
- Most firms (except investment banks) can also include:
  - Receivables from trade debts and fees or commissions receivable within 30 days
  - But only to satisfy 1/3 of the liquidity requirement and subject to a 50% haircut
Pay regulation

Does the firm qualify for an exemption from the most onerous rules?

On- and off-balance sheet total <€100m (averaged over 4 years) (or €300m in MS discretion). But will you measure this on a solo or whole-global-group basis?

- Remuneration **policy** meeting specific requirements – evolution not revolution
- Code Staff:
  - No 2:1 bankers’ bonus cap but must **set and publish ratios** of variable to fixed pay
  - All variable pay must be subject to **malus** (restrictions on vesting) and **clawback** – triggers to be determined
  - Some specific rules e.g. about **golden hellos**
  - **Public disclosures** about aggregate pay (see below)

In addition:

- Establish a gender-balanced **remuneration committee** composed of NEDs
- Code Staff:
  - **Defer** at least 40% and up to 60% of variable pay over at least 3 years
  - Pay 50% of variable pay in **instruments** (as opposed to cash) linked to the employer
Transparency and reporting

Publicly:

- **Remuneration policy and practices** – more granular than current Pillar 3 disclosures including:
  - Aggregate quantitative remuneration, broken down by senior managers and material impact staff, split by fixed vs variable, vested vs unvested and any severance payments
  - Gender pay gap
  - Capital, capital requirements, risk management objectives and policies, internal governance arrangements
  - Audited country-by-country reporting of activities, headcount, turnover, tax paid etc. (added to annual report if possible)
  - Certain large balance sheet firms must disclose voting rights and behaviour in relation to certain listed issuers

To regulators:

- **Quarterly Reporting**: regulatory capital information including the level and composition of own funds, capital requirements, capital requirement calculations, concentration risk and liquidity requirements
- **High Earners Reporting**: The number of natural persons who are remunerated €1m+ pa, in brackets of €1m, including job responsibilities, business area and the elements of salary, bonus, long-term award and pension contribution
SNIFs

The vast majority of firms will be caught by the regime in full. However, Small and Non-Interconnected Investment Firms ("SNIFs") will be subject to lighter requirements. All of the following must be true in order to pass the "SNIF test":

<table>
<thead>
<tr>
<th>K-factor or other factor</th>
<th>Summary</th>
<th>Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>Average total gross revenue from investment services and activities</td>
<td>&lt; €30m*</td>
</tr>
<tr>
<td>AUM</td>
<td>Assets under management plus some assets under ongoing advice</td>
<td>&lt; €1.2bn*</td>
</tr>
<tr>
<td>COH</td>
<td>Client orders handled</td>
<td>&lt; €100m per day for cash trades or €1bn per day for derivatives*</td>
</tr>
<tr>
<td>ASA, CMH, DTF, NPR, CMG, TCD</td>
<td>Zero custody, zero client money held, no trading book activity, not a clearing member</td>
<td></td>
</tr>
<tr>
<td>Size of firm</td>
<td>On- and off-balance sheet total</td>
<td>&lt; €100m*</td>
</tr>
</tbody>
</table>

*These tests must be applied by reference to all investment firms in a group. Currently unclear whether this means only UK/EU27 MiFID firms or all similar firms globally.
SNIFs: summary of treatment

- No K-factor requirement
- Member States (inc. UK) have option to disapply liquidity adequacy rules, otherwise slightly more generous rules on what counts as liquid assets
- No ICAAP by default, but Member States (inc. UK) have the option to require it
- No pay regulation
- Very unlikely to have to report publicly, and (generally) only annual reporting to regulators
- Likely to be treated as “sufficiently simple” to not warrant group requirements
Your immediate to do list, assuming worst case:

Can your firms all qualify as SNIFs?

Consider the relevance of the group requirements to you. Can you credibly claim to be “sufficiently simple”?

Consider the impact of the new remuneration rules and whether you may be exempt from any of them

Calculate the quantum of capital requirements under the new rules and plan to meet any higher requirements

If you reach bad outcomes, consider restructuring
Key messages for the board

1 Refresh
A complete overhaul of “prudential” regulation for most regulated investment firms (capital, liquidity, staff pay, governance, reporting to regulators and public reporting) from mid-2021

2 Capital & liquidity
Some firms will require more capital and/or liquid assets from mid-2021, some a great deal more, some perhaps less!

3 Remuneration
More onerous pay regulation requirements for some firms

4 Disclosure
Public disclosure obligations, including on remuneration and capital (both qualitative and quantitative information)

5 Restructuring
It may be necessary or desirable to restructure corporate groups, for example to mitigate new requirements

6 Licences
May make it relatively less onerous for certain firms to maintain bigger and more flexible licences

7 Project team
Requires a project team, comprising at least Finance and Compliance professionals

8 Project timing
Several material legal uncertainties are unlikely to be resolved until well into 2020 but prudent to make an initial assessment of impact sooner
Contacts

Stephanie Biggs
Partner
Stephanie.Biggs@traverssmith.com
+44 20 7295 3433

Tim Lewis
Partner, Head of Financial Services and Markets
Tim.Lewis@traverssmith.com
+44 20 7295 3321

Jane Tuckley
Partner
Jane.Tuckley@traverssmith.com
+44 20 7295 3238

Michael Raymond
Partner
Michael.Raymond@traverssmith.com
+44 20 7295 3487

Phil Bartram
Partner
Phil.Bartram@traverssmith.com
+44 20 7295 3437