Grant Thornton | Investment Firms Regulation and Directive

The Regulation & Directive were published in November 2019, defining a new prudential regime for investment firms that is due to take full effect from June 2021. The new regime has been brought in to provide a specific prudential framework for investment firms in the EU, with "small and non-interconnected" firms (firms meeting a number of specific conditions, including for Daily Trading Flow, Assets Under Management and Net Position Risk) to benefit from a more proportional regulation.

The requirements set out in the new regime apply to investment firms authorised and supervised under Markets in Financial Instruments Directive (MiFID II). However, there are a number of derogations in place, particularly relating to systemically relevant firms continuing to fall under the Capital Requirements Regulation (CRR) and Directive (CRD IV) regime. It is also noted that there are exemptions that could be applied, mainly based on firms qualifying as "small and non-interconnected" and being subsidiaries of a group.

The four key areas below outline what is expected from firms in order to be compliant with the new prudential regime.

1 - Minimum Capital and Own Funds

Minimum capital requirements are aligned with initial capital requirements, whereby the permanent minimum capital requirement amounts to at least the specific level of initial capital required. The breakdown of these requirements is included in the below table:

MiFID II (Annex I) services provided or activities performed:	**Capital Requirement**
One or more of the following:	**EUR 750,000**
(3) Dealing on own account; (6) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.	
(9) Operation of an OTF, where that investment firm engages in dealing on own account or is permitted to do so	**EUR 750,000**
One or more of the following:	**EUR 75,000**

(1) Reception and transmission of orders in relation to one or more financial instruments;	
(2) Execution of orders on behalf of clients; (4) Portfolio management;	
(5) Investment advice;	
(7) Placing of financial instruments without a firm commitment basis; and which is not permitted to hold client money or securities belonging to its clients.	
All other firms	**EUR 150,000**

A number of new requirements in relation to own funds are introduced. The first requirement is the use of the figure 'D' in own funds composition, with specific percentages to be met at all times. 'D' will be the highest of the items outlined in the below table:

Calculation Methods	**IFR Reference**
Firm's fixed overheads requirement (at least one quarter of the fixed overheads of the preceding year)	**Art. 13**
Firm's permanent minimum capital requirement (at least the level of required initial capital)	**Art. 14**
Firm's K-factor requirement	**Art. 15**

The second requirement is the use of new risk parameters in the form of "K-factors" (Risk-to-Firm, Risk-to-Client, Risk-to-Market) for the calculation of capital requirements. The K-factor methodology aims to capture the range of risks an investment firm can pose. In addition, the K-factors are used to determine whether an investment firm is to be classified as a small, non-interconnected company.

Risk-to-Firm	
K-TCD	**Trading Counterparty Default risk (TCD)** Relative to the exposure in the trading book of an investment firm
K-DTF	**Daily Trading Flow (DTF)** 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
K-CON	**Concentration Risk (CON)** Relative to the exposures in the trading book of an investment firm to a client, or a group of connected clients
Risk-to-Client	
K-AUM	**Assets Under Management (AUM)** Value of assets that an investment firm manages for its clients under discretionary portfolio management and non-discretionary arrangements constituting investment advice
K-CMH	**Client Money Held (CMH)** Amount of client money that an investment firm holds or controls
K-ASA	**Assets Safeguarded and Administered (ASA)** Value of assets that an investment firm safeguards and administers for clients
K-COH	**Client Orders Handled (COH)** 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

Risk-to-Market	
K-NPR	**Net Position Risk (NPR)** Value of transactions recorded in the trading book
K-CMG	**Clearing Member Guarantee (CMG)** Amount of initial margins posted with a clearing member, where the execution and settlement of transactions of an investment firm dealing on its own account take place under the responsibility of a general clearing member

It is important for firms to note that the composition of their initial capital will need to be established in accordance with the rules laid out regarding own funds composition.

2 - Liquidity

Investment firms are not subject to specific liquidity requirements; however, this regime introduces a requirement for firms not classified as small and non-interconnected to hold liquid assets equivalent to at least one third of the fixed overhead requirement. A further consideration for firms is the asset types that are permitted for use in the liquidity requirement calculation.

Overall, this could lead to a change in the approach for managing liquidity and a further implication on monitoring requirements.

3 - Governance and Remuneration

The provisions on governance and remuneration are a revised version of the requirements currently set out from Article 74 to 96 of CRD IV. Governance arrangements incorporating the following aspects will need to be embedded by firms, with this potentially requiring a gap analysis to identify necessary changes to existing processes:

- a clear organisational structure, including well-defined, transparent and consistent lines of responsibility;
- effective processes to identify, manage, monitor and report risks;
- adequate internal control mechanisms in line with the risks identified

Additionally, remuneration policies and practices will need to be consistent with and promoting sound and effective risk management. This is to include the establishment of a remuneration committee and methods to ensure appropriate composition of variable remuneration, where certain criteria are met.

The above provisions will require investment firms to reassess their current approach to governance; this assessment should aim to create a holistic approach to the risks faced by firms.

4 - Reporting and Public Disclosure

The new prudential regime prescribes a more comprehensive set of quarterly reporting to the relevant national competent authority, including level and composition of own funds, concentration risk and liquidity requirements.

It will be then necessary to publicly disclose information on risk management objectives and policies, governance standards, capital resources and requirements, remuneration policies and practices and the firm's investment policy on an annual basis.

While the new regime promotes transparency in the market, investment firms may face an additional reporting burden with potential considerations from an operational point of view (e.g. IT infrastructure, staff resources, etc.).

Why Grant Thornton?

To help your firm with the implementation of the new prudential framework, leverage Grant Thornton's prudential risk experts that already assist a diverse range of investment firms. Our prudential risk team has extensive knowledge of the relevant legislation and guidance and the challenges these pose to your firm.

Our experts could help your firm assess its regulatory requirements arising from the new regime and advise on methods to ensure full compliance with it.