

IFR/IFD: THE NEW EU PRUDENTIAL REGIME FOR INVESTMENT FIRMS

The EU has adopted a new harmonised prudential regime that will apply to all investment firms authorised in the EU from June 2021. The new Investment Firm Regulation and Directive (IFR/IFD) will treat some firms as (or as if they were) credit institutions and subject them to the same prudential rules as deposit-taking banks, while imposing entirely new and potentially challenging capital, consolidation, reporting, governance and remuneration requirements on other investment firms. Firms need to act now to prepare for the application of the new regime.

For more details on the new remuneration rules under IFR/IFD, please see the briefing on our website [here](#).

Background and Timing

Some EU non-bank investment firms authorised under the EU Markets in Financial Instruments Directive (MiFID) are currently subject to similar Basel-derived prudential requirements as apply to deposit-taking credit institutions under the Capital Requirements Regulation and Directive (CRR/CRD). In contrast, the many EU investment firms that are exempted from CRR (such as large numbers of asset managers and advisory firms) are subject to initial capital requirements under CRD but are otherwise prudentially supervised under national regimes, such as the BIPRU and IPRU(In) regimes operated by the UK Financial Conduct Authority (FCA).

In 2017, following a review, the Commission launched its legislative proposals for a new IFR and IFD, aiming to harmonise and recalibrate the prudential and supervisory requirements that apply to investment firms across the EU.

On 16 April 2019, the European Parliament approved the texts of IFR and IFD agreed with the Council of the EU in trilogue, and, on 5 December 2019, the final texts were published in the Official Journal. IFR enters into force on the twentieth day after publication and applies from 26 June 2021 (18 months after entry into force), although it also makes some changes to the Markets in Financial Instruments Regulation (MiFIR) which apply sooner. Member States must adopt and apply their national rules implementing IFD by the same date.

The new regime will have significant impacts on the prudential requirements that apply to many investment firms and will have direct and indirect impacts on groups that include such firms. Firms will need to begin considering the systems and controls they will need to implement in order to assess their status under the new

Key issues

- The new EU Investment Firm Regulation and Directive were published in the Official Journal on 5 December 2019.
- The new prudential rules will apply from 26 June 2021, with limited transitional provisions.
- Systemically important and larger investment firms will be treated as (or as if they were) credit institutions and will remain subject to the bank capital regime.
- All other investment firms will be subject to a new harmonised EU regime.
- Larger and interconnected firms will be subject to a new 'K-factor' approach to assessing capital requirements as well as new remuneration and other rules.
- All investment firms will be subject to consolidated capital and other requirements, with limited waivers.
- Eurozone investment firms treated as credit institutions will be subject to the single supervisory mechanism and the single resolution mechanism.

regime and, in some cases, to comply with wholly new capital, consolidation, reporting, governance and remuneration requirements, especially as there are only limited transitional provisions.

The European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) are tasked with delivering draft technical standards to the European Commission, which – when adopted and effective – will specify many of the requirements in IFR and IFD. However, IFR and IFD only require delivery of these drafts to the Commission 18 months (or, in some cases, 12 months) after the legislation enters into force. Therefore, there is a significant risk that firms will be required to implement the new regime before (or only soon after) finalisation of many of the technical standards. This will create additional implementation challenges for firms, unless (in the end) there are legislative amendments to delay the application date.

Investment firms that are, or become, subject to CRR will also have to manage the impact of the recently adopted EU bank risk reduction package, amending CRR, CRD, the Bank Recovery and Resolution Directive (BRRD) and the Regulation on the Single Resolution Mechanism. Some of this legislation already applies with the rest being brought into effect by the end of 2020 or June 2021. These firms will also have to consider the potential impact of the future EU implementation of the 2017 Basel 3 (final) package scheduled for 1 January 2022 (subject to some transitional provisions).

Brexit

UK firms will also need to consider the impact of IFR or IFD in the context of Brexit. The 2017 EBA advice to the European Commission in advance of the legislative proposal showed that UK firms represented 57% of the 5,700 investment firms in the EU.

The UK will not be required to apply the new prudential rules unless, in June 2021, the UK is still in the EU or still in the transition period under the proposed withdrawal agreement with the EU. However, the UK authorities might choose to implement all or part of IFR/IFD to address deficiencies in the 'onshored' EU prudential regime that will form part of UK law or to facilitate a finding by the European Commission that the UK regime governing investment firms is equivalent to the EU regime for the purposes of the cross-border access requirements in MiFIR (although gaining equivalence could be challenging even if the UK concludes a withdrawal agreement and then a long-term trade agreement with the EU). The FCA is expected to consult in the next few months on the introduction of a new prudential regime for investment firms aligned to IFR/IFD.

In any event, many bank and non-bank financial groups operating through investment firms in the UK have created new EU27 investment firms (or are scaling up existing EU27 investment firms) to serve EU27 clients as part of their Brexit planning. These firms will be subject to the new EU prudential regime.

New Classification of Investment Firms

IFR and IFD will introduce a new classification system for investment firms, based on their activities, systemic importance, size and interconnectedness. Each class of firms will be subject to a different set of prudential requirements, with some systematically important and larger firms remaining under the current Basel-derived CRR/CRD regime (see Table 1 and Appendix: 'Flowchart showing EU Firm Classification after Implementation of IFR/IFD').

Table 1: Categories of firms under IFR and IFD

| Class | Covered firms | | | | | | | | | | | | | | | | | | |
|--|---|--|----------|--|---|---|--------|---------------------------|--------|----------------------------|--------|--|--------|--------------------------------------|--------|--|---------|---|--------|
| 1 | Own account dealer/underwriter firms* if: <ul style="list-style-type: none"> • Their consolidated assets are equal to or exceed €30bn; • They are part of a group where the total consolidated assets of all own account dealer/underwriter firms that have consolidated assets of less than €30bn are equal to or exceed €30bn[†]; or • They are part of a group where the total consolidated assets of all own account dealer/underwriter firms are equal to or exceed €30bn[†] and their consolidated supervisor designates them as Class 1 to address circumvention or financial stability issues. | | | | | | | | | | | | | | | | | | |
| 1a | Authorised investment firms that are own account dealer/underwriter firms* if: <ul style="list-style-type: none"> • Their consolidated assets are equal to or exceed €15bn[‡] (excluding assets of non-EU subsidiary own account dealer/underwriter firms); • They are part of a group where the total consolidated assets of all own account dealer/underwriter firms that have consolidated assets of less than €15bn are equal to or exceed €15bn[‡] (excluding assets of non-EU subsidiary own account dealer/underwriter firms); or • Their consolidated assets are equal to or exceed €5bn (excluding assets of non-EU subsidiary own account dealer/underwriter firms)[‡] and their competent authority designates them as Class 1a based on systemic risk, clearing member status or economic importance, cross-border significance or interconnectedness. | | | | | | | | | | | | | | | | | | |
| 1b | Authorised investment firms that are own account dealer/underwriter firms if: <ul style="list-style-type: none"> • They elect to be subject to CRR; • They are part of a group containing an EU credit institution and subject to consolidated supervision under CRR; and • The competent authority is satisfied that the election does not reduce own funds requirements and is not for purposes of regulatory arbitrage. | | | | | | | | | | | | | | | | | | |
| 2 | Other authorised investment firms meeting any of the following tests: <table border="1"> <tbody> <tr> <td>• AUM (assets under management, discretionary and ongoing non-discretionary advisory)[§]</td><td>≥ €1.2bn</td></tr> <tr> <td>• Daily COH (client orders handled)[§]</td><td>≥ €100m (cash trades) or €1bn (derivatives)</td></tr> <tr> <td>• ASA (assets safeguarded and administered)</td><td>> zero</td></tr> <tr> <td>• CMH (client money held)</td><td>> zero</td></tr> <tr> <td>• DTF (daily trading flow)</td><td>> zero</td></tr> <tr> <td>• NPR (net position risk) or CMG (clearing margin given)</td><td>> zero</td></tr> <tr> <td>• TCD (trading counterparty default)</td><td>> zero</td></tr> <tr> <td>• On- and off-balance sheet total[§]</td><td>≥ €100m</td></tr> <tr> <td>• Total revenues from investment services and activities (average of last 2 years)[§]</td><td>≥ €30m</td></tr> </tbody> </table> | • AUM (assets under management, discretionary and ongoing non-discretionary advisory) [§] | ≥ €1.2bn | • Daily COH (client orders handled) [§] | ≥ €100m (cash trades) or €1bn (derivatives) | • ASA (assets safeguarded and administered) | > zero | • CMH (client money held) | > zero | • DTF (daily trading flow) | > zero | • NPR (net position risk) or CMG (clearing margin given) | > zero | • TCD (trading counterparty default) | > zero | • On- and off-balance sheet total [§] | ≥ €100m | • Total revenues from investment services and activities (average of last 2 years) [§] | ≥ €30m |
| • AUM (assets under management, discretionary and ongoing non-discretionary advisory) [§] | ≥ €1.2bn | | | | | | | | | | | | | | | | | | |
| • Daily COH (client orders handled) [§] | ≥ €100m (cash trades) or €1bn (derivatives) | | | | | | | | | | | | | | | | | | |
| • ASA (assets safeguarded and administered) | > zero | | | | | | | | | | | | | | | | | | |
| • CMH (client money held) | > zero | | | | | | | | | | | | | | | | | | |
| • DTF (daily trading flow) | > zero | | | | | | | | | | | | | | | | | | |
| • NPR (net position risk) or CMG (clearing margin given) | > zero | | | | | | | | | | | | | | | | | | |
| • TCD (trading counterparty default) | > zero | | | | | | | | | | | | | | | | | | |
| • On- and off-balance sheet total [§] | ≥ €100m | | | | | | | | | | | | | | | | | | |
| • Total revenues from investment services and activities (average of last 2 years) [§] | ≥ €30m | | | | | | | | | | | | | | | | | | |
| 3 | Other authorised investment firms. | | | | | | | | | | | | | | | | | | |

*Own account dealer/underwriter firms' are firms whose business it is to carry out (Class 1 firms) or that carry out (other firms) dealing on own account, underwriting or placing on a firm commitment basis.

* Excluding commodity and emission allowance dealers, collective investment undertakings and insurance undertakings.

† For third-country groups, includes total assets of all EU branches of the group.

‡ Calculated on the basis of a 12-month average.

§ Calculated on a combined basis for all investment firms that are part of a group.

Class 1 investment firms: new credit institutions

IFR will reclassify some systemically important or large investment firms as credit institutions for the purposes of CRR/CRD and other EU legislation (this is the regulatory class currently reserved for deposit-taking banks).

Existing investment firms will fall into this class if their business is to carry out the MiFID investment activities of own account dealing, underwriting or placing on a firm commitment basis and if their assets meet the size thresholds summarised in Table 1 (or they are designated by their consolidated supervisor under the powers described in Table 1).

These 'Class 1' investment firms will remain subject to the Basel-derived prudential requirements under CRR/CRD, but their reclassification as credit institutions may have a number of direct and indirect effects discussed below.

IFR does not specifically address whether firms that carry on the activity of dealing on own account but are exempted from authorisation under MiFID can nevertheless be required to be authorised as credit institutions if they meet the tests that apply to Class 1 investment firms.

Class 1a investment firms

The Commission originally proposed that all other investment firms would fall under the new IFR/IFD prudential regime. However, the final texts of IFR/IFD provide that authorised investment firms that carry out the MiFID regulated activities of own account dealing, underwriting or placing on a firm commitment basis will be treated as 'institutions' subject to the CRR/CRD prudential regime if their assets meet the other (lower) size thresholds summarised in Table 1 (or they are designated by their consolidated supervisor under the powers described in Table 1).

Class 1b investment firms

IFR/IFD also provide that authorised investment firms that carry out the MiFID regulated activities of own account dealing, underwriting or placing on a firm commitment basis can elect to be treated as 'institutions' subject to the CRR/CRD regime if they are part of a group containing a credit institution that is subject to consolidated supervision under that regime. Investment firms may wish to make this election to simplify compliance and reporting, but the competent authority can override the election if it considers that applying the election would result in a reduction of the firm's own funds requirements or the election is made for the purposes of regulatory arbitrage. Therefore, these firms may need to be able to assess the capital requirements that would otherwise apply to them under IFR.

Class 2 and 3 investment firms

All other investment firms authorised under MiFID will be subject to the prudential regime in IFR/IFD and will not be subject to the CRR/CRD regime (except to the extent that they are included in a group subject to consolidated supervision under that regime). These investment firms are divided into two main categories.

Larger or interconnected firms (sometimes called Class 2 investment firms) will be subject to more extensive and burdensome requirements under IFR/IFD. Investment firms will fall into this class if they exceed any of the thresholds specified in IFR, and summarised in Table 1.

Smaller and non-interconnected firms (sometimes called Class 3 investment firms) are those investment firms that fall below all these thresholds. These firms are subject to less extensive requirements under IFR/IFD.

Commodity and emission allowance dealers

One of the objectives of IFR/IFD is to create a more appropriate regime for investment firms authorised under MiFID, the main business of which consists exclusively of the provision of investment services or activities in relation to commodity derivatives, derivatives on emission allowances or emissions allowances covered by MiFID. These commodity and emission allowance dealers will not be treated as Class 1 or Class 1a investment firms even if their assets exceed the specified size threshold. Unless they are part of a consolidated group and elect to be treated as Class 1b firms, they will be treated as Class 2 or 3 investment firms according to whether they exceed any of the specified thresholds.

IFR Individual Prudential Requirements

Regulatory capital requirements

Class 1a and 1b investment firms are subject to initial capital requirements under IFR but otherwise will be subject to prudential requirements under CRR/CRD.

Class 2 and Class 3 investment firms will be subject to newly calibrated requirements under IFR to maintain regulatory capital on an individual basis (see below where they are part of a group). They can meet those requirements by maintaining Common Equity Tier 1, Additional Tier 1 and Tier 2 capital, as defined for the purposes of CRR (with some limited modifications). These investment firms will also have to comply with requirements regulating reductions of capital or redemptions or repurchases of capital instruments similar to those in CRR.

Initial capital requirements

IFD sets new initial capital requirements for Class 1a, 1b, 2 and 3 investment firms according to their authorised activities:

- €750,000: dealing on own account or underwriting or placing on a firm commitment basis (including for operators of organised trading facilities authorised to deal on own account);
- €75,000: reception and transmission of orders, execution of orders on behalf of clients, portfolio management, investment advice, placing not on a firm commitment basis;
- €150,000: operation of a multilateral or organised trading facility.

IFD does not reproduce the provisions in CRD that currently exempt certain investment firms that deal on own account from the initial capital requirement of €730,000 where their positions in financial instruments result from a failure to match investors' orders precisely or they only deal on own account to invest own funds.

Class 2 investment firms

Class 2 investment firms will be subject to new risk-based regulatory capital requirements, assessed as the higher of the sum of their 'K-factor' requirements, one-quarter of their annual fixed overheads and their initial capital requirement.

Table 2: The K-factor capital requirements in summary

| Category | K-factor | | Co-efficient (or method) |
|---|---|--------------|---|
| Risk-to-Client (RtC) | Assets under management (discretionary and ongoing non-discretionary advisory). | K-AUM | 0.02% |
| | Client money held (on segregated or non-segregated basis). | K-CMH | 0.4% (seg'd) |
| | | K-CMH | 0.5% (non-seg'd) |
| | Assets under safeguarding and administration. | K-ASA | 0.04% |
| | Client orders handled (cash trades and derivatives). | K-COH | 0.1% (cash trades) |
| | | K-COH | 0.01% (derivatives) |
| Risk-to-Market (RtM) | Net position risk on own account trading book positions (unless K-CMG applies). | K-NPR | N/A (capital as per CRR simplified or standardised approach) |
| | Total margins required by firm's clearing member (if permitted by competent authority). | K-CMG | N/A (capital = 3 rd highest total daily margin requirement over last 3 months) |
| Risk-to-Firm (RtF) | Trading counterparty default (own account trading book exposures). | K-TCD | N/A (capital = $\sum 1.2 \times \text{exposure value} \times \text{risk factor} \times \text{CVA}$). |
| | Daily trading flow for cash trades or derivatives (trading book own account transactions + transactions executed for clients in firm's name). | K-DTF | 0.1% (cash trades) |
| | | K-DTF | 0.01% (derivatives) |
| | Concentration risk on own account trading book transactions. | K-CON | N/A (capital = $\sum [\text{exposure capital requirement} / \text{exposure value}] \times \text{exposure value excess}$) |
| Exceptions and derogations may apply in some cases. | | | |

The K-factor requirements are summarised in Table 2 above. Assessing these requirements will be a new challenge, as they depart radically from the CRR/CRD regime. This is, of course, to be expected – the whole point of IFR/IFD is to move away from the old standards. However, firms and groups will need to reassess their systems and processes for data collection, reporting and analysis – and this process needs to start soon, so that firms are ready in time and have sufficient historical data to comply with the new regime.

Nevertheless, for many firms – especially firms that do not carry out own account dealing but have high staff and office costs – it is likely that the fixed overheads capital requirement will be the binding constraint (as this requirement may well exceed their requirement based on the K-factors).

Interestingly, there is no capital requirement for non-trading book assets (not deducted from capital), such as for assets derived from commercial operations or loans and

similar exposures (other than margin lending). This will be important as it might mean (for example) that firms conducting other commercial or financial activities could be authorised as investment firms, at least in those countries that allow investment firms to conduct non-MiFID activities.

Class 3 investment firms

Class 3 investment firms' capital requirements will be the higher of one-quarter of their annual fixed overheads, and their initial capital requirement. They will not have to assess their capital based on the K-factors (but will have to be able to monitor some of the data required by the K-factors in order to assess whether they become Class 2 investment firms).

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 CRR). These requirements only apply to trading book and other market transactions and so other exposures are not subject to these restrictions. However, commodity and emission allowance dealers are exempted from the requirements for concentration risk where they enter into transactions with non-financial counterparties that are hedging transactions for that counterparty or its group (and certain other conditions are met).

Table 3: Summary comparison of prudential requirements under CRR and IFR

| | Class 1 | Class 1a and 1b | Class 2 | Class 3 |
|--|--------------------------|--------------------------|--|--|
| Category | CRR credit institution | CRR institution | IFR investment firm | IFR investment firm |
| Initial capital | €5m | €750k | €750k, 150k, 75k | €750k, 150k, 75k |
| Risk-based capital | CRR capital rules | CRR capital rules | Higher of Σ K-factors and fixed overhead requirement | Fixed overhead requirement |
| Leverage | CRR leverage rules | CRR leverage rules | None | None |
| Large exposures or concentration risk | CRR large exposure rules | CRR large exposure rules | Part Four IFR concentration risk requirements (and K-CON capital charge) | Part Four IFR concentration risk requirements |
| Liquidity | CRR LCR and NSFR | CRR LCR and NSFR | Part Five IFR (1/3 fixed overhead requirement) | Part Five IFR (but national supervisory discretion to waive) |
| Consolidated requirements | CRR rules | CRR rules | Yes – Art 7 IFR (but possibly simplified approach under Art 8 IFR) | Yes – Art 7 IFR (but possibly simplified approach under Art 8 IFR) |
| Pillar 3 disclosure | CRR | CRR | Part Six IFR | No (Art 46(1) IFR), except for AT1 issuers |
| Reporting | CRR | CRR* | Part Seven IFR | Part Seven IFR (with exceptions) |

* Class 1a investment firms are also subject to the reporting requirements in Article 55 IFR.

Class 2 and 3 investment firms will also be subject to a basic liquidity requirement, calibrated at one-third of annual fixed overheads. These 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 these purposes.

For many investment firms, this will be the first time they have been subject to formal liquidity requirements. However, competent authorities may exempt Class 3 investment firms from these requirements and commodity and emission allowance dealers benefit from specific transitional provisions deferring the application of liquidity and Pillar 3 disclosure requirements for five years.

Class 2 investment firms (and, to an extent, any Class 3 firms that issue additional tier 1 capital instruments) will be subject to public disclosure requirements similar to the Pillar 3 requirements applicable to credit institutions.

Other supervisory requirements

Class 2 and 3 investment firms will also be subject to supervisory requirements under IFD, which for many firms will be entirely new.

Class 2 firms will have to establish internal capital and liquidity adequacy assessment processes (ICAAP/ILAAP), internal governance processes on treatment of risks, country-by-country reporting and (perhaps the most eye-catching) remuneration rules similar to the rules that apply to credit institutions. Class 3 firms are not subject to these requirements, although their competent authority will be able to impose ICAAP/ILAAP requirements on them.

In addition, IFD envisages a more active role for competent authorities of both Class 2 and 3 investment firms, including a supervisory review and evaluation process (SREP) and the possibility for the imposition of supplementary Pillar 2 capital and liquidity requirements on those firms.

IFD also requires the EBA to submit a report (within two years after entry into force) on the introduction of criteria on environmental, social and governance (ESG) risks and how investment firms can take account of these risks in their risk management and how supervisors can assess the impact of those risks in their SREP. Based on this report, the EBA may choose to adopt guidelines to introduce criteria for ESG-related risks into the SREP for both Class 2 and 3 investment firms.

See Table 4 for a summary comparison of these other supervisory requirements.

Table 4: Summary comparison of other supervisory requirements under CRD and IFD

| | Class 1 | Class 1a and 1b | Class 2 | Class 3 |
|--|-------------------------------|-------------------------------|-----------------------------|--|
| Category | CRR credit institution | CRR institution | IFR investment firm | IFR investment firm |
| Applicable regime | Titles VII and VIII CRD | Titles VII and VIII CRD | Titles IV and V IFD | Titles IV and V IFD |
| ICAAP/ ILAAP requirement | Yes (Art 73 CRD) | Yes (Arts 73 CRD) | Yes (Art 24 IFD) | National supervisory discretion to impose (Art 24 IFD) |
| Internal governance | Yes (Arts 73, 88, 91 CRD) | Yes (Arts 73, 88, 91 CRD) | Yes* (Art 26 IFD) | No* (Art 25 IFD) |
| Country-by-country reporting | Yes (Art 89 CRD) | Yes (Art 89 CRD) | Yes (Art 27 IFD) | No (Art 25 IFD) |
| Treatment of risks | Yes (Arts 76-87 CRD) | Yes (Arts 76-87 CRD) | Yes (Arts 28-29 IFD) | No (Art 25 IFD) |
| Remuneration rules | Yes (Arts 92-96 CRD) | Yes (Arts 92-96 CRD) | Yes (Arts 30-34 IFD) | No (Art 25 IFD) |
| Supervisory review and evaluation | Yes (Arts 97-101 CRD) | Yes (Arts 97-101 CRD) | Yes (Art 36 IFD) | Yes (Art 36 IFD) |
| Pillar 2 capital | Yes (Art 104 CRD) | Yes (Art 104 CRD) | Yes (Arts 39 and 40 IFD) | Yes (Art 41 IFD) |
| Pillar 2 liquidity | Yes (Arts 104 and 105 CRD) | Yes (Arts 104 and 105 CRD) | Yes (Arts 39 and 42 IFD) | Yes if subject to solo liquidity rules (Arts 39 and 42 IFD) |

* The rules on internal governance and the management body in Arts 88 and 91 CRD also apply to Class 2 and 3 investment firms under Art 9 MiFID2

Consolidated Group Requirements

Development of the legislation

IFR's approach to the prudential supervision of groups including Class 2 and 3 investment firms shifted radically during the course of its development. The original Commission proposal started from the default position that such groups would not be subject to full consolidation, but rather to group capital requirements resembling the current requirements that apply to investment firms benefitting from a waiver of consolidated supervision under CRR. Competent authorities would be permitted to impose full consolidation upon such groups, where they considered it necessary, or alternatively would be permitted to disapply group-based requirements altogether.

However, the final text of IFR reverses this position, imposing a form of group consolidation on all Class 2 and 3 investment firms using a methodology similar to that which applies to credit institutions under CRR (albeit calculating the consolidated requirements using the IFR methodology for calculating those requirements). Some firms may be able to obtain a limited waiver from those requirements, but there is no option to disapply group prudential requirements altogether.

This creates a new consolidation regime alongside the other existing regimes under CRR, Solvency 2 and the Financial Conglomerates Directive. This will be a radical development for the many investment firms that currently fall outside the scope of CRR/CRD. They will, in many instances, become subject to EU group-wide prudential requirements for the first time. This will be especially relevant to 'local firms' and other firms subject to national rules that currently do not impose capital requirements on a group basis (e.g., the FCA's regime for 'exempt CAD firms').

IFR consolidation groups

IFR introduces a new form of consolidation group: the investment firm consolidation group. The rules for identifying such groups are closely based on the existing CRR group rules, but the group would comprise an EU investment firm (or its EU parent investment holding company) and its subsidiaries that are investment firms or financial institutions (i.e., entities carrying on the activities in Annex I of CRD). However, CRR rules – not IFR rules – will generally apply if the consolidation group includes a credit institution (including a Class 1 investment firm) or a Class 1a or 1b investment firm treated as an 'institution' under CRR.

Where an investment firm consolidation group exists, the prudential requirements of IFR will apply on a consolidated basis to the group as if it were a single entity. Investment firms subject to full prudential consolidation under IFR must also apply the internal governance, transparency, treatment of risks and remuneration rules under IFD on both an individual and consolidated basis.

Investment firm waivers

CRR allows groups comprising only certain 'limited licence' or 'limited activity' investment firms to apply for a waiver from certain consolidated prudential requirements. IFR deletes the relevant provisions from CRR so that investment firms remaining part of CRR consolidation groups will no longer be able to benefit from the waiver regime.

IFR preserves the waiver, in a modified form, for groups that are subject to consolidation under IFR. However, the waiver will only be available for IFR consolidation groups that are considered to be 'sufficiently simple' and where the absence of consolidated supervision does not present significant risks to clients or to the market. Therefore, some groups that currently benefit from a consolidation waiver under CRR

and that become subject to IFR consolidation may not be able to satisfy this test and will fall within the scope of full consolidation for the first time.

Even where a group is able to avail itself of the new consolidation waiver under IFR, there may nonetheless be negative consequences arising from the technical differences between the current CRR waiver and the IFR waiver. Under the CRR waiver regime, parents of groups benefitting from such waivers must maintain sufficient own funds to meet an alternative capital requirement, but are not required to deduct goodwill, investments in subsidiaries or other items when calculating own funds (although some national competent authorities, such as the UK FCA, may seek to ensure that the build-up of goodwill within a group is constrained and reduced).

In contrast, under the IFR waiver regime, the relevant parent undertaking must meet the alternative capital requirements with own funds after deductions for goodwill and other items. However, the parent is still not required to deduct significant investments in other financial sector entities (including subsidiaries), meaning, in effect, that goodwill arising only on consolidation does not have to be deducted when computing own funds for this purpose.

Investment firms benefiting from the IFR waiver are not required to comply with the internal governance, transparency, treatment of risks and remuneration rules under IFD on a consolidated basis.

Competent authorities may also exempt parent undertakings from the application of liquidity requirements on a consolidated basis taking into account the nature, scale and complexity of the group, but they then cannot waive the application of those requirements to investment firms within the group on an individual (entity) level.

Individual waivers

IFR also allows competent authorities to exempt:

- Class 3 investment firms from compliance with the requirements of IFR (other than the liquidity requirements) on an individual basis where the firm is a subsidiary member of a banking or investment firm group subject to consolidated supervision under CRR and the investment firm and its parent are authorised and supervised in the same Member State and if certain other conditions are met;
- Class 3 investment firms from compliance with the IFR disclosure requirements on an individual basis where they are a member of an insurance company group and certain other conditions are met;
- Class 2 and 3 investment firms from compliance with the IFR liquidity requirements on an individual basis where they are members of a group subject to IFR liquidity requirements on a consolidated basis and certain other conditions are met, including the conclusion of an intra-group contract providing for the free movement of funds between the parent undertaking and the investment firm.

Third-country groups

Under IFD, where two or more investment firms are subsidiaries of the same third-country undertaking, then the relevant competent authority should assess whether such investment firms are subject to an equivalent form of group supervision under the applicable third-country regime. Where they are not, then the supervisor must apply 'appropriate supervisory techniques' to the firms in order to achieve the objectives of the IFR group regime. These requirements are similar to the requirements under CRD for EU credit institutions and CRR investment firms with a third-country parent bank or financial holding company. However, the IFR requirements only apply where there are two or more EU investment firms with a third-country parent, but then apply regardless of the type of third-country parent (and so would apply even where the parent is not a bank or investment firm and heads a diversified non-financial group).

Other Impacts

Impact on the CRD5 IPU requirement

CRD5 will require third-country groups which include two or more EU 'institutions' subject to CRR to hold those institutions under a single EU intermediate parent undertaking (IPU) or, in limited cases, two IPUs if the group's EU presence meets certain size thresholds. IFD extends this requirement to cover all investment firms authorised in the EU under MiFID as if they were 'institutions'. Thus, third-country groups with a significant EU presence will need to plan to hold their EU asset management, advisory and other investment firm subsidiaries that currently fall outside the scope of CRR under their IPUs.

Insolvency and resolution rules

The amended definition of 'investment firm' in CRR may also bring all EU MiFID investment firms (not just those currently treated as 'institutions' under CRR) within the scope of the EU Credit Institutions Winding up Directive, thus affecting their treatment in insolvency (and the extent to which host Member States' insolvency proceedings may apply to branches). However, the outcome will depend on how Member States implement the changes in their national laws.

The BRRD currently applies to credit institutions and to investment firms with initial capital requirements of €730,000 under CRD (broadly, investment firms that deal on own account, underwrite issues of financial instruments or operate multilateral or organised trading facilities). IFD amends this so that the BRRD will now apply to investment firms subject to the new initial capital requirement of €750,000 under IFD. This may take some operators of trading facilities outside the scope of the BRRD regime but bring within the scope of the regime some firms that currently rely on the exemptions in CRD for certain order matching, and other firms from the €730,000 initial capital requirement.

MiFIR cross-border services regime

MiFIR created a regime which allows third-country firms registered with ESMA to provide securities and derivatives services covered by MiFID to EU professional clients and eligible counterparties on a cross-border basis – but only where the Commission has adopted an ‘equivalence decision’ regarding the firm’s third-country jurisdiction of origin. IFR makes a number of changes to this regime which may be of particular importance to the UK in the context of Brexit.

IFR will require the Commission to conduct a ‘detailed and granular assessment’ of the third-country’s rules where the relevant EU activities are likely to be of systemic importance for the EU. It will also require the Commission to make a comparison of the third-country’s prudential rules with the new regime under IFR/IFD and will specifically require that firms that deal on own account or provide underwriting services are subject to comparable capital requirements to EU firms. The amendments also make clear that the Commission can limit its decisions to particular categories of MiFID services.

IFR will also impose requirements on third-country firms registered with ESMA to submit annual reports to ESMA on their activities, to hold records, to provide information to ESMA on request and to cooperate in on-site inspections. It also gives ESMA additional powers to restrict or withdraw a firm’s registration. It allows the Commission to impose additional operational conditions on its equivalence decisions where third-country firms’ activities are likely to be of systemic importance for the EU. These conditions may require third-country firms registered with ESMA to comply with post-trade transparency, transaction reporting and share and derivatives trading obligations equivalent to those under MiFIR.

IFR also extends the temporary intervention powers under MiFIR so that they apply to third-country firms performing MiFID services in the EU (whether or not registered with ESMA).

These changes take effect on 26 June 2021.

MiFID tick size regime

IFR amends MiFIR to require systematic internalisers in equities and similar instruments to comply with the tick-size regime applicable to trading venues (with effect from 26 March 2020).

Impacts for specific types of Firms and Groups

Class 1 investment firms: New credit institutions

Large investment firms authorised under MiFID that meet the conditions for being treated as a Class 1 investment firm on 24 December 2019 will need to submit an application for re-authorisation as a credit institution under the relevant national law implementing provisions by 27 December 2020 (i.e., re-authorisation is not automatic).

However, they may need to engage with their consolidated supervisor to determine whether they will be designated for this purpose where they do not meet the thresholds for mandatory treatment as a Class 1 investment firm.

Within the eurozone, investment firms that are re-authorised as credit institutions will be subject to the single supervisory mechanism and the single resolution mechanism and may be subject to direct supervision by the European Central Bank (ECB). This is a significant and controversial change, as the legal basis for this expansion of the ECB and SRB's regulatory role is not beyond doubt.

Investment firms authorised under MiFID that subsequently meet the conditions for being treated as a Class 1 investment firm must apply to be re-authorised as credit institutions no later than the day when they meet those conditions (but applying a varied definition using 12-month averages for some purposes).

Investment firms seeking re-authorisation may continue to carry on their activities pending a decision on their application. However, they may need additional authorisations to take deposits and lend money and it will be a matter of national law in the firm's home state to determine the scope of the other activities permitted to the firm. They may become subject to the financial reporting regime (FINREP) under CRR if they prepare their consolidated accounts under IFRS or use IFRS for reporting their consolidated own funds.

IFD does not address how firms seeking re-authorisation should deal with existing cross-border or branch activities in other Member States that relied on passport notifications under MiFID. 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.

IFD provides that the competent authority can withdraw the authorisation as a credit institution of a Class I investment firm when, for a period of five years, its average total assets falls below the relevant thresholds. However, it does not otherwise address how such a firm that no longer meets the relevant conditions should transition to being authorised under MiFID.

There are many other potential regulatory and other consequences of the reclassification of investment firms as credit institutions: some are obvious, others less so. Until now, the term 'credit institution' has functioned as an approximate synonym or drafting shorthand for 'bank' and there therefore may be an unintended extension of bank-driven restrictions or requirements (or privileges) to Class 1 investment firms under EU, Member State or third-country laws or regulations, the rules and policies of market infrastructures or investment mandates or contracts.

Class 1a and 1b investment firms

Existing large investment firms that are own account dealers or underwriters and meet the conditions to be treated as Class 1a firms will generally already be 'institutions' subject to CRR, and thus may see no significant change in their prudential requirements as a result of IFR. However, they may need to engage with their

consolidated supervisor before IFR begins to apply to determine whether they will be designated for this purpose where they do not meet the thresholds for mandatory treatment as a Class 1a investment firm.

Other existing investment firms that are own account dealers or underwriters, including commodity and emission allowance dealers, may elect to be treated as an institution subject to CRR if they are subject to consolidated supervision under CRR as part of a group containing a credit institution. This may be more efficient because these firms will generally already be 'institutions' subject to CRR and thus should see no significant change in their individual capital and reporting requirements as a result of IFR.

However, they will need to engage with their supervisor before IFR begins to apply to confirm that the election does not reduce the firm's own funds requirements and is not for the purposes of regulatory arbitrage. In some cases, the application of IFR could lead to higher individual capital requirements than the method prescribed by CRR (e.g., where the K-factor or fixed overhead requirements generate capital requirements which exceed the operational risk and risk weighted asset based requirements under CRR).

Special categories of CRR firms

Investment firms that deal on own account but that are currently treated as 'limited activity' firms subject to CRR may meet the conditions to be treated as Class 1 investment firms and may need re-authorisation as credit institutions. In that case, they will cease to benefit from any of the reliefs available to limited activity firms under CRR. Alternatively, they may be Class 1a or 1b investment firms that continue to be treated as 'institutions' under CRR. In that event, they may continue to benefit from some – but not all – of the reliefs applicable to such firms under CRR for a five-year period after entry into force.

Other existing 'limited activity' firms, 'limited licence' firms, commodity and emission allowance dealers and other investment firms subject to CRR may become Class 2 or 3 investment firms under the new regime. In that case, they may benefit from the transitional provisions that, for a five-year period after IFR begins to apply, limit their variable and permanent capital requirements under IFR to twice the relevant requirement under CRR if that had continued to apply.

Conversely, some existing investment firms that deal on own account may not have been subject to CRR because they were able to rely on the CRD exemptions for firms whose positions in financial instruments result from a failure to match investors' orders precisely or that only deal on own account to invest own funds. These firms may need to determine whether they are treated as Class 1, 1a or 1b firms subject to CRR or Class 2 or 3 firms subject to IFR.

CRR consolidation groups

IFR/IFD will generally have a limited impact on the consolidated prudential requirements applicable to groups that are currently subject to consolidated supervision under CRR because they include an existing credit institution or a CRR investment firm that is treated as a Class 1 or 1a investment firm under IFR. These groups will remain subject to the consolidated requirements under the CRR/CRD regime and the existing credit institutions, Class 1 and 1a investment firms and, if they make the necessary elections in time, Class 1b credit institutions that are members of the group, will be subject to

individual requirements under CRR/CRD in much the same way as today. However, any Class 2 or 3 investment firms in the group will be subject to individual requirements under IFR or IFD unless they can benefit from the waivers of individual requirements discussed above.

Other groups subject to consolidated prudential requirements under CRR/CRD or benefiting from a waiver of consolidated supervision under CRR will generally transition to the IFR/IFD consolidation regime discussed above.

Investment firms and groups outside the CRR regime

At present, many investment firms authorised under MiFID fall outside the scope of the CRR regime. In the UK, these are described as BIPRU firms, exempt CAD firms and local firms – although their analogues exist across the EU. These categories of firms include firms that do not deal on own account and cannot hold client money or securities – capturing a range of investment advisors, investment managers and other arrangers and intermediaries (as well as 'local firms' although these benefit from a specific transitional provision limiting the increase in their regulatory capital requirements).

In the UK, groups including BIPRU firms may currently be subject to a form of group prudential supervision. However, in the UK and other Member States, other groups including investment firms are not subject to consolidated supervision at all (unless the group also includes a bank, CRR investment firm or insurer).

All such investment firms – and, likely, the groups to which they belong – will be dragged into the IFR/IFD prudential regime. In many cases, this will trigger group-wide prudential regulatory requirements (and associated governance and remuneration-related requirements) for the first time.

This could also generate very significant increases in individual regulatory capital requirements for at least some firms. For example, many investment firms are currently only subject to a €50,000 initial capital requirement but may become subject to significantly higher capital requirements as a result of the fixed overhead requirement (even if they have no K-factor requirement and are not subject to consolidated supervision) – although it is possible that competent authorities might interpret the transitional provisions in a way that limits this. In any event, these firms will have to implement a range of new policies and procedures to comply with the new requirements.

This will make it even more critical for firms to navigate the boundary between authorisation under MiFID and authorisation under national or other EU regimes where these new rules do not apply (such as the regimes for alternative investment fund managers or UCITS management companies). It will also make it critical for affected firms to engage with their supervisors before IFR begins to apply to discuss the availability of waivers of individual or consolidated requirements under IFR and IFD.

Are you a credit institution as of 2019?
Art 4(1)(1) CRR (unamended)

Yes → **REGULATED UNDER CRR/CRD REGIME**

No → **Are you an investment firm authorised under MIFID as of 2019?**
Art 4(1)(22) IFR

Yes → **REGULATED UNDER CRR/CRD REGIME**

No → **Are you an own account dealer firm or underwrite financial instruments?**

Yes → **REGULATED UNDER CRR/CRD REGIME**

No → **Are you a commodity / emissions allowance dealer?**

Yes → **REGULATED UNDER CRR/CRD REGIME**

No → **Do you meet ANY of the following criteria?**

1. Your consolidated assets ≥ €30bn OR
2. You are part of a group where the total consolidated assets of all own account dealers / underwriters with consolidated assets of less than €30bn ≥ €30bn OR
3. You are part of a group where the total consolidated assets of all own account dealers / underwriters ≥ €30bn and your consolidated supervisor designates you as Class 1

Yes → **REGULATED UNDER CRR/CRD REGIME**

No → **Art 4(1) CRR as amended by Art 62(3) IFR**

Are your consolidated assets ≥ €5bn?

Yes → **Art 5(1) IFD**

No → **Do you elect to be subject to the CRR and meet BOTH the following criteria?**

1. You are part of a group containing an EU credit institution and subject to consolidated supervision under CRR; AND
2. The competent authority is satisfied that the election does not reduce your own funds requirements and is not for purposes of regulatory arbitrage.

Yes → **REGULATED UNDER CRR/CRD REGIME**

No → **Art 1(2)(a) IFR**

Are your consolidated assets ≥ €15bn (excluding assets of certain subsidiaries)?

Yes → **Art 1(2)(b) IFR**

No → **Are you part of a group where the total consolidated assets of all own account dealers / underwriters with consolidated assets of less than €15bn ≥ €15bn (excluding assets of non-EU subsidiaries)?**

Yes → **Art 1(2)(c) IFR & Art 5(1) IFD**

No → **Does the competent authority designate you as Class 1A based on systemic risk, clearing member status or economic importance, cross-border significance or interconnectedness?**

Yes → **REGULATED UNDER CRR/CRD REGIME**

No → **REGULATED UNDER IFR/IFD REGIME**

Do you meet ANY of the following criteria?

1. AUM (assets under management, discretionary and ongoing non-discretionary advisory) ≥ €1.2bn
2. Daily COH (client orders handled) ≥ €100m (cash trades) or €1bn (derivatives)
3. ASA (assets safeguarded and administered) > €0
4. CHM (client money held) > €0
5. DTF (daily trading flow) > €0
6. NPR (net position risk) or CMG (clearing margin given) > €0
7. TCD (trading counterparty default) > €0
8. On- and off-balance sheet total ≥ €100m
9. Total revenues from investment services and activities (average of last 2 years) ≥ €30m

Yes → **REGULATED UNDER IFR/IFD REGIME**

No → **REGULATED UNDER IFR/IFD REGIME**

REGULATED UNDER CRR/CRD REGIME

CREDIT INSTITUTION (TRAD)
 "Credit institutions" subject to the CRR/CRD regime.
Art 4(1)(1) CRR (unamended)

CREDIT INSTITUTION (CLASS 1)
 Classified as "credit institutions" subject to the CRR/CRD regime.
Art 4(1) CRR as amended by Art 62(3) IFR

INVESTMENT FIRM (CLASS 1A)
 Not classified as "credit institutions" but still subject to the CRR/CRD regime

INVESTMENT FIRM (CLASS 1B)
 Firm subject to the CRR/CRD regime (subject to override by the competent authority)
Art 1(2) IFR Art 2(2) IFD

INVESTMENT FIRM (CLASS 2)
 Larger or interconnected firms subject to the IFR/IFD regime e.g. risk-based capital requirement assessed as the higher of the sum of their "K-factor" requirements, 1/4 of annual fixed overheads and initial capital requirements, remuneration code etc.

INVESTMENT FIRM (CLASS 3)
 Smaller, non-interconnected firms and subject to less extensive requirements under the IFR/IFD regime e.g. capital requirement is higher of 1/4 of annual fixed overheads and base capital requirement, no need to assess capital based on K-factors, no remuneration code etc.

REGULATED UNDER IFR/IFD REGIME

CONTACTS



Charles Morris
Senior Associate
London
T: +44 20 7006 8288
E: charles.morris@cliffordchance.com



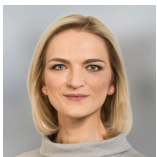
María Luisa Alonso
Counsel
Madrid
T: +34 91590 7541
E: marialuisa.alonso@cliffordchance.com



Christopher Bates
Partner
London
T: +44 20 7006 1041
E: chris.bates@cliffordchance.com



Marc Benzler
Partner
Frankfurt
T: +49 69 7199 3304
E: marc.benzler@cliffordchance.com



Anna Biala
Advocate
Warsaw
T: +48 22429 9692
E: anna.biala@cliffordchance.com



Lucio Bonavitacola
Partner
Milan
T: +39 02 8063 4238
E: lucio.bonavitacola@cliffordchance.com



Simon Crown
Partner
London
T: +44 20 7006 2944
E: simon.crown@cliffordchance.com



Lounia Czupper
Partner
Brussels
T: +32 2 533 5987
E: lounia.czupper@cliffordchance.com



Caroline Dawson
Partner
London
T: +44 20 7006 4355
E: caroline.dawson@cliffordchance.com



Laura Douglas
Senior Associate
Knowledge Lawyer
London
T: +44 20 7006 1113
E: laura.douglas@cliffordchance.com



Simon Gleeson
Partner
London
T: +44 20 7006 4979
E: simon.gleeson@cliffordchance.com



Steve Jacoby
Managing Partner
Luxembourg
T: +352 48 50 50 219
E: steve.jacoby@cliffordchance.com



Frédéric Lacroix
Partner
Paris
T: +33 1 4405 5241
E: frederick.lacroix@cliffordchance.com



Owen Lysak
Partner
London
T: +44 20 7006 2904
E: owen.lysak@cliffordchance.com



Caroline Meinertz
Partner
London
T: +44 20 7006 4253
E: caroline.meinertz@cliffordchance.com



Monica Sah
Partner
London
T: +44 20 7006 1103
E: monica.sah@cliffordchance.com



Jeremy Walter
Partner
London
T: +44 20 7006 8892
E: jeremy.walter@cliffordchance.com

OUR INTERNATIONAL NETWORK

32 OFFICES IN 21 COUNTRIES



Abu Dhabi
Amsterdam
Barcelona
Beijing
Brussels
Bucharest
Casablanca
Dubai
Düsseldorf
Frankfurt
Hong Kong
Istanbul
London

Luxembourg
Madrid
Milan
Moscow
Munich
Newcastle
New York
Paris
Perth
Prague
Rome
São Paulo
Seoul

Shanghai
Singapore
Sydney
Tokyo
Warsaw
Washington, D.C.
Riyadh*

*Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh
Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

CLIFFORD CHANCE

This publication does not necessarily deal with every important topic nor cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street,
London, E14 5JJ

© Clifford Chance 2019

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571
Registered office: 10 Upper Bank Street,
London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications.

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or contact our database administrator by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ.

Abu Dhabi • Amsterdam • Barcelona
Beijing • Brussels • Bucharest
Casablanca • Dubai • Düsseldorf
Frankfurt • Hong Kong • Istanbul
London • Luxembourg • Madrid
Milan • Moscow • Munich • Newcastle
New York • Paris • Perth • Prague
Rome • São Paulo • Seoul • Shanghai
Singapore • Sydney • Tokyo • Warsaw
Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.