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Regulatory Newsflash

New Regulatory Capital Regime for MiFID Investment Firms – European Commission Proposals

On 5 February 2018, the European Commission ('the Commission') set out its plans for a [regulation and directive](#) to amend the prudential rules for investment firms. The Commission's proposals are closely aligned to recommendations published by the [EBA](#) last September, with some important clarifications.

A **three-tier categorisation system** based on the scale and scope of activities undertaken should create a more risk-focused prudential regime for MiFID investment firms.

Class 1 - Systemic investment firms

Class 2 – Larger investment firms

Class 3 – Small and non-interconnected firms

Overview of the proposals

For Class 1 firms, the Commission plans to change the definition of 'Credit Institution' to include dealing on own account or underwriting or placing financial instruments on a firm commitment basis, where the total value of the assets of the undertaking are **EUR 30 billion** or more. The directive also specifies arrangements for firms seeking authorisation as a Credit Institution.

A Class 2 categorisation will apply if a firm exceeds specific business-related thresholds, and Class 3 firms should be small in nature and subject to a simpler regime.

It is proposed that Class 1 firms will remain aligned to the existing **CRR**; Class 2 firms will be required to conduct a '**K-factor**' risk assessment; and Class 3 firms will be subject only to **permanent minimum capital and fixed overhead requirements (FOR)**.

Class 2 firms will experience the most significant changes to their capital calculation requirements. The proposed K-factor assessments are based on the extent to which firms participate in certain risk related activities. These are **Assets Under Management; Client Money Holdings; Assets Safeguarded; Client Orders Handled; Net Position Risk; Clearing Member Guarantees; Trading Counterparty Default, Concentration Risk; and Daily Trade Flow**. The K-factor calibrations previously proposed by the EBA have not been altered by the Commission.

K-Factor	Metric	New or based on CRR	Definition	Coefficient / Driver in the Investment Firm Regulation
K-AUM	Assets under management	New	Value of assets managed for clients under discretionary 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%
K-CMH	Client money held	New	Amount of client money held or controlled, regardless of	0.45%

			segregation arrangements, and irrespective of the applicable national accounting regime.	
K-ASA	Assets safeguarded and administered	New	Value of assets safeguarded and administered for clients, including assets delegated to another undertaking and assets that another undertaking has delegated to the investment firm.	0.04%
K-COH	Customer orders handled	New	Value of orders handled for clients, through both the reception and transmission of orders, and the execution of orders on their behalf.	0.01 – 0.1%
K-NPR	Net position risk	CRR	Value of transactions recorded in the trading book of an investment firm.	Own account dealing as per IFR article 22
K-CMG	Clearing member guarantee	New	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.	Based on highest initial margin as per IFR article 23
K-TCO	Trading counterparty default	CRR	The exposures in the trading book in instruments giving rise to counterparty default risk.	Counterparty exposure as per IFR article 26
K-CON	Concentration risk	CRR	The exposures in the trading book to a client or group of connected clients, the value of which exceeds specified limits.	Trading book exposure as per IFR article 38
K-DTF	Daily trading flow	New	The daily value of transactions dealt on own account, or on behalf of clients in an investment firm's own name.	0.01 – 0.1%

Class 1 firms should be subject to full **liquidity requirements**, with Class 2 and 3 firms required to hold an amount of liquid assets equal to one third of their FOR.

Firms will be required to have in place **an internal capital adequacy assessment process** to cover internal capital, governance, transparency and risks and remuneration. **Pillar 2 self-assessments** should be applicable to Class 2 and 3 firms (p.23 Commission Staff Working Document – Review of the prudential framework for investment firms), with individual authority firm-specific assessments able to increase capital and liquidity requirements where necessary.

It is proposed that **Group Capital Test** requirements will apply to investment firm only groups, with the ultimate parent company responsible for all the prudential requirements for

the group at the consolidated level. Class 2 firms should also be required to report on **concentration risks**.

Further, the Commission's proposals clarify that a systemic investment firm will be subject to the CRD/CRR, authorised as a Credit Institution, and **supervised by the ECB** in the context of the SSM for their operations in member states participating in the Banking Union.

The equivalence regime

The proposals undertake targeted changes to the existing equivalence regime for third-country firms under Articles 46 and 47 of MiFIR to maintain a level playing field between EU firms and third-country firms. The Commission notes that this is to ensure that third-country firms providing services cross-border to EU professional clients and eligible counterparties do not benefit from a more favourable treatment than EU firms in terms of prudential, tax and supervisory requirements.

Access to the EU will be conditional on the Commission adopting an equivalence decision, and ESMA registering the third-country firm. Third-country firms will be required to report information annually to ESMA concerning the scale and scope of services provided, and activities carried out in the EU. The Commission is required to take into account the potential risks posed by these services and activities in their equivalence considerations. The Commission may also consider whether a jurisdiction is identified as a non-cooperative jurisdiction for tax purposes, or as a high risk third-country.

While this is not currently relevant for UK based firms setting up subsidiaries in the EU27 as part of their Brexit related contingency plans, it will be relevant to firms seeking to use the equivalence provisions to provide services to EU professional clients and eligible counterparties without establishing a branch. Furthermore, depending on a Member State's decision to opt into the MiFID II requirement for third-country investment firms to establish a branch, firms may have to establish a branch in the Member State where they intend to perform their services and carry out their activities.

Remuneration requirements

MiFID II remuneration requirements are deemed appropriate for class 3 firms, and CRR IV provisions considered suitable for

class 1 firms. No specific limits have been set on the ratio between variable and fixed components of remuneration, with investment firms expected to set appropriate ratios themselves. Additional **Regulatory Technical Standards** will clarify requirements in this area, as well as in the areas of **supervisory information sharing, credit institution authorisation and branch arrangements, and the application of additional capital requirements** (in certain circumstances where a competent authority considers the calculated capital requirement to be inadequate).

Next Steps

The Commission will seek agreement from the Council and European Parliament ('EP') for the legislative proposals.

The Commission will encourage the Council and EP to work quickly to finalise political negotiations on the file ahead of EP elections set for June 2019. While this is possible, and could result in an implementation date occurring in 2020, **such a negotiating timetable is very ambitious by EU standards**, and an attempt to reach a political agreement in H1 2019 could stall, particularly in light of pending EP elections. Proposals relating to the handling of market risk could also be the source of contention between member states.

Therefore, it is conceivable that no agreement will be reached before EP elections in 2019. In this situation, negotiations are expected to resume in Q1 2020 with a new EP and Commission, and could take up to one additional year to reach a political agreement. Once entry into force of the legislation occurs, a further 18 month implementation period will apply, resulting in a likely projected date for implementation of H2 2022.

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