

## **Investment Firms Regulation and Directive**

The [Investment Firms Regulation](#) (“IFR”) and [Investment Firms Directive](#) (“IFD”) (together called “IFR/IFD”) have finally been published in the Official Journal of the European Union and will come into effect on 26 June 2021. The IFR/IFD is a stand-alone prudential framework that focusses on the risk profiles and business models of investment firms. The definition of investment firms in IFR/IFD is aligned to the definition in MiFID II, Article 4(1) e.g. portfolio management, investment advice etc. (***IFD Art.3***).

IFR/IFD aims to be a more proportionate and risk sensitive prudential framework than the Capital Requirements Regulation (“CRR”) and Capital Requirements Directive IV (“CRD”) (together called “CRD IV”) that some investment firms are currently subject to. Credit institutions and systemic and large investment firms will continue to be subject to CRD IV. Systemic investment firms must be re-authorised as credit institutions.

IFR/IFD covers firm classifications, own fund requirements, liquidity requirements, prudential consolidation, governance and remuneration, disclosure requirements, regulatory reporting requirements, transitional provisions and implications for AIFMs and UCITS ManCos.

### i. **Firm Classification**

Investment firms fall under separate firm classifications that dictate which prudential regime they must adhere to, and to what extent:

Class	Definition and scope	Reference	Prudential Regime
Systemic investment firms (Class 1a)	Firms which: <ul style="list-style-type: none"> <li>- Have permission of dealing on own account, or underwriting or placing financial instruments on a firm commitment basis; and</li> <li>- Have total value assets equal to or greater than EUR 30 billion.</li> </ul>	IFR Art.62 (3)(b)	CRD IV (required to be authorised as credit institutions)
Large investment firms (Class 1b)	Firms which: <ul style="list-style-type: none"> <li>- Have permission of dealing on own account, or underwriting or placing financial instruments on a firm commitment basis; and</li> <li>- Have total value assets equal to or greater than EUR 15 billion.</li> </ul>	IFR Art.1(2) & IFR Art.59	CRD IV
Other firms (Class 2)	Firms which: <ul style="list-style-type: none"> <li>- Are not Class 1a and 1b firms; and</li> <li>- Are not Class 3 firms</li> </ul>	IFR Art.12(3)	IFR
Small and non-interconnected firms (Class 3)	Firms which meet all the following conditions: <ul style="list-style-type: none"> <li>- AUM is less than EUR 1.2bn</li> <li>- Total annual gross revenue is less than EUR 30m</li> <li>- Balance sheet is less than EUR 100m</li> <li>- Client Orders Handled (COH) is less than EUR 100m per day for cash trades or EUR 1bn per day for derivatives</li> <li>- Zero client money held (CMH)</li> <li>- Zero client assets safeguarded and administered (ASA)</li> <li>- Zero daily trading flow (DTF)</li> <li>- Zero net position risk (NPR) or clearing member guarantee (CMG)</li> <li>- Zero trading counterparty default (TCD)</li> </ul>	IFR Art.12(1)	IFR (with exemption)

The IFD allows the competent authority discretion to reduce the balance sheet size threshold of large investment firms (Class 1b) from EUR 15bn to EUR 5bn (**IFD Art.5**).

## ii. Own Funds

The initial capital requirement (also known as the permanent capital requirement) will be one of the following, depending on the regulatory permissions and the activities the investment firms undertake:

Initial Capital	Activity	Reference
EUR 75,000	<ul style="list-style-type: none"> <li>- Reception and transmission of orders in relation to one or more financial instruments</li> <li>- Execution of orders on behalf of clients;</li> <li>- Portfolio management;</li> <li>- Investment advice;</li> <li>- Placing of financial instruments without a firm commitment basis;</li> <li>- Does not hold client money or assets</li> </ul>	IFD Art.9(2)
EUR 150,000	<ul style="list-style-type: none"> <li>- Activities not captured by EUR 75,000 and EUR 750,000</li> </ul>	IFD Art.9(3)
EUR 750,000	<ul style="list-style-type: none"> <li>- Dealing on own account;</li> <li>- Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis;</li> <li>- Operation of an OTF/MTF</li> </ul>	IFD Art.9(1) and (2)

IFR introduces the new K-factor capital calculation methodology. It calculates the capital requirement based on the volume of investment service activities a firm undertakes and the inherent risk posed by these services to clients, the market and the firm itself. The K-factor is a sum of the risk to clients ("RtC"), risk to markets ("RtM") and risk to firm ("RtF") (*IFR Art 15-42*).

Risk Type	K-Factor	Full Name	Definition	Coefficient / Methodology
Risk to Clients (RtC)	K-AUM	Assets Under Management	The value of assets that an investment firm manages for its clients under both discretionary portfolio management and nondiscretionary arrangements constituting investment advice of an ongoing nature.	0.02%
	K-CMH	Client Money Held	The amount of client money that an investment firm holds, taking into account the legal arrangements in relation to asset segregation.	0.4% (segregated accounts) 0.5% (non-segregated accounts)
	K-ASA	Assets Safeguarded and Administered	The value of assets that an investment firm safeguards and administers for clients, irrespective of whether assets appear on the investment firm's own balance sheet or are in third-party accounts.	0.04%
	K-COH	Client Orders Handled	Value of orders that an investment firm handles for clients, through the reception and transmission of client orders, and through the execution of orders on behalf of clients.	Cash - 0.1% Derivatives - 0.01%
Risk to Markets (RtM)	K-NPR	Net Position Risk	The value of transactions recorded in the trading book of an investment firm.	Market Risk outlined in the Capital Requirements Directive: i) Simplified Standard Approach ii) Standard Approach iii) Internal Models
	K-CMG	Clearing Margin	The amount of total margin required by a clearing member or qualifying central counterparty, where the execution and settlement of transactions of an investment firm dealing on own account take place under the responsibility of a clearing member or qualifying central counterparty.	Highest total amount of the initial margin posted to the clearing member
Risk to Firm (RtF)	K-CON	Concentration Risk	Relative to the exposures in the trading book of an investment firm to a client, or a group of connected clients, the value of which exceed the limit as set out as 25% of own funds.	Exposure Value Excess x Risk Factor
	K-DTF	Daily Trading Flow	Relative to the daily value of transactions that an investment firm enters through dealing on one account, or the execution of orders on behalf of clients in its own name.	Cash - 0.1% Derivatives - 0.01%
	K-TCD	Trading Counterparty Default	This is relative to the exposure in the trading book of an investment firm.	Exposure Value x Risk Factor

The K-factor methodology only applies to Class 2 firms; however, all firms must monitor themselves against the K-factors and the thresholds set out by IFR as they may drive a reclassification and trigger different prudential requirements.

Class 2 firms' own fund requirements are the higher of its permanent capital requirement, fixed overhead requirement ("FOR") or the sum of the K-factors. Class 3 firms' own fund requirements are the higher of its permanent capital requirement and FOR.

The definition and composition of own fund is aligned to Chapter 2 – 4 of Title 1 of Part 2 of CRR. Own funds are a sum of:

- Common Equity Tier 1 ("CET1")  $\geq 56\%$
- CET1 + Additional Tier 1 ("AT1")  $\geq 75\%$
- CET1 + AT1 + Tier 2 ("T2")  $\geq 100\%$

iii. **Liquidity**

There is a new quantitative liquidity requirement, which requires firms to hold 1/3 of its FOR as liquid assets, this applies to all Class 2 firms and competent authorities may exempt class 3 firms (*IFR Art.43*).

The definition of liquid assets is largely aligned to Commissioned Delegated Regulation on the Liquidity Coverage Ratio (2015/61), which underpins CRR and outlines the definition of high-quality liquid assets. IFR has been slightly altered from 2015/61 to reflect the business models of investment firms.

Investment firms may supplement liquid assets with unencumbered short-term deposits that are held at a bank. Class 3 firms, if not exempt, and Class 2 firms that do not deal on own account or underwrite/place financial instruments on a commitment basis may include trade debtors and fees or commissions receivable within 30 days in their liquid assets (subject to haircuts and caps).

Client guarantees to customers will reduce the liquid assets by 1.6% of the total guarantee. Firms will need to increase their liquid assets to offset the impact of guarantees (*IFR Art.45*).

iv. **Prudential Consolidation**

Firms with a parent, financial holding or mixed financial holding company in the EU are expected to meet prudential requirements on a consolidated basis (**IFR Art.7**).

There is a group test that allows lighter consolidation requirements. Investment firms may be allowed lighter requirements if they have simple structures and do not pose significant risks to clients or the market. The parents of groups that meet the requirements for the group test will be allowed to hold sufficient capital to support the book value of its subsidiaries (**IFR Art.8**).

v. **Governance and Remuneration**

The remuneration rules outlined in IFR/IFD are fairly similar to the existing framework, however there are explicit requirements that Class 2 firms must meet i.e. gender-neutral remuneration policies and at least 50% of variable remuneration must be in the form of non-cash and 40% of variable remuneration must be deferred over 3-5 years (**IFD Art.32**).

Investment firms with an average balance sheet size greater than EUR 100m (average over last 4 years) will need to establish a Risk Committee (**IFD Art.28**) and a Remuneration Committee (**IFD Art.33**).

Class 2 firms must undertake an ICAAP and have strategies and processes in place to assess and maintain adequate capital and liquidity. Competent authorities have discretion as to whether Class 3 firms are required to undertake an ICAAP (**IFD Art.24**).

Competent authorities can impose additional own funds requirements for risks that are not sufficiently addressed by the own fund requirements or if there are other deficiencies e.g. governance (**IFD Art.40**).

vi. **Disclosures**

Class 2 firms are required to make annual public disclosures from which Class 3 firms are exempt, unless they have AT1 instruments in issuance. Disclosures must be published on the same date as annual financial statements (**IFR Art.46**).

Investment firms will need to disclose:

- Business risk management and objectives;
- Internal governance arrangements;
- Own funds and own fund requirements; and
- Remuneration policies and practises including fixed vs variable remuneration, and variable remuneration paid to senior management.

Firms with a balance sheet size greater than EUR 100m must disclose information on their investment policy i.e. shares directly held, voting guidelines and ESG risks (*IFR Art.52-53*).

vii. **Regulatory Reporting**

Class 2 firms have new regulatory reporting requirements (*IFR Art.54*), that must be reported quarterly to the competent authorities:

- Amount and decomposition of own funds;
- Own funds requirements;
- Own funds requirements calculations;
- Assessment against K-Factors;
- Concentration risk; and
- Liquidity requirements.

Class 3 firms must report on an annual basis and are not subject to either the concentration risk or liquidity requirements reporting (per the competent authority's discretion).

Investment firms that have regulatory permissions to deal as principal or place/underwrite financial instruments on a commitment basis is required to report total assets on a quarterly basis if their balance sheet size is equal or greater than EUR 5bn (*IFR Art.55*).

viii. **Transitional Provisions**

IFR outlines transitional provisions that provide an upper cap on own funds requirements for a period of 5 years from 26 June 2021 (*IFR Art.57*).

- Investment firms subject to CRR capital framework, are limited to twice their existing own funds requirement.
- For Investment firms that are only subject to initial capital requirements, their own funds requirements are capped at twice their initial capital requirements.
- For new investments firms, that did not exist prior to the date IFR/IFD comes into effect, their own funds requirement will be capped at twice their FOR.

ix. **AIFM and UCITS ManCos**

IFD stipulates that AIFMs and UCITS ManCos own funds requirements can never be less than the fixed overhead requirement outlined by IFR Article 13 (***IFD Art.60-61***).

*If you have any comments on this article, or any questions in general, then please speak to your usual Optima consultant or contact us at [info@optimapartners.com](mailto:info@optimapartners.com)*



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