FINANCIAL REGULATION

Investment Firms: New prudential rules will apply from 26 June 2021

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MiFID investment firms will be subject to a new prudential regime from 26 June 2021 under the Investment Firms Directive and Investment Firms Regulation. Firms will be classified by reference to asset-levels, activities and systemic importance, with the largest systemic firms needing re-authorisation as credit institutions. Regulatory activity is increasing in advance of the new regime, with the Central Bank of Ireland launching a consultation and the EBA progressing the key actions set out in its June 2020 Roadmap.

BACKGROUND

From 26 June 2021, a new prudential regime will apply to Markets in Financial Instruments Directive (**MiFID**) investment firms across the EU. The changes are being introduced by the Investment Firms Regulation (**IFR**) and the Investment Firms Directive (**IFD**).

The core aim of the IFR/IFD is to introduce more proportionate rules for all MIFID investment firms in relation to capital, liquidity and other risk management requirements, while ensuring a level-playing field between large and systemic financial institutions.

While the IFR will be directly applicable across the EU once it enters into force in full, Member States must implement the IFD into national law by way of domestic legislation. Implementing legislation for Ireland has not yet been published.

CLASSIFICATION

Which of the new rules will apply to a particular MiFID investment firm will depend on that firm's classification under the new IFR/IFD regime.

Depending on their size and certain other factors, under the IFR/IFD investment firms will be classified as follows:

CLASSIFICATION	NOTES
'Class 1'	Systemically important firms that are authorised to deal on own account and/or underwrite or place financial instruments on a firm commitment basis and whose total assets exceed €30 billion (individually or on a group basis) will be **'Class 1'** firms. **'Class 1'** firms will be required to be authorised as credit institutions, subject to direct supervision by the European Central Bank under the Single Supervisory Mechanism. They will be regulated from a prudential perspective under the existing Capital Requirements Regulation (**CRR2**)/Capital Requirements Directive (**CRDV**) regime.
'Class 1 minus'	**'Class 1 minus'** firms are firms that are authorised to deal on own account and/or underwrite or place financial instruments on a firm commitment basis and whose total value of consolidated assets exceeds €15 billion but does not meet the €30 billion **'Class 1'** threshold. National competent authorities (**NCAs**) will also be able to classify firms that carry on *'bank-like'* activities but whose consolidated assets are between €5 billion and €15 billion as **'Class 1 minus'** firms. There will be no requirement for these **'Class 1 minus'** firms to re-authorise as a credit institution (unlike **'Class 1'** firms), but they will nonetheless be subject to the more onerous prudential and remuneration requirements under CRR2/CRDV.
'Class 2'	Firms that are not systemically important but that hold a particular level of own funds will be classified as **'Class 2'**. These firms will need to comply with the new IFR/IFD regime (rather than CRR2/CRDV), unless they are part of a group that is subject to consolidated supervision under the CRR2/CRDV regime.
'Class 3'	Small and non-interconnected investment firms that do not meet certain thresholds and do not hold client assets will be classified as **'Class 3'**. These firms will need to comply with the new IFR/IFD regime (save for the remuneration requirements), unless they are part of a group that is subject to consolidated supervision under the CRR2/CRDV regime.

CAPITAL REQUIREMENTS

IFD sets new initial capital requirements for all MiFID investment firms, which will depend on their activities.

As explained above, **'Class 1'** and **'Class 1 minus'** firms will remain subject to the CRR2/CRDV regime in relation to ongoing capital requirements. **'Class 2'** and **'Class 3'** firms will be subject to the new IFR/IFD requirements in relation to the calculation of their ongoing capital.

'Class 2 'firms will be subject to new risk-based regulatory capital requirements. They will be required to hold minimum own funds based of the higher of their permanent minimum capital requirement, their fixed overhead requirement or a new *'K-factor'* own funds requirement (a directly proportional capital requirement based on the specific risks investment firms face and the risks they pose to customers/markets (effectively a series of risk parameters/indicators).

'Class 3' firms will be required to hold minimum own funds based on the higher of their permanent minimum capital requirement or their fixed overhead requirement (they will not be subject to the new *'K-factor'* requirement).

IFR/IFD also introduces new liquidity rules, ICAAP requirements and detailed disclosure rules (including under Pillar 3 and in relation to environmental, social and governance (**ESG**) risks) and new remuneration rules (described below).

In a similar manner to CRR2/CRDV, IFR/IFD requires relevant **'Class 2'** and **'Class 3'** firms to comply with capital requirements, disclosure and reporting on a consolidated basis unless the competent authority grants a waiver from such requirements.

REMUNERATION

Categorisation

At present, CRR2/CRDV-scope MiFID investment firms are subject to the CRR2/CRDV remuneration requirements.

Under IFR/IFD, this will change as MiFID investment firms will fall into one of three separate categories for remuneration purposes:

- **'Class 1'** firms and **'Class 1 minus'** firms will remain subject to the CRR2/CRDV remuneration regime
- **'Class 2'** firms will be subject to the new IFR/IFD remuneration regime
- **'Class 3'** firms will not be subject to the new IFR/IFD remuneration regime and will be subject to the high-level MiFID requirements

The new remuneration rules applicable to **'Class 2'** firms will apply to all staff whose professional activities have a material impact on the firm's risk profile: senior management, risk takers, control functions, and employees receiving overall remuneration equal to at least the lowest remuneration of any risk taker or member of senior management.

Gender Balance

As an overarching requirement, all firms with on and off-balance sheet assets exceeding €100 million must have a gender-balanced remuneration committee (which can be established at group level) whose members must not hold executive roles in the firm.

Variable Remuneration

The following types of variable remuneration will be affected by the new remuneration rules:

TYPE OF VARIABLE REMUNERATION	IMPACT
Fixed to variable remuneration ratio	Firms must set a ratio between fixed and variable remuneration and make provision for cases in which paying variable remuneration would be inappropriate. Member States will be allowed to cap variable remuneration in their IFD implementing legislation, but the IFD does not (unlike the existing CRR2/CRDV regime) provide for an express bonus-cap.
Guaranteed bonuses	These may only be awarded by firms, with a strong capital base, to new staff in their first year of employment.
Pay-out (payment in shares and equivalent interests)	50% or more of the variable element of remuneration must be paid in certain instruments (e.g. shares or equivalent ownership interests), and such instruments must be connected to the firm's retention policy. Member States may limit the types and designs of these instruments or ban certain instruments, as appropriate.
Malus and clawback	Malus and clawback requirements will apply to variable remuneration.
Deferral	40% or more (or at least 60% in cases of *'high'* pay-outs) of the variable remuneration must be deferred over a period of 3 to 5 years, vesting pro-rata.
Discretionary pension benefits	Where employees leave a firm before reaching retirement, the firm must hold discretionary pension benefits for 5 years in the form of instruments. If an employee reaches retirement, benefits must be paid as instruments which are subject to a 5-year retention period.
Payments on termination	These payments may not be used to reward failure or misconduct on behalf of the employee.
Proportionality	Firms are free to dis-apply the rules on pay-out and deferral if: • the value of firm's on and off-balance sheet assets are on average equal to or less than €100 million over the 4-year period immediately preceding the given financial year; and • the individual's variable remuneration does not exceed €50,000 and does not represent more than one quarter of the individual's total annual remuneration.

DISCLOSURES AND REPORTING

Firms will be required to disclose detailed information depending on their classification. This will include:

- information on internal governance arrangements, such as the number of directorships held by members of the management body and details of the diversity policy relevant to selection for membership of the firm's management body;
- ESG risks including physical risks and transition risks;
- details on the firm's own funds and compliance with its own funds requirements;
- remuneration policy and practices, including aspects related to gender neutrality and the gender pay gap, the level of variable remuneration and the ratios between fixed and variable remuneration; and
- details of the firm's investment policy, such as the proportion of voting rights attached to the shares held directly or indirectly by the investment firm, broken down by Member State and sector.

Firms will be also required to report to their NCA details of the number of staff that receive remuneration of €1 million or more in any given financial year, including information on their job responsibilities, business area and details relating to salary, bonus, long-term award and pension contribution.

COMMENT

The new IFR/IFD requirements will introduce significant changes for many investment firms. With exactly 5 months to go until the implementation date, firms should be progressing their implementation projects and re-authorisation applications.

WHAT'S NEXT?

- **Irish Legislation**

  It is unclear when the Department of Finance will issue the domestic implementing legislation, albeit work is underway. In 2020, the Department of Finance ran a consultation (which closed on 6 July 2020) on the national discretions available under the IFD, which are centred on variable remuneration.

- **Central Bank Consultation**

  The Central Bank began its consultation on competent authority discretions on 14 January 2021, in anticipation of being designated as the Irish NCA. Among the Central Bank's proposals are:

  - to maintain the discretion to, on a case-by-case basis, designate certain investment firms as **'Class 1 minus'** where the relevant firm carries out *'bank-like'* activities on such a scale that its failure or distress could lead to systemic risk, or where the firm is a clearing member that offers its clearing services to other financial sector entities which are not clearing members themselves, or where the Central Bank considers that classification to be justified in light of the size, nature, scale and complexity of the activities of the investment firm concerned;
  - to prevent investment firms from having a qualifying holding which exceeds 15% of own funds or total qualifying holdings which exceed 60% of own funds, in each case in undertakings that are not financial sector entities;
  - to allow 'Class 2' firms (which would otherwise be subject to the IFR/IFD) that are supervised on a consolidated basis with a credit institution to continue to apply the CRR prudential requirements;
  - to only exempt 'Class 3' firms on an exceptional basis from the requirement to hold one-third of their fixed overhead requirement in liquid form; and
  - to require all 'Class 3' firms to perform an assessment of internal capital and liquid assets.

  The consultation will close on 26 March 2021. Once the Central Bank has reviewed the feedback from this consultation, it will publish a regulatory notice on 'Implementation of NCA Discretions in IFD/IFR' by the end of June 2021, setting out its approach to the various discretions.

  The Central Bank also plans to consult on some of the changes arising from the CRR2/CRDV regime later in 2021 – this will impact both **'Class 1'** and **'Class 1 minus'** firms.

- **EBA Roadmap**

  The EBA published its Roadmap on Investment Firms in June 2020, which summarises its key mandates under IFR/IFD which span six areas:

THRESHOLDS AND CRITERIA
A particular focus is the transition of **'Class 1'** investment firms to *'credit institution'* status.
REPORTING AND DISCLOSURES
The area of reporting covers own funds, minimum capital levels, concentration risk, liquidity requirements, levels of activity for **'Class 3'** firms, and the reporting requirements for **'Class 1 minus'** firms. The area of disclosures covers capital resources, capital requirements, remuneration policies and practices, governance standards, own funds and investment policy.
SUPERVISORY CONVERGENCE AND SREP
The EBA's strategy will include a focus on anti-money laundering/countering the financing of terrorism, the consistent and proportionate application of Pillar 2 methodologies across the EU, and ensuring cross-sectoral consistency between supervisory cooperation, the SREP and the Pillar 2 framework under CRDV and the IFD.
CAPITAL REQUIREMENTS AND COMPOSITION
A key focus is the measuring methodology for each of the *'K-factor'* calculations.
REMUNERATION AND GOVERNANCE
The EBA is focused on ensuring consistency between the governance and remuneration framework under the IFD and CRDV, while taking into account the requirements contained in the Alternative Investment Fund Managers Directive and the UCITS Directive.
ESG FACTORS AND RISKS
The EBA's ESG mandate under IFR/IFD is similar to its ESG mandate under CRR2/CRDV (covering common definitions, risk management tools, prudential treatment and disclosures) and it is exploring synergies between the two.

The EBA plans to deliver on its mandate in four stages – while it plans to complete much of its work by December 2021, aspects of its work on supervisory convergence, SREP and ESG are pencilled in for 2022-2025, although work on Pillar 2 add-ons and an initial report on ESG risks are to be delivered by the end of 2021.

To date, it has launched a consultation on guidelines on sound remuneration policies under IFD, a consultation on internal governance under IFD, and a package of seven draft RTS covering matters such as the calculation of regulatory capital requirements, identifying firms on the basis of their systemic importance and the information needed to support an application by a firm for authorisation as a credit institution.

On 21 January 2021, it also announced the publication of final draft RTS on classes of instrument that can be used for variable remuneration, and on criteria for the identification of categories of staff whose professional activities have a material impact on a firm's risk profile or the assets that it manages.

KEY CONTACTS

If you require advice or assistance in relation to the application or impact of IFR/IFD on your firm, please contact any of the following:

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