ALLEN & OVERY

New Prudential Regime for Investment Firms

September 2020

1. Firm classification

Overview

One of the key changes introduced by the Investment Firm Regulation (**IFR**) and the Investment Firm Directive (**IFD**) will be to create new prudential categorisation of investment firms. The IFR/IFD creates four new categories of firms.

(i) Systemically important investment firms – often referred to as 'Class 1A firms' – this category covers those investment firms that are considered to be sufficiently important to the orderly functioning of financial markets that they should be reclassified as credit institutions and be subject to the prudential requirements contained in the Capital Requirements Regulation (**CRR**) and the Capital Requirements Directive (**CRD**).

(ii) (Large) investment firms – often referred to a 'Class 1B firms' – these are large investment firms that deal on own account and/or carry out underwriting/placing on a firm commitment basis (MiFID activities (3) and/or (6)) but which are not of the same systemic importance as the Class 1A firms. This category of firms will remain subject to the prudential requirements contained in the CRR and CRD.

(iii) Investment firms – often referred to as 'Class 2 firms' – these are non-systemic investment firms that do not carry out dealing on own account or underwriting activities. This category of firms is subject to the full scope of the prudential regime is set out in the IFR and IFD.

(iv) Small and non-interconnected investment firms – often referred to as 'Class 3 firms' these are very small investment firms with 'non-interconnected' services. This class of firms is subject to a more 'light touch' regime under the IFR/IFD which is proportionate to the risks that the firms pose to the public and the financial markets.

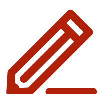
Of these categories, Class 2 firms will be most heavily impacted by the new prudential regime set out in the IFR/IFD. For the other firms, there will be fewer new obligations to comply with, although all in-scope investment firms will be required to measure and report against the new thresholds for each category of investment firm.

This bulletin sets out the tests for each class of firm, together with the areas of the new regime that are relevant to the different classes.

Source materials

(i) IFR Articles 1, 12, 55, 58 and 62

(ii) European Banking Authority Consultation Paper EBA/cp/2020/06 setting out Draft Technical Standards dated 4 June 2020



(iii) Financial Conduct Authority Discussion Paper DP 20/2 dated June 2020

(iv) HM Treasury (**HMT**) policy statement "Prudential standards in the Financial Services Bill: June update"

Thresholds

(a) Class 1A firms

IFR amends the CRR definition of credit institution to include an investment firm that:

(i) carries out MiFID activities (3) and/or (6); and

(ii) has consolidated assets equal to or greater than EUR30 billion; or

(iii) has consolidated assets with a value that is less than EUR30bn, but the firm is part of a group in which the total value of the consolidated assets of all undertakings in that group that individually have total assets of less than EUR30bn and which carry out MiFID activities (3) and/or (6) is equal to or exceeds EUR30bn; or

(iv) have assets whose total value is less than EUR30bn, but where the firm is part of a group in which the total value of the consolidated assets of all undertakings in the group that carry out MiFID activities (3) and/or (6) is equal to or exceeds EUR30bn, where the consolidating supervisor, in consultation with the supervisory college, so decides in order to address potential risks of circumvention and potential risks for the financial stability of the Union.

Class 1A firms must apply for authorisation under CRD as a credit institution and will be directly supervised by the European Central Bank (**ECB**) if they are established in the Eurozone.

Where a firm falls below the relevant thresholds for a period of five years, competent authorities can change the categorisation of systemically important investment firms back from credit institutions to investment firms (ie from Class 1A to Class 1B).

It is important to note that in the UK, HMT has decided that it will not be adopting the Class 1A categorisation, but will instead be maintaining the pre-existing designation regime for regulating systemically important investment firms.

(b) Class 1B firms

IFR Article 1(2) defines Class 1B firms as those investment firms that:

(i) carry out MiFID activities (3) and/or (6);

(ii) are part of a group where the combined total value of the assets of all undertakings in the group that carry out any of the activities of dealing on own account or underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis (or both) and have total assets below EUR15bn exceeds EUR15bn; and

(iii) have been determined by the relevant competent authority, in accordance with IFD Article 5, as satisfying the two criteria above and are sufficiently systematically important to be considered to be Class 1B firms.

Class 1B firms will fall into Class 2 if they no longer meet the thresholds calculated over a period of 12 consecutive months or their competent authority decides that they should be reclassified.

Class 2 firms will be elevated to Class 1B where they cross the relevant thresholds on an average over 12 months or where the relevant competent authority decides. Should a firm cross a relevant threshold then they must notify their competent authority (though no approval is required). Class 2 firms that are part of a consolidated banking group under CRR may also apply to their national competent authorities to be classified as Class 1B firms (subject to meeting requirements under IFR Article 1(5)).

(c) Class 2 firms

Class 2 firms are all those investment firms that:

(i) do not meet the special criteria for any of the other classes of firm; and

(ii) have not received approval to be treated as a Class 1B firm in accordance with IFR Article 1(5).

A Class 2 firm may become a Class 3 firm if it ceases to meet the Class 2 firm criteria for a continued period of at least six months. It is necessary for firms changing their categorisation to notify their competent authority, although no formal approval is required.

(d) Class 3 firms

IFR Article 12(1) sets out that Class 3 firms are those investment firms for whom a set of risk measures are below certain thresholds – with the result that those investment firms should be relatively low risk and therefore should be subject to less onerous prudential regulation. For an investment firm to be a Class 3 firm, it is necessary for it to satisfy each of the following requirements:

(i) K-AUM – Assets under management of less than EUR1.2bn or more on a combined basis across all investment firms within the group (calculated at end-of-day);

(ii) K-COH – Client orders handled of less than EUR100 million/day for cash trades or EUR1bn/day for derivatives on a combined basis across all investment firms within the group (calculated at end-of-day);

(iii) K-ASA – Client assets safeguarded and administered is zero on a solo entity basis (end-of-day);

(iv) K-CMH – Client money held is zero on a solo entity basis (intra-day);

(v) K-DTF – Daily trading flow and net position risk is zero on a solo entity basis (end-of-day);

(vi) K-NPR – Net position risk is zero on a solo entity basis (end-of-day);

(vii) K-CMG – Clearing margin given is zero on a solo entity basis (intra-day);

(viii) K-TCD – Trading counterparty default is zero on a solo entity basis (end-of-day);

(ix) On and off balance sheet total of less than EUR100m (based on previous financial year data) on a combined basis across all investment firms within the group; and

(x) Total gross revenues from investment services and activities of less than EUR30m (based on previous financial year data) on a combined basis across all investment firms within the group.

Where a Class 3 firm breaches any one of the following criteria it will immediately be classified as a Class 2 firm:

(i) K-ASA – Client assets safeguarded;

(ii) C-CMH – Client money held;

(iii) K-NPR – Net position risk;

(iv) K-CMG – Clearing margin given; or

(v) K-TCD – Trading counterparty default.

A Class 3 firm must breach one of the following criteria for a sustained period of three months for it to be reclassified as a Class 2 firm:

(i) K-AUM – Assets under management;

(ii) K-COH – Client orders handled;

(iii) On and off balance sheet total; or

(iv) Total gross revenues.

Which aspects of the IFR/IFD are relevant to each class of firm?

(a) Class 1A firms

Outside of the UK, large investment firms that may be categorised as systemically important will need to engage with their supervisor in advance of submitting an application for reauthorisation as a credit institution by 27 December 2020. Any firms that are re-authorised as credit institutions will also be subject to direct supervision by the ECB and subject to the single supervisory mechanism going forward (including consolidated supervision as relevant) to the extent they are established in the Eurozone.

(b) Class 1B firms

Class 1B firms will remain subject to the CRR/CRD. The key new IFR/IFD obligation for these firms is the threshold-reporting regime set out in Article 55 of the IFR. This requires Class 1B firms to report to their competent authority against the threshold criteria set out in section 3 above.

(c) Class 2 firms

Class 2 firms are the category of firms most impacted by the new regime set out in IFR/IFD. They will be subject to the new IFR/IFD regime in the following key areas:

(i) regulatory capital and liquidity requirements, including using the new K-factors for calculating capital requirements;

(ii) governance;

(iii) remuneration;

(iv) regulatory reporting; and

(v) public disclosure.

(d) Class 3 firms

Class 3 firms are not subject to a number of the IFR/IFD modules that impact Class 2 firms. Where Class 3 firms are subject to specific requirements set out in the IFR/IFD, they are often subject to a less onerous version of the module. The key areas that will impact Class 3 firms are:

(i) regulatory capital and liquidity requirements (although competent authorities can exempt Class 3 firms from liquidity requirements);

(ii) regulatory reporting; and

(iii) public disclosure (for firms that issue AT1 capital instruments).

Practical next steps for firms

A firm's classification under the IFR/IFD is the key factor for determining how the new regime will impact that firm going forward. Therefore the most important immediate step for firms is to carry out their internal assessments against the criteria to determine what category of firm they will be under the new regime. To be able to do this, firms may need to build new monitoring systems to capture the necessary data. These systems will also be able to be used for ongoing monitoring purposes as required under the new regime. Firms should note that because some of the thresholds are based on group-wide metrics, the corresponding data will need to be monitored and assessed on a group-wide basis.

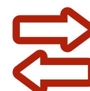
When determining their future classification, firms may wish to take a more nuanced view than simply looking at the different criteria and then measuring against the relevant data. Firms that would (based on the quantitative criteria) be a Class 2 firm may wish to consider the benefits and disadvantages of opting up to a Class 1B firm if they are already within a group subject to consolidation under CRR. Equally, firms may wish to consider the impacts that different group restructurings or new business lines could have on their future classification.

Once firms have determined their classification, they can begin their scoping exercise to determine which modules will be relevant. This information can then be used as the basis for implementation project planning.

To summarise, firms should:

Determine the firm's prudential classification under IFR/IFD

Set-up systems and controls to monitor data against applicable thresholds



Class 2 firms operating within banking groups should consider whether to opt-up to Class 1B

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