

Capital requirements for MiFID investment firms – all change?

In a December 2015 report the European Banking Authority (EBA) recommends significant changes to the EU's regulatory capital rules for MiFID investment firms. The proposed changes are relevant to asset managers and a wide range of other non-bank investment firms. The report criticises the current legal framework as overly complex and recommends replacing it with a simpler, more proportionate system that better reflects the different risk profile of investment firms compared to banks. The report's main focus is on the framework for establishing prudential requirements for investment firms rather than the eligibility of different instruments to satisfy those requirements.

The status quo

Under the CRR / CRD IV, MiFID investment firms are subject to the same basic regulatory capital framework (derived from Basel standards) that applies to EU banks. This framework already takes some account of the differences between banks and investment firms. The CRR / CRD IV establishes tailored prudential regimes for different categories of investment firm. These categories use the various MiFID investment services that investment firms conduct as proxies for the risks that firms pose to investors and to the system as a whole. Whether or not an investment firm is authorised to hold client money is a particularly important factor. All categories are subject to some level of initial capital requirement, and most categories are subject to some level of own funds requirements, as outlined in Table 1.

Existing attempts under the CRR / CRD IV framework to tailor prudential rules for non-banks have produced a

confusing array of at least eleven different EU regulatory capital regimes for investment firms. Divergent national implementation of relevant Directives means that in reality the situation is even more complex. For example, the definition of MiFID investment services and activities varies across Member States and there is no harmonized EU wide definition of what it means to hold client money and securities. These differences can produce anomalous outcomes where firms in different Member States may be subject to different rules despite conducting fundamentally similar activities.

However, divergent national implementation may be of less practical significance when considering how EU prudential rules for investment firms disproportionately impact a few Member States. The report observes that of the 6,500 MiFID investment firms in the EU (not counting AIFMs and UCITS

management companies that conduct MiFID services and activities) just over half are based in the UK while France, Germany and the UK together account for more than 70% of all EU investment firms.

The report concludes that the scope of a firm's MiFID permissions is not necessarily a good proxy for risk. Under current rules a firm whose sole MiFID activity is to place financial instruments without a firm commitment is hit by the highest initial capital requirement (of EUR 730,000). By contrast, a firm using its permission to receive and transmit orders to conduct fundamentally similar activity in the secondary markets can avail of a lower initial capital requirement of EUR 125,000.

The treatment of portfolio managers under the current regime is also unusual in that all managers are subject to the same regime, with no account taken of portfolio size. The report also observes that a firm with a proprietary trading permission and no

external clients is currently hit by the full CRD IV regime. This may make sense if the firm is part of a banking

group but seems harder to justify for a standalone firm with limited

connections and low systemic significance.

Table 1: current categorisation of MiFID investment firms within the CRD framework

	Categories	Initial capital	Own funds requirements
1	Local firms (CRR 4(1)(4))	€50 000 (CRD 30)	Not applicable
2	Firms falling under CRR 4(1)(2)(c) that only provide reception/transmission and/or investment advice	€50 000 (CRD 31(1))	Not applicable
3	Firms falling under CRR 4(1)(2)(c) that only provide reception/transmission and/or investment advice and are registered under the Insurance Mediation Directive (IMD)	€25 000 (CRD 31(2))	Not applicable
4	Firms falling under CRR 4(1)(2)(c) that perform, at least, execution of orders and/or portfolio management	€50 000 (CRD 31(1))	CRR 95(2)
5	Investment firms not authorised to perform deals on own account and/or underwriting/placing with firm commitment that do not hold client funds/securities	€50 000 (CRD (29(3))	CRR 95(1)
6	Investment firms not authorised to perform deals on own account and/or underwriting/placing with firm commitment but hold client funds/securities	€125 000 (CRD 29(1))	CRR 95(1)
7	Investment firms that operate an MTF	€730 000 (CRD 28(2))	CRR 95(1)
8	Investment firms that only perform deals on own account to execute client orders	€730 000 (CRD 28(2))	CRR 96(1)(a)
9	Investment firms that do not hold client funds/securities, only perform deals on own account, and have no external clients	€730 000 (CRD 28(2))	CRR 96(1)(b)
10	Commodity derivatives investment firms that are not exempt under the MiFID	€50 000 to 730 000 (CRD 28 or 29)	CRR 493 & 498
11	Investment firms that do not fall under the other categories	€730 000 (CRD 28(2))	CRR 92

Source: EBA December 2015 Report on investment firms, EBA/Op/2015/20

The EBA proposals

The EBA report concludes that the existing set up is far too complicated. In place of the current, eleven categories, the EBA outlines a three tier approach that focuses on the relative systemic significance of firms and the extent to which they take 'bank-like' risks.

1. First, the full set of CRR / CRD IV rules would apply to the most systemically important firms (**systemic firms**) conducting large scale intermediation and underwriting activities and facing significant counterparty credit risk, as well as market risk on assets held on their own account (whether or not for external clients).
2. Secondly, a simpler regime would apply to less systemically significant firms (**non-systemic firms**), with a focus on the specific risks these firms pose to investors or other market participants through credit, market, liquidity and operational risks.

3. Finally, the simplest regime would apply to small, non-interconnected firms. This regime could be based on fixed overheads and large exposure rules with the aim of setting aside enough capital for an orderly wind down. Simpler reporting rules could also apply to this category.

Measuring the systemic importance of a firm and setting the boundaries between these three categories would involve qualitative and quantitative assessments. The EBA outline some pros and cons of different measurement approaches. Having fixed, nominal thresholds common to all Member States would be clear and simple but could mean that some firms (while systemically significant domestically in their home states) are never caught in the highest category.

An alternative approach would be to set quantitative thresholds in percentage rather than nominal terms (e.g. a firm crosses a threshold if its balance sheet comprises more than a certain percentage of the total balance sheet of all firms). Such an approach would have the advantage of not distinguishing between Member States on size grounds. However, in some Member States it could push some nominally smaller firms into a higher category. A third approach outlined in the report would give Member States more flexibility to take into account local factors.

Which firms would benefit and which would suffer additional capital costs from a simpler regime would depend to a large extent on the method chosen to set the boundaries between the three tiers proposed. In the UK at least, it seems probable that a simpler regime would make most difference to smaller firms subject to FCA prudential supervision. For large UK investment firms subject to PRA prudential supervision, the changes outlined in the EBA report may not make a great deal of difference and might, in certain cases, pose an increased regulatory capital burden.

In terms of assets under management, the report observes a skewed distribution of firms, with a mere eight firms representing around 80% of all EU investment firm assets. However, in gauging systemic significance the EBA warns against placing too much emphasis on balance sheet size noting that balance sheet data provides no information on intraday exposures, concentration risk or idiosyncrasies of business models.

The report emphasises the importance of gauging operational risk when setting prudential requirements for MiFID investment firms. The report questions whether expenditure based metrics like fixed overhead requirements (FOR) are the best tool for this job. Current fixed overhead requirements in the CRR also apply to AIFMs and UCITS

management companies whose own funds requirements under AIFMD and the UCITS Directives can never be less than their fixed overhead requirement calculated under the CRR (25% per cent of the previous year's fixed overheads). The report identifies both pros and cons of FOR and indicates that if changes to FOR are made for MiFID investment firms, the impact on AIFMs and UCITS management companies needs to be considered as well.

The report also considers the prudential regulation of commodities dealers and recommends extending the exemption that they currently enjoy from CRR capital requirements from December 2017 until December 2020. On 11 May 2016 the European Parliament adopted a proposed Regulation to give effect this extension. That legislative proposal will now be considered by the Council.

What next?

The Investment Association has welcomed the report's recommendations as an important first step in overhauling EU prudential rules for investment firms. It is unlikely that we will see any formal legislative proposal before 2018. In the meantime, the EBA will conduct further work on the possible quantitative and qualitative underpinnings of any new regime.

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