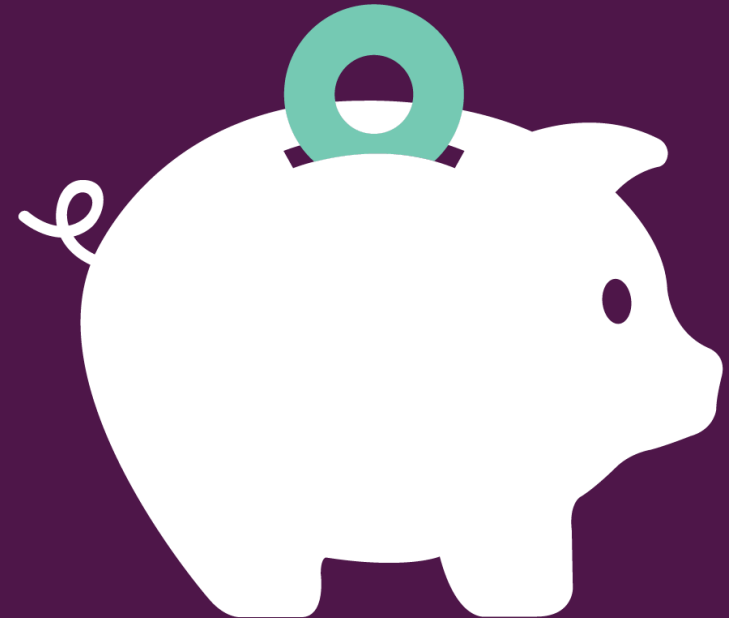


Investment Firms Directive and Regulation: An Introduction

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



**Current legal uncertainty
and topics to watch**

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

- **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

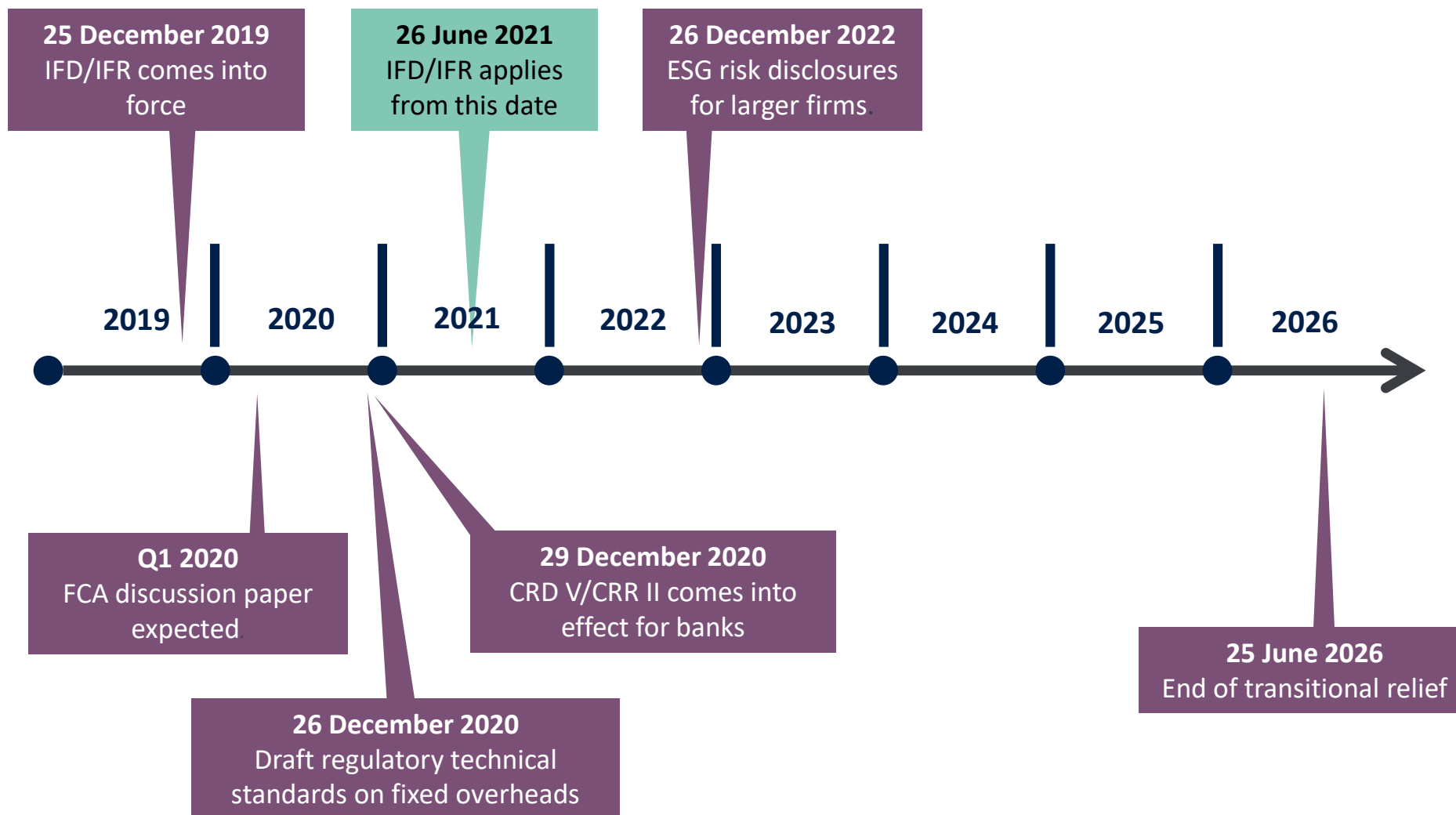
Trade associations such as AIMA (and Travers Smith) heavily involved throughout



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

Timeline



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



Depends on national implementation
Consistent with current approach in the UK but varies by jurisdiction

Key requirements (for most firms)

- 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



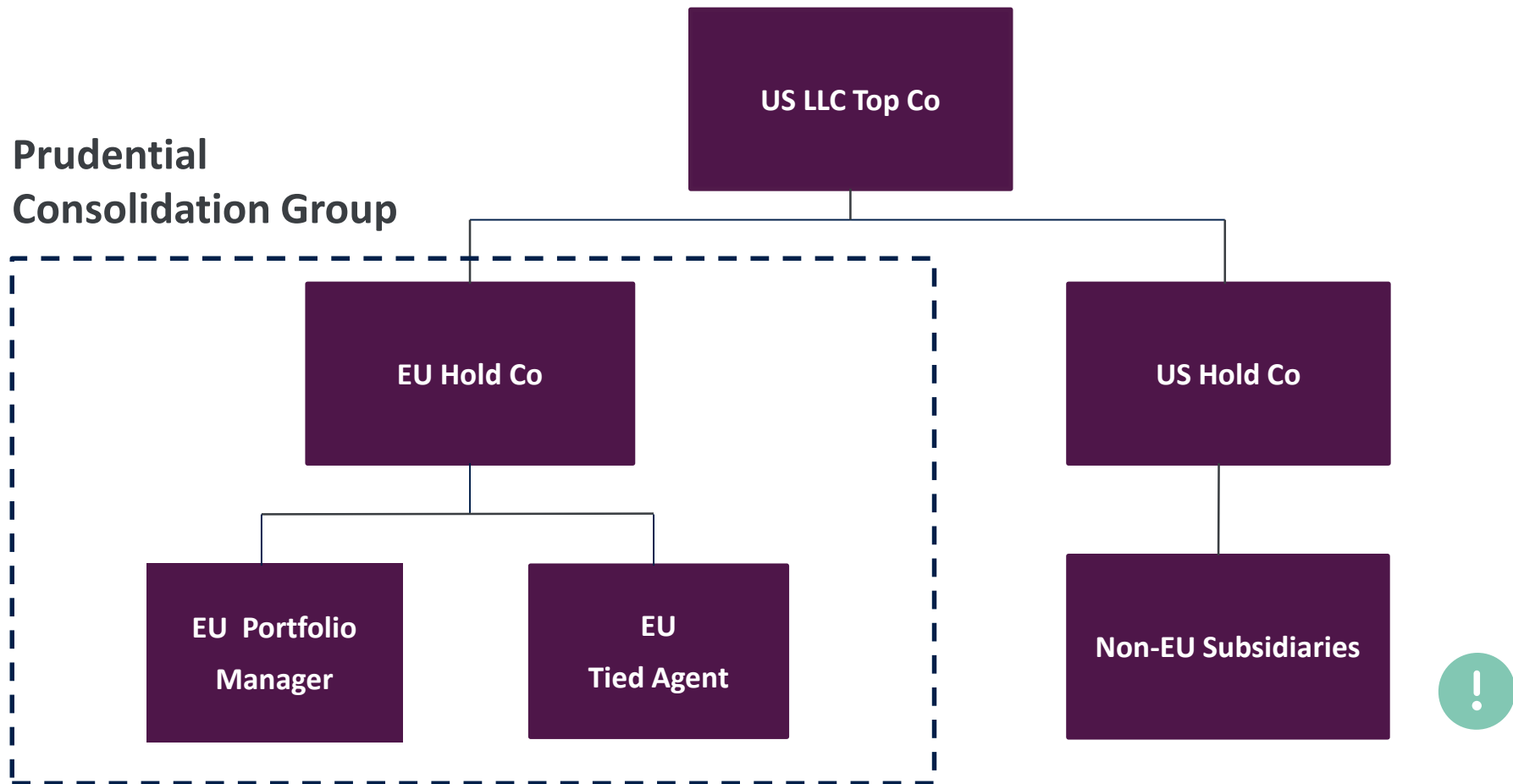
...headed by a non-EU parent

- 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

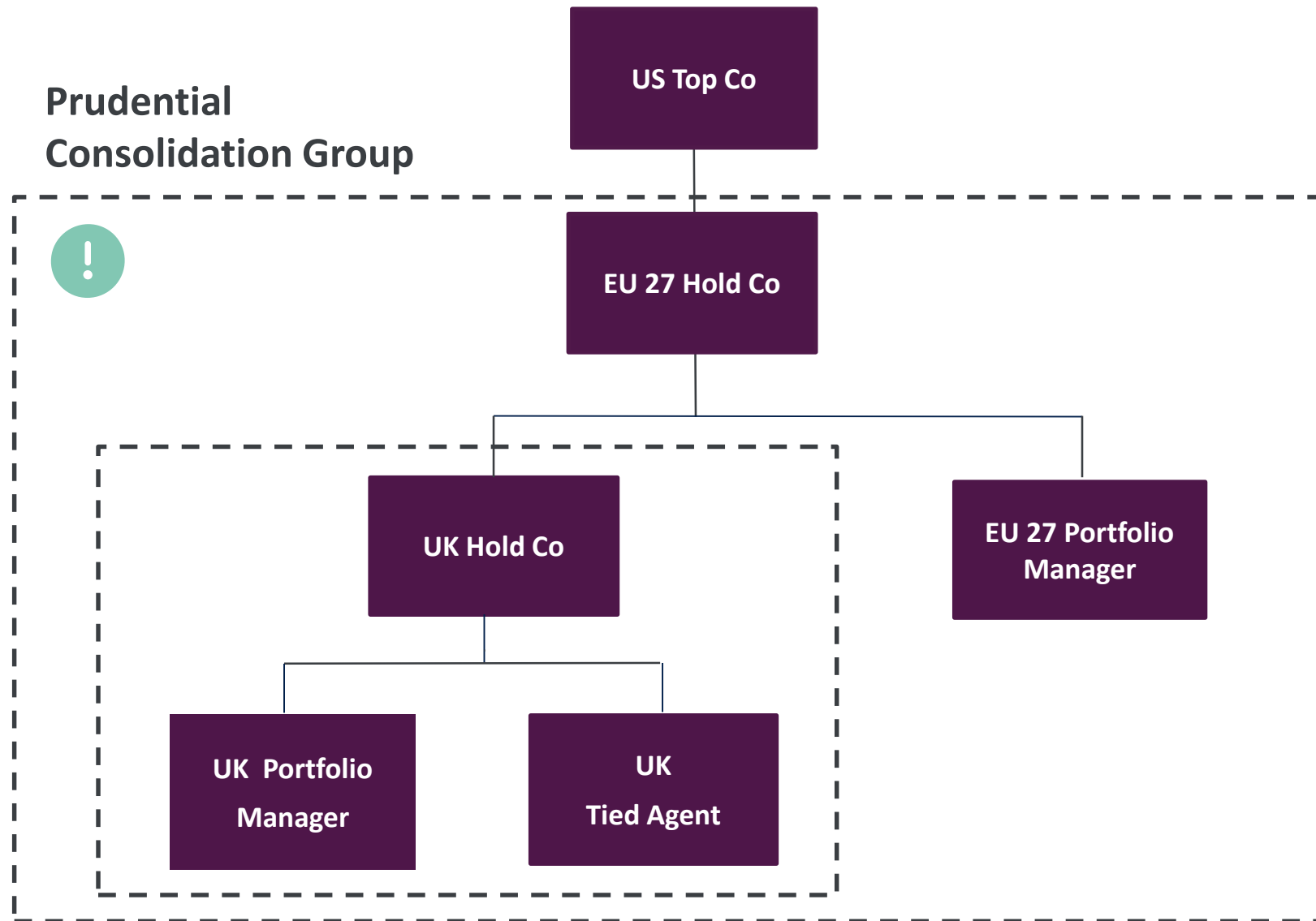


- Brexit implications...

Groups and sub-groups – example structure



Groups and sub-groups – post Brexit?



Capital requirements

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

	K-factor	Explanation	Coefficient	Notes
Risk-to-Client	K-AUM	Assets under management	0.02% 	Ignore assets delegated to the firm Some uncertainties about calculation of AUM and, in particular, AUA
	K-CMH	Client money held	0.4% segregated accounts 0.5% otherwise	Client money “controlled” under a mandate is ignored
	K-ASA	Assets in custody	0.04%	
	K-COH	Client orders handled	0.1% for cash trades 0.01% for derivatives trades	Includes RTO as well as dealing in the client’s name, but should not result in double counting from K-AUM
Risk-to-Market	K-NPR	Net position risk	The position	Relevant to trading book positions of firms dealing on own account (for themselves or on behalf of clients) 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)
	K-CMG	Clearing margin given	The value	

K-factors (cont.)

	K-factor	Explanation	Coefficient	Notes
Risk-to -Firm	K-TCD	Trading counterparty default	The position	Only relevant to firms dealing on own account (for themselves or on behalf of clients) with trading book positions
	K-DTF	Daily trading flow	0.1% for cash trades 0.01% for derivatives	As K-TCD in terms of firms caught but will also catch some agency transactions (e.g. for an undisclosed principal)
	K-CON	Exposures which exceed new concentration limits	N/A	<p>Application unclear but better view is that it is confined to firms dealing on own account or on matched principal basis</p> <p>Firms are subject to a limit on exposure to an individual client or group of connected clients of:</p> <ul style="list-style-type: none"> • 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) <p>All firms may be required to monitor and report on concentration risk</p>

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? 

Yes

- 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)

No

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”:

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



***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



Michael Raymond

Partner

Michael.Raymond@traverssmith.com

+44 20 7295 3487



Tim Lewis

Partner, Head of Financial Services and Markets

Tim.Lewis@traverssmith.com

+44 20 7295 3321



Phil Bartram

Partner

Phil.Bartram@traverssmith.com

+44 20 7295 3437



Jane Tuckley

Partner

Jane.Tuckley@traverssmith.com

+44 20 7295 3238