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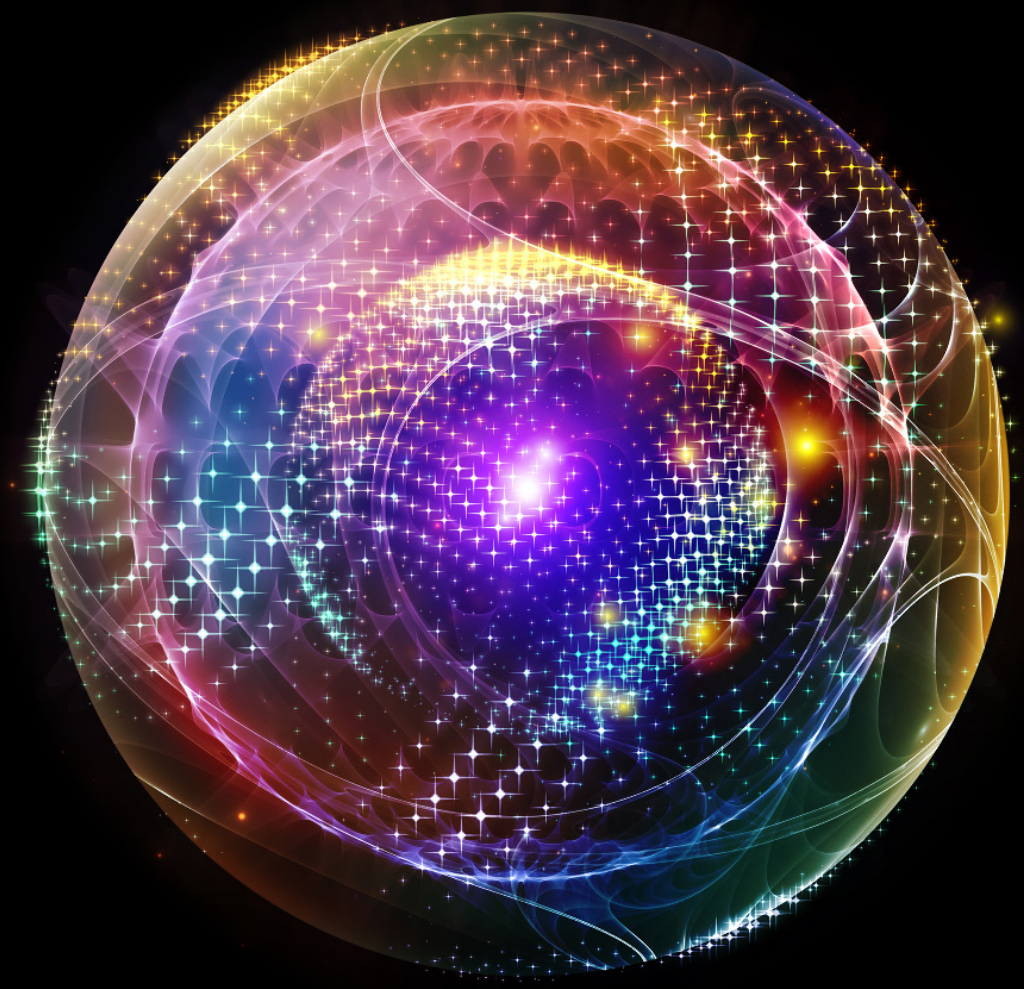

The impact of the new IFD/IFR regime
An article series with five different perspectives

Article 3

MAKING AN IMPACT THAT MATTERS since 1845

How to master my governance and remuneration under IFD/IFR?

IFD/IFR leads to new regulatory standards in the field of internal governance and remuneration. But not for every firm. This article discusses key requirements that will apply to EU investment firms in the new situation. Are you aware of the consequences for your company?

1. So what's new?

A new prudential framework for EU investment firms is coming into effect on June 26, 2021: the Investment Firm Regulation and Directive ("IFD/IFR")[1]. As previously introduced in our other articles, this article provides several high level consequences of the new framework from an internal governance & remuneration perspective.

2. Which governance & remuneration requirements apply to me?

Let's start with the scope of the new governance and remuneration requirements. Do all investment firms need to apply the same requirements and to which extent? The answer is relatively simple: the requirements are meant for class 2 firms only, with some minor exceptions. As discussed in our previous article on the IFD/IFR categorization, class 1 firms need to apply the CRD IV regulatory framework[2]. This is also the case with regard to governance & remuneration. So large, systemically important firms are therefore subject to CRD IV governance & remuneration requirements. Class 3 firms, the small and non-interconnected firms, are explicitly excluded from the scope of the new IFD governance & remuneration requirements and remain in scope of the MiFID II requirements on these subjects[3]. For Dutch firms, the governance & remuneration requirements are (mainly) laid down in the Dutch Financial Supervision Act ("Wet op het financieel toezicht", Wft) and other specific regulations[4].

Please note that some class 2 or 3 firms may be (also) covered by a different regulatory framework due to consolidated supervision, such as Solvency for an insurance group or CRD IV for a banking group. Local requirements may be applicable on top of the "European" requirements. In the Netherlands, the requirements as laid down in the Wft will apply to all investment firms irrespective of class allocation, unless explicitly exempted in the Wft.

3. What does this mean for my governance specifically?

Currently, investment firms governed by CRD IV and MiFID II already have quite some governance requirements to adhere to. From requirements around the (adequacy of the) management body and CEO, to specific requirements on internal control mechanisms. These are found (amongst others) in the Dutch Financial Supervision Act, the Dutch Corporate Governance Code and EBA-Guidelines. We will not discuss the requirements for Class 1 firms, but we do mention that the EBA Guidelines on Internal Governance will be amended in the near future[5].

Class 2 firms under IFD should assess to which extent their organization already complies with the new governance requirements and, if not (fully), what steps to take next. What does the new IFD governance framework require from them? Class 2 firms need to ensure their governance arrangements are robust[6]. This encompasses a clear organizational structure, effective risk management processes, adequate internal controlling and gender-neutral remuneration policies and practices. The requirements do not distinguish between different forms of governance (e.g. one-tier or two-tier boards). All of these arrangements should be appropriate and proportionate to the risks related to the firm concerned, as the aim is to guarantee effective, timely and accurate risk management for the firm itself, its customers and markets.

To achieve this, the management body must have a stronger involvement in risk management [7]. For example in approving and periodically reviewing strategy and risk appetite and having a risk committee with non-executive members of the

1 Directive (EU) 2019/2034 of the European Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms ("IFD") and Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms ("IFR").
2 Soon to be replaced by the CRD V/CRR II framework.
3 Article 25 IFD.
4 For example the "Regeling beheerst beloningsbeleid ("Rbb")".
5 The public consultation runs until 31 October 2020. These guidelines are not only amended in accordance with the new
6 Article 26 IFD.
7 Article 28 IFD.

management body (for larger firms). From a risk management point of view it is also important to align the full organization (including policies, processes and systems) with the new IFD/IFR framework and (K-factor) methods.

For the former CRD IV governed firms, these are not significant changes. For other firms, these requirements overlap to a lesser extent with the Commission Delegated Regulation as regards organizational requirements (under MiFID II)[8]. EBA will clarify the requirements in guidelines.

4. How is my remuneration impacted?

As indicated above, only class 2 firms have to comply with the new remuneration requirements. Other firms will be either in scope of CRD V or MiFID II regarding remuneration. So what is new for class 2 firms?

4.1 Remuneration Policies

The IFD prescribes on a high-level basis which requirements should apply to the remuneration policy for Identified Staff (including e.g. senior management and staff engaged in control functions)[9]. These requirements will be further detailed in the EBA Guidelines on the application of sound remuneration policies under the IFD[10].

Most requirements are aligned with the CRD IV framework. The remuneration policy should for instance be consistent with, and promote, sound and effective risk management. Furthermore, the implementation of the policy should be subject to a central and independent internal review on at least an annual basis.

The types of staff considered as Identified Staff is somewhat broader than was the case with CRD IV. The EBA is currently drafting Regulatory Technical Standards[11] in this respect.

Major deviations (compared to the CRD IV) mainly relate to variable remuneration and gender requirements. These will be discussed in more detail in the paragraphs below.

4.2 Variable remuneration & Dutch Bonus cap

In general, most IFD requirements regarding variable remuneration[12] for Identified Staff are to a certain extent similar to CRD IV. For instance, the total amount of variable remuneration should still be based on a combination of the assessment of the performance of the individual, of the business unit concerned and of the overall results of the company and should include both financial and non-financial performance criteria. Furthermore, at least 40% of variable remuneration, and 60% in case of particularly high amounts, should be deferred over a 3 to 5 year period, but only if certain (new) proportionality thresholds are exceeded.

At least 50% of variable remuneration must consist of instruments such as shares or equivalent ownership interests, but, again, only if certain (new) proportionality thresholds are exceeded. An appropriate retention period should apply once the instruments have vested. Under the IFD, a broader array of instruments may be used than is currently the case under CRD IV. The EBA is currently drafting Regulatory Technical Standards[13] specifying which classes of instruments are allowed.

Unlike the CRD IV framework, the IFD does not include a single maximum bonus ratio for Identified Staff. Instead, firms should set appropriate ratios themselves. However, it is important to note that the Dutch Financial Supervision Act contains a bonus cap of (in principle) 20% which will continue to apply to investment firms[14] and to all staff working for the firms. Furthermore, the malus- and clawback requirements as included in the Dutch Financial Supervision Act continue to apply.

4.3 A gender-neutral remuneration policy and practice

The IFD requires the remuneration policy and practice to be gender-neutral. This entails the principle of equal pay for male and female workers for equal work or work of equal value. The EBA will issue Guidelines[15] on this topic.

In the Netherlands, the government has proposed to include the requirement in the Dutch Financial Supervision Act, with the consequence being that the scope will be extended to all financial companies.

4.4 Remuneration committee

CRD IV requires significant institutions to establish a remuneration committee[16]. In the IFD, this requirement applies to all firms (but this may be on a group level) that have on and off-balance sheet assets with a value which is on average equal to or less than EUR 100 million[17]. The remuneration committee should be able to exercise competent and independent judgment on the remuneration policies and practices and the incentives created for managing risk, capital and liquidity.

A new feature in the IFD is the requirement to have a gender-balanced remuneration committee.

5. What steps to take next?

Investment firms will need to take action in time to be prepared for IFD/IFR. It is important to form project teams that will prepare the changes to the internal governance and remuneration policies and practices. The team should consist of persons with various specialisms, such as HR, Risk Management and Compliance. Next step would be to perform a gap analysis to assess which policies and practices should be changed in order to comply with the IFD requirements and in what manner. Finally, firms should draft a plan to prepare for and (ultimately) implement the required changes.

8 Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.
9 Article 30 IFD.
10 Final Guidelines to be expected in Q2-Q4 of 2021.
11 Final RTS to be expected before the end of 2020.
12 Article 32 IFD.
13 Final RTS to be expected before the end of 2020.
14 Unless a firm is, based on the Dutch Financial Supervision Act, exempted from the bonus cap. An exemption exists for e.g. certain market makers. These firms are however not exempted from the IFD-requirement to set an appropriate ratio themselves.
15 Final Guidelines to be expected in Q2-Q4 of 2021.
16 Article 33 IFD.
17 Over the four-year period immediately preceding the given financial year.

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