AIMA

THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

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Summary of the New EU Prudential Regime for Investment Firms

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01

BACKGROUND

The **Investment Firms Regulation (IFR)** and **Investment Firms Directive (IFD)** will introduce a new, bespoke prudential regime for most **Investment Firms** to replace the patchwork of regimes that currently apply. The rule changes will affect all types of Investment Firms. This includes investment banks, brokers, portfolio managers and firms that advise / arrange transactions (among others). They may also apply to **AIFMs** and **UCITS Mancos** if and to the extent that they have **MiFID** "top-up" permissions, although this remains uncertain.

The new rules represent a complete overhaul of "prudential" regulation (with new and re-shaped requirements relating to: own funds, liquidity, group supervision, staff pay, governance, regulatory reporting and public reporting).

The new rules are likely to be a significant step-up for many Investment Firms, and the biggest impact is likely to be for so-called adviser-arrangers. These firms generally undertake only the MiFID activities of investment advice and / or reception and transmission of orders, often for intra-group clients headquartered overseas. To date, adviser-arrangers have been exempt from the majority of EU-based prudential regulation (which includes the fixed overheads capital requirement and most remuneration rules) but IFR / IFD will bring them within the scope of these rules for the first time.

Key Impacts

- The new regime will be effective in the EU in June 2021 and is likely to apply in the UK regardless of Brexit. Several material legal uncertainties are unlikely to be resolved until well into 2020, but it is prudent for firms to start to plan given the scale of proposed changes.
- Most MiFID Investment Firms (spanning firms currently subject to CRR and CRD IV and those which remain subject to the CRD III regime – e.g. so-called "BIPRU" firms in the UK), including portfolio managers, investment banks / brokers and adviser-arranger firms, will be subject to the new regime. Some firms which are below specified thresholds will be subject to a more limited set of requirements. A handful of the largest Investment Firms will stay on bank regulation under CRR II and CRD V.
- The impact for AIFMs and UCITS Mancos with MiFID "top-up" permissions will be driven by the UK and EU 27 Member States' approach to implementation. Current impact is uncertain, but this is one of a number of issues to track as part of monitoring implementation in key jurisdictions (e.g. Ireland, Luxembourg and the UK).
- Many rules will apply on a group-wide basis when certain group tests are triggered.
- Some Investment Firms are likely to require more capital from mid-2021. New procedures and data-points are likely to be required to perform the necessary calculations.
- The impact of new liquid assets and concentration risk requirements will need to be assessed.
- Most firms will be subject to 'bank-like' remuneration rules (e.g. malus and clawback), although not the 2:1 variable-to-fixed bonus cap and there is an exemption for some small and medium size firms from deferral and payment in securities. Some Investment Firms may need to establish remuneration committees.
- There will be public disclosure obligations, including about remuneration and capital (both qualitative and quantitative). Confidential reports must also be made to regulators on a quarterly basis (though some firms benefitting from an exemption will only need to file annual reports), and high earners reporting will be extended in scope.
- Enhanced internal governance requirements will apply.

02

IMPLEMENTATION

The new regime will take effect on 26 June 2021.

In the run-up to implementation, Investment Firms will need to be aware of national implementing measures which will determine the final shape of the new rules and apply additional glosses to the requirements. Given that these final details may not be settled for some time, Investment Firms should not delay in starting to assess the impact of the new IFR / IFD rules.

As IFR is an EU regulation, its provisions take effect directly in EU Member States (national governments and regulators do not need to take any additional steps to bring it into force, though see section 3 below for the impact of Brexit in the UK). IFD, on the other hand, is a directive, which will require national implementing measures. Investment Firms will need to monitor the approaches of relevant governments and national regulators to implementation during 2020 and in early 2021.

03

BREXIT

The UK is expected to implement IFR / IFD regardless of the status of Brexit at the time the new rules come into force. If the UK has exited the Brexit transitional period by 26 June 2021, the UK government and the FCA will need to take additional steps to bring both IFR / IFD into force, and they are currently expected to do so. For these purposes and for convenience, **Member State** in this summary should be read as including the UK post-Brexit or following the expiration of any agreed transition period. Depending on the approach of the UK government, it is possible that groups containing both UK and EU Investment Firms may be subject to two versions of the regime – an EU version and a UK version. This will need to be monitored.

04

THIS SUMMARY

This summary sets out the main provisions and principal impacts of IFR / IFD and indicates some of the key areas of uncertainty in relation to how the new requirements will apply. As this is only a summary, anyone considering the implications of IFR / IFD should refer to the summary of the legislation or consult their professional advisers. The legislation calls for the development of detailed regulatory technical standards which have not yet been drafted and which will also impact firms' policies, systems and procedures.

Given the fundamental nature of the changes under IFR / IFD and the potential implications for firms (which may include holding substantial additional capital and putting in place new processes to capture the data points necessary to calculate the firm's capital resources requirements), firms should prioritise their implementation projects during the course of 2020. It is likely that such projects will need to draw on resource from, at least, firms' internal compliance, finance and human resources teams. In particular, firms should consider at an early stage whether there is any scope to benefit from the exemptions and derogations for smaller firms and the extent to which their capital requirements are likely to rise. Some firms may want to restructure their operations to mitigate the impact of the new regime, which may require a significant lead time. Defined terms in this summary are capitalised and set out in bold at their first use with definitions in Appendix 1.

05

FULL APPLICATION OF THE NEW REGIME

Investment Firms that do not fall within section 6 (Partial Application of the New Regime) or section 8 (CRR / CRD IV Firms) below will be subject to the full application of IFR / IFD. See section 7 for the likely impact for AIFMs or UCITS Mancos with MiFID top-up permissions.

The key implications for firms subject to the full application of IFR / IFD are:

Requirement	High level summary	Section of this summary containing more detail
Application to Groups	Some IFR / IFD rules will apply on a group-wide basis when certain group tests are triggered.	Section 9
Own funds requirements	Rules relating to how Investment Firms calculate the amount of capital that they need to hold will change. Some firms will be required to hold materially more capital and will also need to factor in re-cut deduction rules. New procedures and data-points are likely to be required to perform the mechanical calculations under the new "K-factor" rules.	Section 10
Liquid assets requirements	Investment Firms will need to comply with new rules relating to holding sufficient liquid assets on an ongoing basis.	Section 11
Pay regulation	Staff pay rules are likely to become more onerous for Investment Firms. Although there will not be a bonus cap, other measures are likely to have a material impact.	Section 12
Concentration risk rules	Certain Investment Firms (those with a trading book) will be subject to more detailed requirements on concentration risk (i.e. exposures that an Investment Firm has to a single client or group of connected clients).	Section 13
Public disclosure requirements	Public ("Pillar 3") disclosure requirements will be changed and extended. Much of this will be new for adviser-arrangers. The extra public disclosures about remuneration policies and practices may give rise to concerns about the confidentiality and sensitivity of data.	Section 16
Governance rules	IFR / IFD will introduce new governance rules that Investment Firms must implement.	Section 17
Regulatory reporting rules	The rules relating to the private reports that Investment Firms must make to regulators will change, subject to additional detail to be published closer to IFR / IFD coming into force. So-called "high earners" reporting (currently applicable to CRR / CRD IV firms) will be extended to cover a broader range of Investment Firms.	Section 18

06

PARTIAL APPLICATION OF THE NEW REGIME

Firms that meet the requirements to be a "small and non-interconnected investment firm" or **SNIF** will be subject to IFR / IFD, but will either be exempt from certain rules or will be required to comply with them in a modified form.

However, many Investment Firms, including portfolio managers, CLO managers (depending on the scale of their retention investments) and adviser-arrangers, are likely to find that they will not be able to satisfy all of the criteria to be classified as a SNIF. In particular, the thresholds relating to total gross revenue (generally less than EUR 30 million per year) and assets under management (less than EUR 1.2 billion) are likely to be mean that many Investment Firms will not qualify as SNIFs and so will be subject to the full application of IFR / IFD.

Details of both (a) the threshold conditions to qualify as a SNIF and (b) how the IFR / IFD rules are modified for them are set out in Appendix 2.

07

APPLICATION TO AIFMS AND UCITS MANCOS

The IFR / IFD regime applies to Investment Firms licensed under MiFID and so will not be directly applicable to AIFMs and UCITS Mancos (even those that have MiFID top-up permissions).

It is not yet clear how AIFMs and UCITS Mancos with MiFID "top-up" permissions will be affected. It is likely to be a matter of Member State interpretation as to whether and to what extent they wish to apply IFR / IFD requirements to AIFMs and UCITS Mancos with top-up permissions (Ireland, Luxembourg and the UK[1] will be key jurisdictions to monitor).

The key areas to watch for additional detail include Member States' approach to:

- where IFR / IFD is applied to AIFMs or UCITS Mancos with top-up permissions, confirmation that only the regime producing the higher requirement is relevant in practice;
- application of separate liquidity regimes (in particular, the relationship between the types of permissible liquid assets under the two regimes) and remuneration regimes;
- the availability of SNIF status;
- **ICAAPs** (and, if the firm qualifies as a SNIF, whether it can dispense with having to undertake the ICAAP);

[1] Currently, the UK FCA does apply a modified version of the CRD regime to these firms.

- group supervision rules;
- reporting; and
- transitional reliefs.

In the longer term, it is possible that IFR and IFD could be a source of inspiration for future changes to the prudential requirements applicable to AIFMs and UCITS Mancos without MiFID top-up permissions (note that the scope of the European Commission's review of IFR / IFD (see section 20 below) is not restricted to Investment Firms covered by IFR / IFD).

08

CRR / CRD IV FIRMS

Some Investment Firms which deal on own account and / or carry out the activities of underwriting or placing on a "firm commitment basis" and which, as a result of their size and / or interconnectedness in the financial system, are considered to be systemically important will not be subject to IFR / IFD. These firms will continue to be subject to the current **CRR** and **CRD IV** (and, in due course, **CRR II** and **CRD V**) requirements.

In practice, this is likely to be relevant to a very small number of firms that are large investment banks or are part of groups with such firms.

Smaller Investment Firms subject to CRR rules because, for example, they hold client money or client assets or undertake certain placing activity (including managers of CLOs who need a placing licence to qualify as "sponsor" under European risk retention rules) should in future be subject to IFR / IFD rather than the bank-like CRR / CRD IV rules.

As CRR II and CRD V will come into force ahead of IFR / IFD, there is a technical risk that Investment Firms currently subject to CRR / CRD IV could be required to step-up to CRR II and CRD V before stepping back down to IFR / IFD. It is anticipated that an EU legislative fix will resolve this.

09

GROUP SUPERVISION

Very broadly, groups which are headed by a parent undertaking in a Member State will be required to apply certain requirements on a group basis. This applies to a **Union Parent Investment Firm**, a **Union Parent Investment Holding Company**, and a **Union Parent Mixed Financial Holding Company**. This essentially captures holding companies established in the EU or UK regardless of whether they are themselves regulated, as well as regulated Investment Firms. The implications of Brexit for this test will need to be monitored.

The consolidation group will include the relevant parent and its direct and indirect subsidiaries worldwide which fall into the definitions of Investment Firm, **Financial Institution, Ancillary Services Undertaking** or **Tied Agent**. These tests are not straightforward for groups that contain non-UK financial services undertakings. For many firms, this may not represent a major change from existing group requirements, but it will be new for adviser-arrangers.

The IFR / IFD requirements that need to be applied on a group basis include:

- own funds requirements (see section 10 below);
- pay regulation (see section 12 below);
- public disclosure and transparency requirements (see section 16 below); and
- regulatory reporting requirements (see section 18 below).

In applying these requirements, there will be some read-across to equivalent rules for banks and large systemically important Investment Firms in relation to determining minority interests and qualifying capital of subsidiaries in the consolidation group.

Where group supervision applies, the default requirement will be prudential consolidation on a line-by-line basis. However, national regulators will have the discretion to apply a simpler and lighter-touch group requirement in the case of group structures deemed "sufficiently simple" and in respect of which no significant risks to clients or the market will arise from not applying consolidated requirements. Policy in this area will need to be watched during the course of 2020. If this is relevant, the consolidating parent will be subject to a requirement to hold at least enough own funds to cover the full book value of all its holdings in subsidiary Investment Firms, Financial Institutions, Ancillary Services Undertakings and Tied Agents in the group, together with the total amount of all its contingent liabilities in favour of such firms.

For groups with a parent established outside of the EU / UK, see section 15 (Additional Powers for Regulators) below. In summary, in some circumstances, regulators could require a non-EU group with two or more Investment Firms to establish an intermediate EU holding company in order to force an IFR / IFD consolidation group. Again, policy and practice in this area will need to be monitored.

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OWN FUNDS REQUIREMENTS

Subject to the transitional phasing in provisions (more detail below) and depending on whether the firm forms part of a prudential group, Investment Firms will be required to have own funds of at least the higher of their:

- permanent minimum requirement;
- fixed overheads requirement; and
- K-factor requirement.

PERMANENT MINIMUM REQUIREMENT

The permanent minimum requirement is a fixed sum which varies depending on the activities undertaken by the firm. Investment Firms will fall into one of three buckets:

- **EUR 75,000** – firms authorised to carry on:
  - reception and transmission of orders;
  - execution of orders on behalf of clients;
  - portfolio management;
  - investment advice; and / or
  - placing without a firm commitment,

and which do not hold client money or securities. This will include most portfolio managers and adviser-arrangers;

- **EUR 750,000** – Investment Firms authorised to deal on own account and / or underwrite and / or place instruments on a firm commitment basis; and
- **EUR 150,000** – any other Investment Firm (including those which hold client money or securities).

FIXED OVERHEADS REQUIREMENT

The fixed overheads requirement is at least one quarter of the firm's fixed overheads (e.g. salaries, rent, other recurring operating expenses) for the preceding year.

In due course, more detailed rules for calculating this requirement will be developed, including specifying items which can be deducted from the calculation (e.g. because they are optional or variable, or because they are irrelevant on a wind-down). These are expected to follow equivalent standards under the CRR / CRD IV, but firms will need to check their approach against these rules when finalised to confirm their calculations are correct.

K-FACTOR REQUIREMENT

This is an activities-based capital requirement which is designed to ensure firms hold sufficient capital against the risks generated by the specific activities they undertake. It is derived from the aggregate of various components, known as "K-factors". A summary of the main K-factors and their application are given below. Investment Firms should note that the rules setting out the types of activity caught by each K-factor are complex and technical. The granular requirements of each K-factor should be considered against the relevant firm's business and regulatory licence to ascertain which apply and the extent to which exemptions limit the scope of a specific K-factor's scope of application.

The additional capital requirement is generally determined by volume (e.g. how big is the firm's AUM?; how much client money does it hold?; how many orders does it handle?). This figure is typically multiplied by a prescribed co-efficient to give the amount of capital that must be held against the risks generated by that activity.

K-Factor	Factor	Coefficient (where relevant)	Notes
Risk-to-Client (RtC) K-factor requirements – the aggregate of the below components (if applicable) calculated on a rolling average basis in accordance with the new rules and multiplied by a prescribed coefficient:			
K-AUM	Assets Under Management (including Assets Under Advice if the advice is ongoing or recurring)	0.02%	Disregards assets delegated to the firm from another financial entity. There remain some uncertainties relating to the determination of assets under management and, in particular, assets under advice.
K-CMH	Client Money Held	0.4% – for segregated accounts 0.5% for non-segregated accounts	Note that client money controlled under a mandate is not caught by this K-factor.
K-ASA	Assets Safeguarded and Administered	0.04%	

K-Factor	Factor	Coefficient (where relevant)	Notes
K-COH	Client Orders Handled	0.1% – for cash trades 0.01% – for derivatives	This covers the value of client orders handled through the reception and transmission of orders and through execution on behalf of clients in the client's name. There are detailed exclusions to avoid double counting (e.g. if the investments are already covered by K-AUM).
Risk-to-Market (RtM) K-factor requirements - for the trading book positions of an Investment Firm which deals on own account (whether for itself or on behalf of clients) (including emission allowances) is either one or the other of the following two K-factors:			
K-NPR	Net Position Risk		This is the value of transactions recorded in the trading book and is calculated by reference to the CRR.
K-CMG	Clearing Margin Given		This is generally the third highest amount of total margin required on a daily basis by a clearing member from the Investment Firm over the preceding three months multiplied by 1.3, subject to further technical requirements yet to be published.
Risk-to-Firm (RtF) K-factor requirements – this is calculated by aggregating together all of the following components (as applicable) calculated in accordance with the new rules and multiplied (if relevant) by the applicable coefficient:			
K-TCD	Trading Counterparty Default		This represents the exposures in the trading book in instruments and transactions giving rise to the risk of counterparty default. The calculation methodology is set out in IFR, Chapter 4, Section 1 (article 25 onwards) and takes into account exposure value, counterparty risk factor and credit valuation adjustments.

K-Factor	Factor	Coefficient (where relevant)	Notes
K-DTF	Daily Trading Flow	0.1% – for cash trades 0.01% – for derivatives	This component represents the daily flow of transactions entered into through own account dealing or execution of orders on behalf of clients in the firm's name. Again, there are detailed exclusions to avoid, e.g., double counting.
K-CON	Concentration Risk	No separate coefficient used following calculation	Although the precise scope of application is unclear, this is likely to have material implications for firms dealing on own account or on a matched principal basis, or if they have a trading book in a consolidation group. This component will trigger an additional capital requirement for exposures which exceed the new concentration limits (see section 13 below).

Once an Investment Firm has identified the relevant K-factors which are likely to be relevant for it, it should be noted that additional rules govern the manner and frequency with which K-factors need to be calculated. It is also possible that these may be supplemented by additional requirements and guidance to be published closer to IFR / IFD implementation.

New processes are likely to be needed to capture the data required and to perform the calculations.

TRANSITIONAL ARRANGEMENTS

There are certain limited transitional provisions applicable to the own funds requirements to facilitate the building up of capital over a period of five years post-implementation. In summary, for five years, firms whose K-factor capital requirement is significantly in excess of their existing requirement under CRR / CRD IV can substitute 2x their existing own funds requirement under CRR / CRD IV for the fixed overheads / K-factor requirements under IFR / IFD. There is also a five year phase-in for the increase in the permanent minimum requirement, but in practice this is likely to benefit only the very smallest firms. The application of these provisions will likely differ between different types of Investment Firm depending on the scope of their licences. It should be noted that the transitional provisions do not appear to be helpful in mitigating the impact for adviser-arrangers.

COMPOSITION AND DEDUCTIONS

Own funds must be made up of common equity tier 1 (e.g. fully paid up ordinary shares or equivalent ownership interests), additional tier 1 (e.g. preferred shares, contingent convertible securities (CoCos)) and tier 2 instruments (e.g. subordinated debt).

At least 56% must be common equity tier 1, and at least 75% must be a combination of common equity tier 1 and additional tier one.

As is the case under the CRR, certain items will need to be deducted when calculating own funds (e.g. deferred tax assets, holdings of capital instruments in certain financial sector entities). When forecasting their capital requirements under IFR / IFD, Investment Firms will need to consider the rules relating to deductions and, if necessary, make the appropriate adjustments.

CLO MANAGERS

Note that IFR / IFD does not replicate the complex securitisation methodologies currently found in the CRR (i.e. the external ratings-based approach (SEC-ERBA), standardised approach (SEC-SA) and default 1250% risk weight). For CLO managers who transition to IFR / IFD and who are not part of, e.g., a wider banking group, these are not expected to apply and their capital requirements will instead be driven by the factors outlined above.

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LIQUID ASSETS REQUIREMENTS

In addition to the own funds requirements (see section 10 above), firms will be required to hold liquid assets equal to at least one third of their fixed overheads requirement, i.e. one month's fixed overheads. This replaces the uncertain rules that currently apply to some firms and creates a liquid assets requirement for adviser / arranger firms for the first time.

What will count as a "liquid asset" is tightly defined but includes:

- cash in an unencumbered, short term bank account;
- gilts and government bonds (either EU central governments or non-EU central governments with a sufficiently high credit rating);
- some other forms of debt (e.g. high-quality covered bonds, corporate debt, securitisations, but subject to specific eligibility criteria and haircuts);
- shares or units in collective investment schemes, subject to strict eligibility criteria and a cap of EUR 50 million; and
- other assets traded on a trading venue for which there is a liquid market (as defined in **MiFIR** and the **MiFIR Delegated Regulation**) subject to a haircut of 55%.

Some Investment Firms 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.

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PAY REGULATION

New rules on pay regulation will apply, which represent a development of the existing rules (although there is no 2:1 variable-to-fixed bankers' bonus cap). The changes are most significant for adviser-arranger firms who are not currently subject to any remuneration code.

A key consideration is whether the Investment Firm will qualify for an exemption from the most onerous rules. The exemption is available where "the value of on- and off-balance sheet assets [of the firm] is on average equal to or less than EUR 100 million over the four-year period immediately preceding the financial year". Member States have discretion to raise this threshold to EUR 300 million for Investment Firms meeting certain criteria, although it is not currently known which jurisdictions will exercise this discretion. This measures the assets of the firm as opposed to the assets of any fund or client account (although firms which manage CLOs as sponsor and which hold risk retention stakes on balance sheet should check the value of their retention stakes versus this threshold).

This bright-line balance sheet test replaces the current concept of "proportionality", which currently allows firms to self-assess whether it is proportionate to apply certain requirements to their business. There is some uncertainty about whether the exemption test is to be measured on a solo basis or by reference to the balance sheet of the Investment Firm's group.

If the exemption applies, the key requirements concerning remuneration are as follows:

- Investment Firms will need to revise their remuneration policy (this will be a substantial exercise if the firm is not already subject to a regulatory remuneration code, but even firms already subject to a remuneration code will need to amend it in line with the new requirements). The remuneration policy will still need to deal with the high-level MiFID II pay requirements but will also need to be adapted to comply with detailed requirements in relation to a subset of staff (known as **Remuneration Code Staff** or **Identified Staff**). In summary, they are generally the directors, other people whose function poses a material risk to the firm (such as investment committee members or portfolio managers, heads of risk and compliance etc.) and others whose pay takes them into the same remuneration bracket as people in the preceding categories;
- an "appropriate" ratio between the fixed and variable component of total remuneration will need to be set in the remuneration policy, taking into account the Investment Firm's activities and associated risks, as well as the impact that Remuneration Code Staff have on the firm's risk profile;
- 100% of variable remuneration paid to Remuneration Code Staff must be made subject to mechanisms by which it can be reduced or recovered in certain circumstances, for example through malus and clawback arrangements. Malus refers to a situation in which variable pay which has been awarded but which has not yet vested does not vest. Clawback refers to arrangements under which variable pay which has been awarded and paid can be recouped by the firm; and
- make certain public remuneration disclosures (see section 16 below for more information).

If the exemption is not available, additional requirements apply, including:

- establishing a remuneration committee, responsible for exercising independent judgment on remuneration policies and practices as well as on specific remuneration or incentive decisions affecting particular staff. The committee must be gender balanced and made up of non-executive directors;
- ensuring that at least 40% of the variable remuneration (and expected to be up to 60% for those with variable remuneration of EUR 500,000 or more) of Remuneration Code Staff is deferred over at least three years; and

- ensuring that at least 50% of the variable remuneration (both the deferred and undeferred elements) of Remuneration Code Staff consists of shares in the Investment Firm (or equivalent ownership interests, such as phantom shares), share-linked instruments or (in relation to portfolio managers) non-cash instruments which reflect the instruments of the portfolios managed, and these must be subject to an appropriate retention policy. If an Investment Firm does not have any relevant instruments, national regulators may approve the use of alternative arrangements fulfilling the same objectives. Delegated legislation will elaborate on each these concepts.

Once the impact of these changes is fully scoped, Investment Firms are likely to have to involve their human resources teams to assess how these rules should be implemented in employment contracts and other documents (e.g. award letters) and their HR policies and procedures. The new rules also extend the obligation for Investment Firms to make "high earners reports" to their national regulators to a broader range of firms (currently this requirement only applies to firms licensed under CRR / CRD IV). See section 18 for more detail. These reports will be a private filing between the Investment Firm and the relevant national regulator.

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CONCENTRATION RISK

Investment Firms are required to monitor and control their concentration risk, which looks at exposures in the trading book to a client or group of connected clients. This is likely to have material implications for firms dealing on own account or on a matched principal basis, or if firms have a trading book within their prudential group.

Very broadly, Investment Firms will be required to ensure that no exposure (i) to an individual client or group of connected clients exceeds 25% of "own funds"; or (ii) in the case of exposures to certain financial sector clients, the higher of 25% of "own funds" and EUR 150 million (or, if lower, 100% of "own funds"). These firms will also need to submit (private) reports, on a quarterly basis, to their national regulators covering matters relating to concentration risk.

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ICAAP

Firms will be required to conduct an internal capital adequacy assessment process which may result in a firm needing to hold a higher level of capital than that prescribed by the mechanical, own funds requirements alone. This already applies for most, but not all, Investment Firms (some adviser-arranger firms are not currently required to undertake an ICAAP). The nature of the arrangements, strategies and process that an individual firm will be required to have should be appropriate and proportionate to the nature, scale and complexity of the activities it carries out.

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ADDITIONAL POWERS FOR REGULATORS

An Investment Firm's risk assessment and overall compliance with the IFR / IFD regime is subject to review by the regulator, known as the supervisory review and evaluation process (**SREP**). National regulators have a broad discretion to require firms to hold additional capital in certain circumstances, including where it considers that the firm is exposed to risks not adequately covered by the standard capital requirement.

Where two or more Investment Firms are subsidiaries of a non-EU parent then the relevant regulator may, if it considers that the group is not subject to equivalent prudential supervision by a non-EU regulator, apply "appropriate supervisory techniques". One such technique could include requiring the non-EU group to establish an intermediate EU holding company for the group's EU Investment Firms. The policy of national regulators in this regard, and any Brexit implications, will need to be monitored.

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DISCLOSURES AND PUBLIC REPORTING

Investment Firms (generally excluding SNIFs, unless they issue additional tier 1 instruments where some requirements will apply) will be required to make a variety of public disclosures. Those disclosures, at a high level, include the following:

- **Risk management objectives and policies** – on capital, concentration risk and liquidity;
- **Governance** – including the number of directorships held by members of the management body; the firm's diversity policy (and the extent to which any objectives or targets have been achieved); and whether the firm has a risk committee (and if so, how many times it met during the year);
- **Own Funds** – including details of quantity and composition of capital held;
- **Country-by-country disclosure** – Investment Firms with financial institution subsidiaries or branches in other countries (EU or non-EU) than their home Member State will have to disclose certain audited information such as the turnover, number of employees and profit or loss before tax of the relevant entity;
- **Remuneration** – including the most important design characteristics of the Investment Firm's remuneration system; the ratios between fixed and variable remuneration; certain aggregated quantitative information (including broken down between fixed, variable, deferred and vested); and whether the firm benefits from the exemption to the deferral and payment in shares or share linked interests requirements.

Firms will need to assess the new, granular requirements to evaluate what additional disclosures they are required to make and also whether any additional data points need to be captured to make these disclosures.

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GOVERNANCE

Investment Firms will need to have in place a range of internal governance measures including:

- a clear organisational structure with well defined, transparent and consistent lines of responsibility and adequate internal control mechanisms;
- policies and processes for the identification and management of risks including, for certain firms, a requirement to establish a risk committee;

- policies and procedures around the payment of remuneration including, for certain firms, a requirement to establish a remuneration committee;
- arrangements for monitoring certain aspects of regulatory capital, such as the components of the K-factor calculations; and
- procedures for the internal reporting by employees of breaches of IFR / IFD.

These will require firms to consider their current policies, procedures and processes and make changes, where appropriate. In many cases, these measures should be implemented on a basis which is appropriate and proportionate to the nature, scale and complexity of the risks inherent in the firm's business model and the activities. Note that some of the requirements above will not apply to SNIFs.

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REGULATORY REPORTING

Investment Firms will be required to file private reports with their home state national regulator on the following matters:

- the quantity and composition of "own funds";
- the firm's "own funds" requirement and associated calculations;
- the level of relevant activities underlying the K-factors;
- concentration risk (where applicable); and
- liquidity requirements.

These reports will need to be made on a quarterly basis for most firms (or annually if the firm qualifies as a SNIF).

In addition, Investment Firms will be required to report to their home state national regulator on the number of individuals who are remunerated EUR 1,000,000 or more per financial year, presented in pay brackets of EUR 1,000,000. The disclosure will need to include information broken down in relation to job responsibilities, business area and the elements of salary, bonus, long-term award and pension contribution.

The format of these reports (and the granular data sets that need to be included) have yet to be finalised. When this detail is available, Investment Firms will need to undertake a gap analysis

between the current reports (which currently differ depending on an Investment Firm's licence) and the new reports to check if any additional IT solution is required (e.g. to convert files into the reporting format) or if new data points need to be captured.

Other private, regulatory notification obligations will apply on an event-driven basis and firms will need to ensure that their policies, systems and procedures allows for such events to be identified and the relevant reports to be made.

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ENVIRONMENTAL, SOCIAL AND GOVERNANCE DISCLOSURES

By 26 December 2021, the EBA is required to compile a report on **ESG** related risks and deliver it to the European Parliament, Council and Commission. That report will set out, among other things, a definition of ESG-related risks, physical risks and the risks related to the transition to a more sustainable economy, an assessment of whether significant concentrations of specific assets may increase such risks and a description of the process that an Investment Firm might use to identify, assess and manage such risks. Following that report the EBA may decide to adopt guidelines on ESG-related risks.

From 26 December 2022, all Investment Firms (other than, broadly, those with on- and off-balance sheet assets below EUR 100 million or EUR 300 million depending on whether the relevant Member State has decided to increase the threshold as a matter of national discretion) will be required periodically to disclose information on ESG-related risks, physical risks and transition risks, as defined in the EBA's report (see above).

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REVIEW

The European Commission will be required to review and assess the operation of the new rules and report back to the European Parliament and Council by 26 June 2024. It is unclear how this will dovetail with aspects of the IFR / IFD transitional reliefs as some firms may not be applying the full set of prescribed metrics by the date of the review.

Appendix 1

DEFINITIONS

"**AIFMD**" means Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011

"**AIF**" means alternative investment fund in accordance with article 4(1)(a) of AIFMD (which is a collective investment undertaking, including investment compartments thereof, which:

- raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and
- does not require authorisation pursuant to article 5 of the UCITS Directive)

"**AIFM**" means a legal person whose regular business is managing one or more AIFs in accordance with article 4(1)(b) of AIFMD

"**Ancillary Services Undertaking**" means an undertaking, the principal activity of which consists of owning or managing property, managing data-processing services, or a similar activity which is ancillary to the principal activity of one or more Investment Firms

"**CRD IV**" means Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013

"**CRD V**" means Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019

"**CRR**" means Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013

"**CRR II**" means Regulation (EU) No 2019/876 of the European Parliament and of the Council of 20 May 2019

"**ESG**" means environmental, social and governance

"**Financial Conglomerates Directive**" means Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002

"**Financial Institution**" means an undertaking other than a credit institution or Investment Firm, and other than a pure industrial holding company, the principal activity of which is to acquire holdings or to pursue one or more of the activities listed in points (2) to (12) and point (15) of Annex I to CRD IV, including a financial holding company, a mixed financial holding company, an investment holding company, a payment institution within the meaning of PSD2, and an asset management company, but excluding certain insurance holding companies and mixed-activity insurance holding companies

"**Investment Firm**" or "**MiFID Investment Firm**" generally means an investment firm as defined in point (1) of Article 4(1) of MiFID II subject to general and specific scoping provisions within the legislation

"**Investment Firms Directive**" or "**IFD**" means Directive (EU) 2019/2034 of the European Parliament and of the Council of 27 November 2019

"**Investment Firms Regulation**" or "**IFR**" means Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019

"**Member State**" means a Member State of the European Union and should be read as including the UK post-Brexit or following the expiration of any agreed transition period

"**MiFID II**" or "**MiFID**" means Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014

"**MiFIR**" means Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014

"**MiFIR Delegated Regulation**" means Commission Delegated Regulation (EU) 2017/565 of 25 April 2016

"**PSD2**" means Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015

"**Tied Agent**" means a tied agent as defined in point (29) of Article 4(1) of MiFID II (namely, "*a natural or legal person who, under the full and unconditional responsibility of only one Investment Firm on whose behalf it acts, promotes investment and / or ancillary services to clients or prospective clients, receives and transmits instructions or orders from the client in respect of investment services or financial instruments, places financial instruments or provides advice to clients or prospective clients in respect of those financial instruments or services*")

"**UCITS**" means undertakings for collective investment in transferable securities that are established in accordance with the UCITS Directive

"**UCITS Directive**" means Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009

"**UCITS Manco**" means a firm that is licensed to manage UCITS products

"**Union Parent Investment Firm**" means an Investment Firm in a Member State which is part of an Investment Firm group and which has an Investment Firm or a Financial Institution as a subsidiary or which holds a participation in such an Investment Firm or Financial Institution, and which is not itself a subsidiary of another Investment Firm authorised in any Member State, or of an investment holding company or mixed financial holding company set up in any Member State Mixed Financial Holding Company

"**Union Parent Investment Holding Company**" means an investment holding company in a Member State which is part of an Investment Firm group and which is not itself a subsidiary of an Investment Firm authorised in any Member State or of another investment holding company in any Member State

"**Union Parent Mixed Financial Holding Company**" means a parent undertaking of an Investment Firm group which is a mixed financial holding company as defined in point (15) of Article 2 of the Financial Conglomerates Directive (namely, "*a parent undertaking, other than a regulated entity, which together with its subsidiaries, at least one of which is a regulated entity which has its head office in the Community, and other entities, constitutes a financial conglomerate*")

Appendix 2

APPLICATION OF IFR / IFD TO SNIFs

The threshold conditions to qualify as a SNIF are set out in the box below.

Note that all of these conditions (with the exception of the final one) must be applied by reference to all Investment Firms in a group. It remains unclear whether this means only EU / UK Investment Firms (i.e. those licensed under MiFID) or all similar firms globally (whether or not formally designated as part of a prudential group under IFR / IFD).

THE SNIF THRESHOLD CONDITIONS

To qualify as a SNIF, a firm must satisfy all of the following conditions:

- it must have an average total gross revenue from investment services and activities of less than EUR 30 million (calculated as an average of the annual figures for the two year period immediately preceding the relevant financial year subject to some specific relief for double counting in a group context);
- its assets under management (AuM) and some assets under ongoing advice must be less than EUR 1.2 billion;
- its client orders handled must be less than either EUR 100 million per day for cash trades or EUR 1 billion per day for derivatives;
- it must have an on- and off-balance sheet total of less than EUR 100 million; and
- it must have zero custody assets, zero client money held, no trading book activity and not be a clearing member.

For the purposes of the SNIF threshold condition relating to AuM:

- firms may disregard assets that they manage under a delegation from another financial entity, but they must include assets where they have delegated the management to another entity; and
- it includes some assets subject to investment advice of an ongoing nature.

Firms which conclude they are SNIFs will be required to monitor on an ongoing basis that they continue to satisfy the SNIF criteria.

If a firm ceases to qualify as a SNIF, it will move immediately into the full application of IFR / IFD (subject to a three-month transitional period in certain limited circumstances).

For Investment Firms that qualify as a SNIF, certain requirements under IFR / IFD either do not apply or are modified in application. These include the following:

- **Application of IFR / IFD Requirements on an Individual Basis**

  National regulators may waive the requirement for a SNIF to comply with the IFR's requirements relating to own funds composition, the calculation of own funds requirements, concentration risk, liquidity requirements, disclosure and reporting on a solo basis, where the SNIF is, broadly speaking, within a prudential consolidation group, subject to the satisfaction of a number of detailed conditions.

- **Own funds Requirements**

  The own funds requirements apply on a modified basis to SNIFs; they will not be directly subject to the K-factor requirements. A SNIF will be required to have own funds at all times at least equal to the higher of its fixed overheads requirement and its permanent minimum requirement.

- **Liquidity Requirements**

  A SNIF's own funds will be subject to the liquidity requirements but will also be able to include certain trade receivables and fees or commissions receivable within 30 days. In addition, national regulators will have the discretion to exempt them from having to comply at all.

- **Remuneration**

  The remuneration provisions do not apply to SNIFs.

- **Public Disclosures**

  SNIFs are only required to make public disclosures where they issue Additional Tier 1 instruments, and these are limited to disclosures about own funds and risk management objectives and policies. The public country-by-country reporting rules will also not apply.

- **Disclosures to National Regulators**

  SNIFs will only be required to disclose regulatory capital information to their home state national regulators on an annual basis rather than quarterly.

- **ICAAP**

  The default position for SNIFs is that these firms do not need to undertake an ICAAP. However, Member States have the option to require such firms to do so as a matter of national discretion.

- **Internal Governance**

  Some of the internal governance requirements do not apply to SNIFs including the requirement to have robust governance arrangements such as a clear organisational structure and adequate internal control mechanisms. The requirement to establish a risk committee also does not apply to SNIFs.

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About AIMA

The Alternative Investment Management Association (**AIMA**) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (**ACC**) to help firms focused in the private credit and direct lending space. The ACC currently represents over 170 members that manage $400 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (**CAIA**) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

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