THE EUROPEAN COMMISSION'S PROPOSAL FOR A NEW PRUDENTIAL REGIME FOR INVESTMENT FIRMS

The European Commission has published a proposal for the overhaul of the prudential regime for EU investment firms: i.e. regulated firms carrying on securities and derivatives business. This will have significant impacts on such firms' individual prudential requirements, and on the groups to which they belong.

The proposed changes will likely take effect sometime after mid-2019 and come at a time of significant change in this field, notably the CRD V/CRR 2 reforms and Brexit.

Key issues

- The European Commission has proposed a new prudential regime for investment firms
- Certain larger investment firms that carry on the MiFID investment service of dealing on own account or securities underwriting will be reclassified as credit institutions
- Other investment firms will be subject to new non-Basel based prudential requirements
- There are a number of direct and indirect consequences that need to be considered carefully, including the impact for consolidation groups, and the interaction with the proposed IPU requirement

BACKGROUND

Since the 1990s, investment firms (i.e. regulated firms that carry on securities and derivatives business, but which do not have deposit-taking licences) across the EU have been subject to the same Basel-derived prudential requirements that apply to credit institutions (i.e. deposit-taking banks). Such current prudential requirements are governed by the Capital Requirements Regulation (**CRR**) and the Capital Requirements Directive (**CRD**).

On 20 December 2017, the European Commission published a proposal for the overhaul of the prudential regime for such investment firms. The proposal comprises a new Investment Firm Regulation (**IFR**) and Investment Firm Directive (**IFD**).

The new regime will have significant impacts for investment firms' individual and group prudential requirements – and will have many direct and indirect impacts for wider groups comprising such firms.

NEW THREE-TIER CLASSIFICATION

The proposal outlines a three-tier classification system for investment firms, based on their systemic importance, activities, size and interconnectedness. Each class of firms would be subject to a different set of prudential requirements, with systemically important Class 1 firms remaining under the current Basel-derived CRR/CRD regime.

Class 1 investment firms: credit institutions

An investment firm will fall into Class 1 where it conducts either or both of the MiFID investment activities of **dealing on own account** and **placing on a firm commitment basis/underwriting** in any of the following circumstances:

a) where its assets exceed EUR 30 billion;

b) where the total assets of such investment firm, combined with the assets of other investment firms in the same group that carry on such dealing/underwriting activities, exceed EUR 30 billion; or

c) otherwise, where the firm is designated by its consolidating supervisor, for the purposes of ensuring financial stability.

The precise drafting of such Class 1 classification provisions may require further refinement.

Class 1 investment firms will be reclassified as "*credit institutions*" (as deposit-taking banks are today) and will therefore remain subject to the Basel-derived CRD/CRR regime. Although this means that the substantive basis on which their capital and other prudential requirements are assessed will remain unchanged, the reclassification of such firms as credit institutions may have a number of direct and indirect effects.

For example, within the Eurozone, such firms would become subject to the Single Supervisory Mechanism, under the auspices of the ECB and SRB. Classification as a credit institution would also broaden the scope of passports available to such firms: raising the possibility of such firms being able to passport FX, lending and other services throughout the EU.

Until now, the term "credit institution" has functioned as an approximate synonym or drafting shorthand for "bank" and there is therefore the risk of unintentional application of bank-driven restrictions or requirements to Class 1 investment firms, in the context of EU and third country laws, regulations and under the procedures, investment mandates, contracts, and policies of market infrastructures, investment funds, counterparties and others. For example, funds whose investment policies explicitly prohibit investing in credit institutions would need to consider whether they are required to dispose of holdings in investment firms that are reclassified as credit institutions.

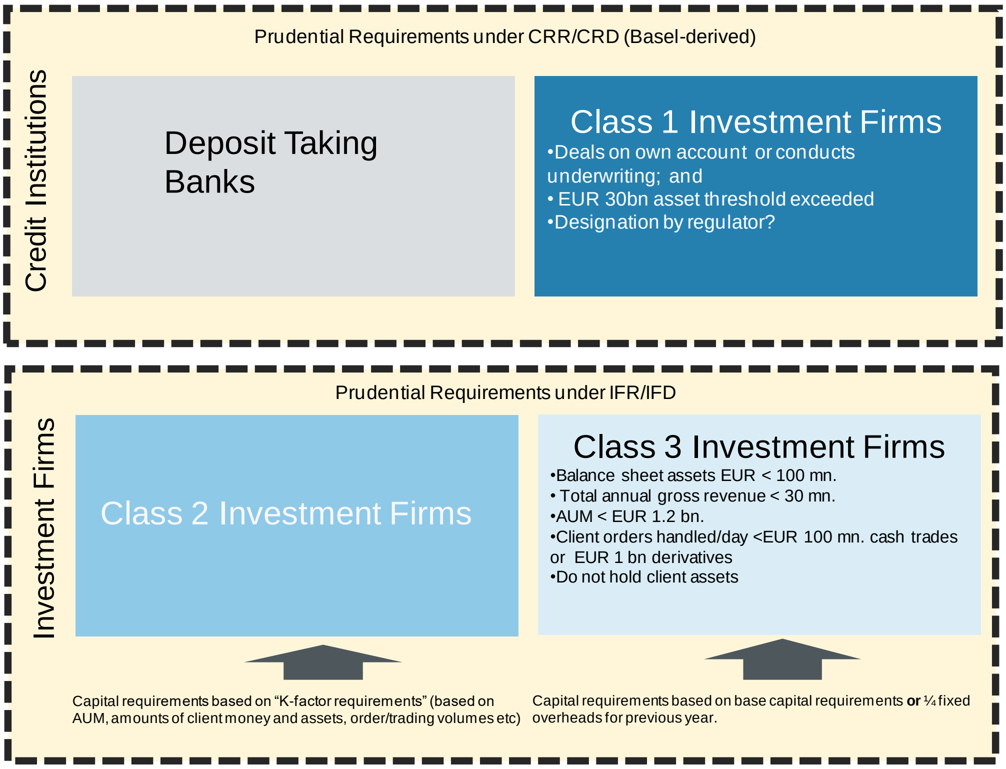
These unintended consequences will require further detailed analysis.

Class 2 and 3 investment firms

Other investment firms will fall into Class 2 or Class 3, depending on whether the investment firm in question falls under certain thresholds (calibrated with reference to balance sheet assets, AUM and client orders). Some of these thresholds are assessed on a group, others only on an individual, basis. Moreover, any investment firm that holds client assets or client money (other than on an intra-day basis) will automatically fall within Class 2 (if not Class 1).

Class 2 and 3 investment firms will, on an individual basis, be excluded from the scope of the CRD/CRR regime, and become subject to prudential requirements under the new IFR.

Figure 1: Proposed Classification of Investment Firms and Applicable Prudential Requirements.



IFR INDIVIDUAL PRUDENTIAL REQUIREMENTS

Capital Requirements

Class 2 and Class 3 investment firms will be subject to newly calibrated capital requirements, which may be satisfied with Tier 1 or Tier 2 regulatory capital instruments (using the same eligibility requirements as those that apply under the CRR). As under the CRR regime, certain holdings in non-financial sector entities will trigger deductions from capital.

Class 2 investment firms

Class 2 investment firms will be subject to new regulatory capital requirements, known as **K-factor requirements**. The K-factor requirements will comprise various components, each driven by business volumes, reflecting:

- Risk-to-Customer, which comprises elements reflecting:
  - assets under management;
  - client money held;
  - client assets (safekeeping and administration);

  - client orders handled; and
  - daily trading flow.
- Risk-to-Market: based on CRR standardised or IRB market risk requirements (or for firms with smaller trading books, a simplified version thereof).

Interestingly, there is no capital requirement for traditional credit risk for loans and similar exposures (other than margin lending). This is particularly significant, given that (as discussed below) non-deposit taking lenders (financial institutions) may be included in such firms' consolidated groups.

Class 3 investment firms

Class 3 investment firms' capital requirements will be the higher of their base capital requirements or 1/4 of annual fixed overheads (technically, these requirements also apply, as a minimum for Class 2 investment firms, in case they exceed the K-factors).

Other prudential requirements

Class 2 and 3 investment firms will also be subject to concentration risk monitoring and reporting requirements. Investment firms that deal on own account or execute client orders in their own name will be subject to concentration risk limits (analogous to the 25% of capital large exposures limits under the CRR).

Exposures not arising in the trading book are excluded from the concentration risk limits – meaning that, as with capital requirements, general lending activities (other than margin lending) would seem to fall outside the scope of prudential supervision.

Class 2 and 3 investment firms will also be subject to basic liquidity requirements, calibrated at 1/3 of annual fixed overheads.

Such liquidity requirements must be met with cash and other high quality liquid assets (tracking the CRR LCR concept), although Class 3 investment firms will be able to treat a wider range of assets as liquid assets, for such purposes.

Class 2 investment firms will be subject to Pillar III-style public disclosure requirements.

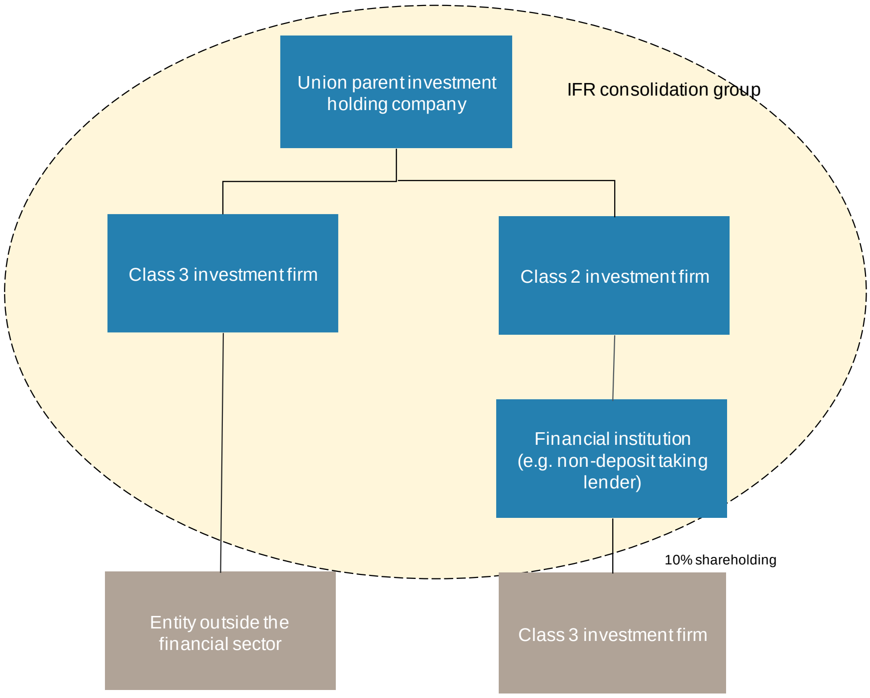
CONSOLIDATED GROUP REQUIREMENTS

IFR Consolidation Groups

The IFR introduces a new form of consolidation group (adding to the current CRR, Solvency II and Financial Conglomerates consolidation regimes): the investment firm consolidated group.

The rules for identifying such groups are closely based on the existing CRR group formulation, but would comprise an EU Class 2 or Class 3 investment firm (or its EU parent investment holding company) and its Class 2 or 3 investment firm and financial institution subsidiaries (i.e. entities carrying on the activities in Annex 1 of the CRD). Effectively, such a group is identical to a present-day CRD IV consolidation group, without any credit institutions.

Figure 2: An Investment Firm Consolidation Group



IFR prudential requirements would apply at a group level, on the basis of an aggregation-plus style method of consolidation.

Investment firm waivers

Article 15 of the CRR enables groups comprising only certain investment firms to apply for a waiver from certain consolidated prudential requirements. This waiver will be preserved within the IFR (and deleted from the CRR, where it will no longer be relevant).

Financial institutions within IFR consolidation groups

Financial institutions are entities that carry out certain finance activities (including lending), but which do not have deposit-taking licences. In many jurisdictions they are not subject to prudential requirements on an individual basis: however, where such financial institutions are held within a CRR consolidation group, their activities contribute to consolidated capital and other prudential requirements.

It is interesting that, whilst such financial institutions may be included within an IFR consolidation group, their lending activities will no longer be subject to consolidated capital and other prudential requirements. This may be a significant boon for non-bank groups comprising both investment firms and such financial institutions.

CRR Consolidation Groups and Financial Conglomerates

The CRR's definition of "*financial institution*" will be amended, so as to include investment firms. As discussed above, Class 1 investment firms will become reclassified as credit institutions.

This means that investment firms will remain fully consolidated entities within a CRR consolidation group of which they are currently a member (rather than being excluded and triggering deductions from capital). Moreover, amendments to the CRR should ensure that minority interests in consolidated investment firms may continue to be eligible as group capital.

Similarly, their change in status should not directly impact any current assessment as to whether or not a group is a financial conglomerate.

Intermediate Parent Undertakings

The investment firm reforms need to be carefully considered in the light of the intermediate parent undertaking (**IPU**) requirement, which was originally proposed in November 2016 (through the so-called CRD V proposal).

The original CRD V proposal requires that all credit institutions and investment firms within certain large third country groups are held under a single entity within the EU. The proposal has been subject to much discussion: with many industry participants advocating for a dual IPU solution (in order to facilitate international group structures comprising distinct bank and broker sub-groups).

Given that the CRD V proposal is not yet finalised, there are too many variables to make any definitive observations – but it will be important to consider how the CRD V IPU requirements and IFR/IFD texts interact. At present, it seems likely that, where a third country group is subject to the IPU requirement (due to its size, and where it comprises at least one credit institution), all investment firms within such group would be required to be held under an IPU, but that groups comprising only Class 2 and 3 investment firms would not be subject to the IPU requirement.

MIFIR CROSS-BORDER SERVICES

Regulation (EU) 600/2014 (**MiFIR**) came into effect on 3 January, as part of the MiFID2 reforms. Articles 46 and 47 of MiFIR allow third country firms to provide MiFID investment services (i.e. securities and derivatives-related financial services) to non-retail clients in the EU, on a cross-border basis – but only where the European Commission has adopted an "equivalence decision" on the firm's third country jurisidiction of origin. The grounds for determining such equivalence are set out in Article 47 of MiFIR.

The IFR proposes amendments to Article 47 of MiFIR. These do not fundamentally change the basis for equivalence, but leave less scope for the European Commmision to exercise discretion in making its determination. This is because the revised Article 47 expressly refers to the CRR or IFR as the standard against which prudential equivalence should be assessed. Query whether, in practice, this will make any material difference to the

Commission's assessment of equivalence, as has been implied by some media sources.

TIMING

The IFR will likely apply around 18 months following its publication in the Official Journal. Even assuming a swift passage through the EU legislative process, this means that it would come into effect mid/late 2019 at the earliest (although new capital requirements will be subject to a five-year phase-in period). This is broadly consistent with the Commission's aspiration to put in place all of the building blocks of its Capital Markets Union project by the end of 2019. It is also broadly synchronous with Brexit and the CRD V/CRR 2 reforms, presenting a number of challenges in assessing the impact and interaction of such overlapping and concurrent regulatory reforms.

It will be interesting to observe the reactions of the UK Prudential Regulation Authority and Financial Conduct Authority, and whether they will react with similar proposals, or retain the status quo. This is particularly significant given that the core CRR and IFR amendments will (unless Brexit is delayed beyond March 2019) certainly take effect after Brexit, meaning that the current CRR regime will be preserved as a matter of UK statute, and any changes made in line with the developing IFR regime would likely require the passing of primary UK legislation.

CLIFFORD

CHANCE

CONTACTS

Chris Bates
Partner

T +44 207006 1041
E chris.bates
@cliffordchance.com

Marc Benzler
Partner

T +49 697199 3304
E marc.benzler
@cliffordchance.com

Lucio Bonavitacola
Partner

T +39 028063 4238
E lucio.bonavitacola
@cliffordchance.com

Simon Crown
Partner

T +44 207006 2944
E simon.crown
@cliffordchance.com

Jose Manuel Cuenca
Partner

T +34 91590 7535
E josemanuel.cuenca
@cliffordchance.com

Lounia Czupper
Partner

T +32 2533 5987
E lounia.czupper
@cliffordchance.com

Simon Gleeson
Partner

T +44 207006 4979
E simon.gleeson
@cliffordchance.com

Frank Graaf
Partner

T +31 20711 9150
E frank.graaf
@cliffordchance.com

Steve Jacoby
Partner

T +352 485050 219
E steve.jacoby
@cliffordchance.com

Frédérick Lacroix
Partner

T +33 14405 5241
E frédérick.lacroix
@cliffordchance.com

Owen Lysak
Partner

T +44 207006 2904
E owen.lysak
@cliffordchance.com

Jurgen van der Meer
Partner

T +31 20711 9340
E jurgen.vandermeer
@cliffordchance.com

Marc Mehlen
Partner

T +352 485050 305
E marc.mehlen
@cliffordchance.com

Caroline Meinertz
Partner

T +44 207006 4253
E caroline.meinertz
@cliffordchance.com

Monica Sah
Partner

T +44 207006 1103
E monica.sah
@cliffordchance.com

Charles Morris
Senior Associate

T +44 207006 8288
E charles.morris
@cliffordchance.com