INVESTMENT COMPANY INSTITUTE

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European Commission Issues Legislative Proposals for a New Prudential Regime for Investment Firms

[31012]

January 9, 2018 TO: ICI Global Brexit Task Force
ICI Global EU Capital Markets Union Task Force
ICI Global Regulated Funds Committee RE: European Commission Issues Legislative Proposals for a New Prudential Regime for Investment Firms

On December 20, 2017 the European Commission (EC) published a proposal for a regulation[1] and a proposal for a directive[2] to amend the current European Union (EU) prudential rules for investment firms (the proposals).

These legislative proposals follow from the European Banking Authority's (EBA) Opinion and related report containing final recommendations for the EC regarding the design and calibration of a new prudential framework for EU investment firms.[3]

If adopted by both the co-legislators, these legislative texts would design the following framework:

Removing most investment firms from the scope of the banking prudential regime

The proposals seek to amend the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR) to remove most investment firms from their scope. Indeed, the purpose of the initiative is to remove investment firms from the complex and disproportionate application of a framework which was designed to capture the risks of banks, and base their prudential requirements on the specific and most relevant risks they pose for customers and markets. Investment firms which are part of a banking group will remain subject to the provisions in the CRR/CRD framework which are relevant for the banking group, such as the rules on prudential consolidation.

However, in an exception to this sensible approach, the EC proposes that the EBA will retain primary competence for the coordination and convergence of supervisory practices in the area of prudential supervision over investment firms, with “only” close cooperation with the European Securities and Markets Authority (ESMA).

Classification of investment firms

The proposals classify investment firms in three classes:

Class 1 “systemic investment firms”:

Unlike the EBA’s advice, which was to develop detailed Level 2 regulation for the identification of Class 1 systemic investment firms, the EC proposes that this identification is more appropriately done at Level 1. The EC explains that the background of Brexit and the backdrop of UK-based systemic investment firms relocating to the EU27 makes this option the most appropriate. In addition, the EC suggests amending the definition of "credit institution" in the CRR/CRD IV to cover these systemic investment firms based on the nature and size of investment services they provide.[4] Although the EC correctly notes that these firms would continue to apply the current CRD/CRR framework, this approach would bring Class 1 investment firms under the scope of the Single Supervisory Mechanism (SSM)[5] and, for those established in Member States participating in the Banking Union (Eurozone), subject them to the prudential supervision by the European Central Bank.

Class 2 “non-systemic investment firms”

Class 2 is expected to be the largest category. These non-systemic firms would fall out of the CRR/CRD framework and would have to be authorized under MiFID II.

Class 3 “small and non-interconnected investment firms”:

These firms are defined as those not authorized to safeguard and administer client assets, hold client money or deal for their own account, or which have assets under management[6] less than EUR 1.2 billion, and do not cross other thresholds.

Minimum Capital, Initial Capital, and Own Funds

The EC’s proposals do not go beyond the EBA’s recommendations for Class 2 and Class 3 investment firms. Thus, Class 2 firms would be subject to a minimum Pillar 1 capital requirement equal to the higher of: (1) Initial Capital/Permanent Minimum Capital requirement; (2) Fixed Overheads requirement; and (3) capital requirements determined by a new “k-factors” formula. For example, K-AUM (Assets under Management), would consist of assets under management relating to all investment management customers, managed on both a discretionary and non-discretionary basis.

The metric includes AUM that the firm in question has delegated to another firm, but excludes AUM that another firm has delegated to it.

Brexit-related issues: third country equivalence

The EC’s proposals also address the issue of third-country equivalence, presumably with an eye to Brexit. Where the services provided by a third-country firm are likely to be of systemic importance in the EU, a more rigorous/granular assessment of equivalence will be required. This seems intended to ensure that the rules and supervision to which the third-country firm is subject will remain closely aligned with the rules and supervision to which EU firms are subject.

In a move similar to the ESAs review[7], ESMA would be tasked with monitoring the regulatory and supervisory developments, enforcement practices and other relevant market developments in third countries for which equivalence decisions have been adopted.

In addition, non-EU firms will have to report to ESMA on an annual basis the scale and scope of services provided and activities carried out in the EU, as well as how they comply with investor protection and risk management requirements.

Governance and remuneration: no bonus cap

The proposals put forward rules on corporate governance and remuneration in order to ensure the orderly functioning of investment firms and to prevent excessive risk-taking by their staff.

The EC acknowledges that these rules ought to reflect the differences in risks posed by credit institutions and investment firms and to ensure the consistency of remuneration and governance rules across the different pieces of legislation, including CRD IV, Directive 2009/65/EC (UCITS) and 2011/61/EU (AIFMD).

Consequently, the proposals do not set a specific limit on the ratio between variable and fixed components of variable remuneration. There is no bonus cap for Class 2 and Class 3 investment firms. Class 2 investment firms would be required to set appropriate ratios themselves.

Next steps

The proposals will be examined and discussed by the European Parliament and Council under the Bulgarian presidency over the first half of 2018. Although the EC did not indicate any date of entry into force, our understanding is that the EC would like these proposals to be adopted by the co-legislators by the end of its current mandate (mid-2019).

We encourage members to evaluate how the proposed rules would affect their firms if adopted, and to contact us promptly with any comments or concerns. This information will assist us in determining our strategy and the next steps of engagement with policymakers. Please direct any feedback to Patrice Bergé-Vincent by email (patrice@iciglobal.org) or telephone (direct: +44 (0)20 7961 0833; mobile: +44 (0)7795 514 841).

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endnotes

[1] *See*: Proposal for a regulation on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010

[2] *See*: Proposal for a directive on the prudential supervision of investment firms and amending Directives 2013/36/EU and 2014/65/EU

[3] *See* ICI Global Memorandum No. 30916: EBA Issues Opinion and Report on New Prudential Regime for EU Investment Firms

[4] The proposals would amend the definition of "credit institution" to include a firm that undertakes to deal for its own account, engage in underwriting, or place financial instruments on a firm commitment basis, where the total value of the assets of the undertaking, or the group to which it belongs, is EUR 30 billion or more. This definition

would exclude collective investment undertaking (funds).

[5] The Single Supervisory Mechanism (SSM) refers to the system of banking supervision in Europe. It comprises the ECB and the national supervisory authorities of the participating countries. See: Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010

[6] This notion encompasses both discretionary portfolio management and non-discretionary (advisory) arrangements

[7] *See* Memorandum No. 30901: EU Commission Proposed Regulation to Reform the European System of Financial Supervision