

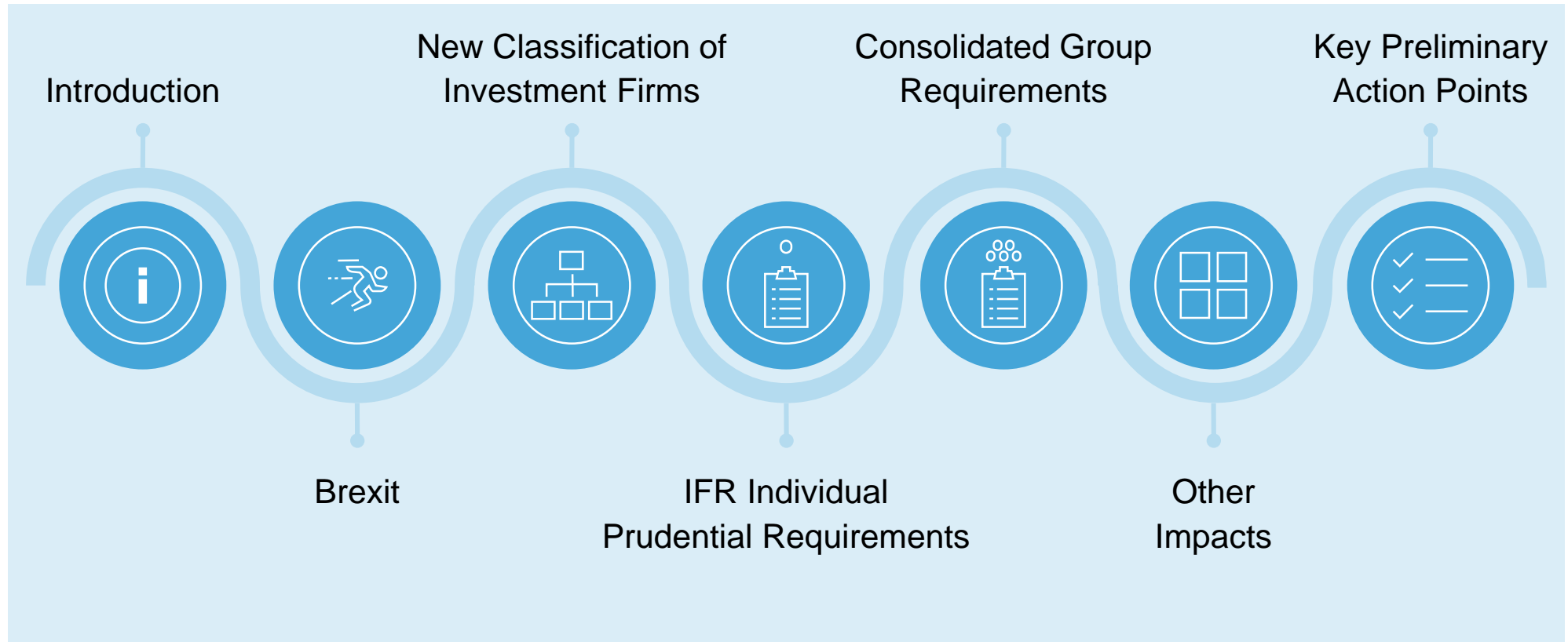
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CHANCE



**IFR/IFD: THE NEW EU PRUDENTIAL REGIME
FOR INVESTMENT FIRMS**

FIA WEBINAR
MARCH 2020

AGENDA

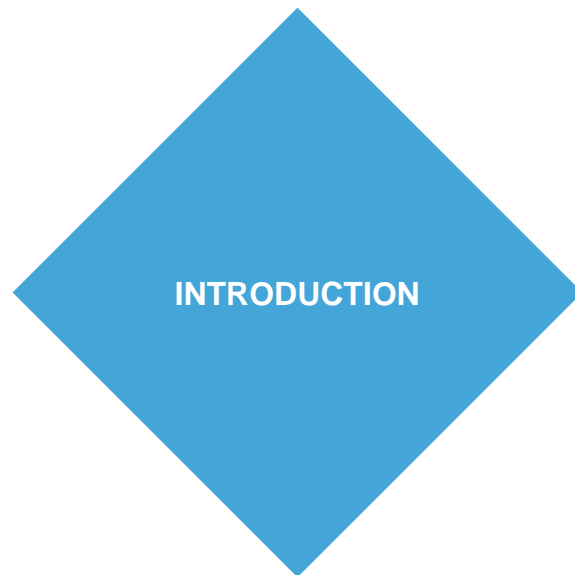
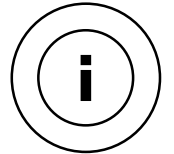


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INTRODUCTION

A NEW REGIME FOR EU INVESTMENT FIRMS



The new EU Investment Firm Regulation and Directive (**IFR/IFD**) introduce, from June 2021, a new harmonised prudential regime impacting all investment firms authorised in the EU under MiFID.

FCA plans to consult on a new post-Brexit regime for UK investment firms which may be aligned with IFR/IFD.

Currently, EU investment firms are subject to the Basel-derived CRR/CRD or national regimes (e.g., FCA BIPRU or IPRU(INV) regime).

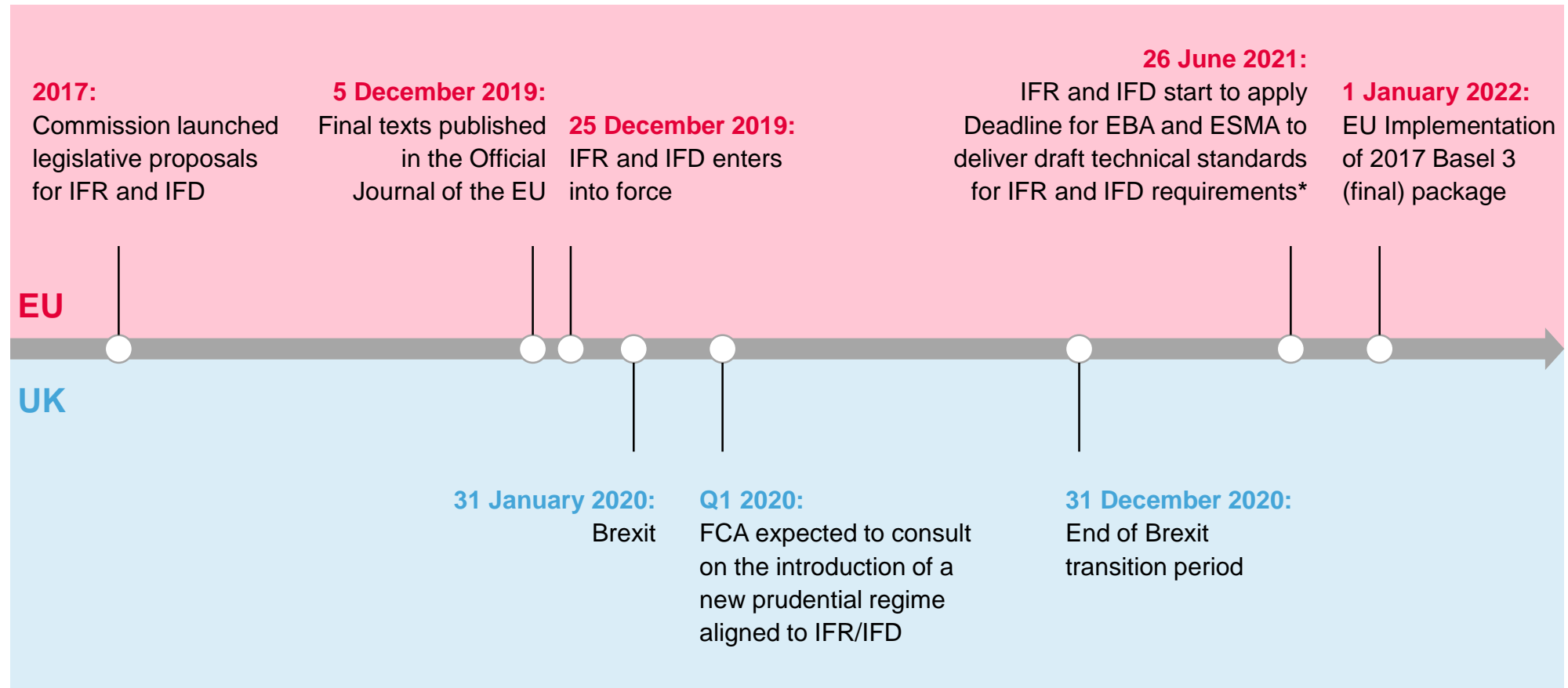
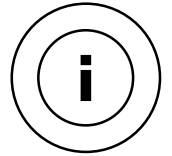
Under IFR/IFD, investment firms will fall into one of 3 broad classes, based on their activities, systemic importance, size and interconnectedness:

- **Class 1** firms (systematically important and larger own account dealers/underwriters) will remain subject to CRR/CRD.
- Other firms will be either **Class 2** (larger or interconnected firms) or **Class 3** (smaller and non-interconnected firms) subject to IFR/IFD.

Class 2 and Class 3 firms will be subject to new, different prudential and supervisory requirements, such as regulatory capital requirements (assessed on the basis of fixed overheads requirements or “K-factors”), remuneration requirements etc.

INTRODUCTION

BACKGROUND AND TIMING



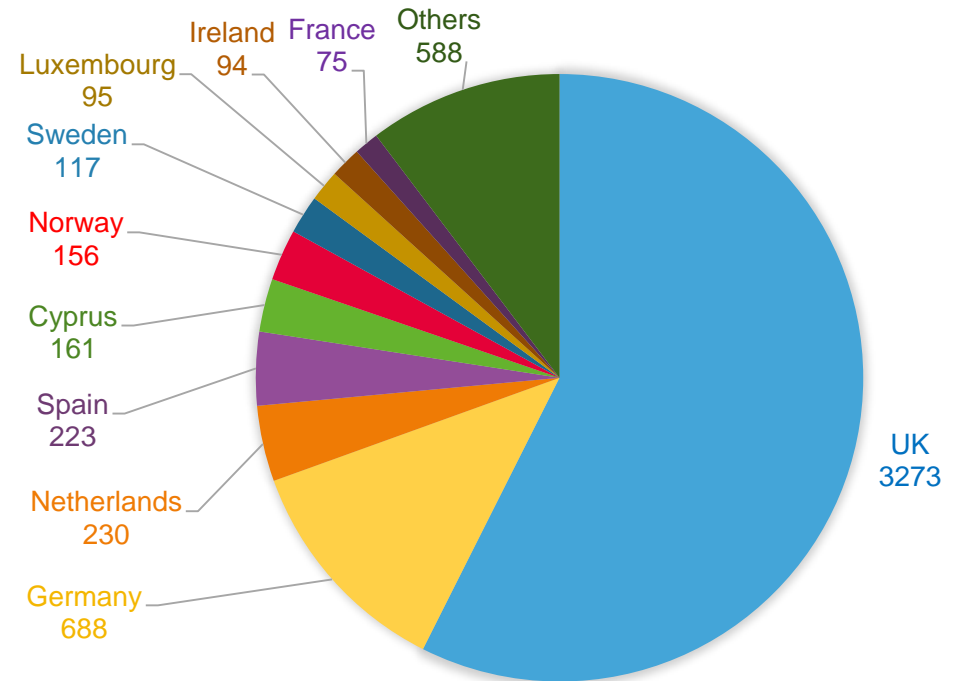
*IFR and IFD require delivery of draft technical standards to the European Commission 18 months (or in some cases, 12 months) after date of entry into force i.e. 25 December 2019.

BREXIT IMPLICATIONS



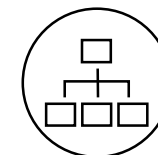
- UK firms represented 57% of the 5,700 MiFID investment firms in the EU
- UK-authorized firms not required to apply the new prudential rules unless still within the transition period under Withdrawal Agreement in June 2021
- But the UK might choose to implement all or part of IFR/IFD
- FCA expected to consult in next few months
- EU27 investment firms (often created to serve EU27 clients as part of Brexit planning) will be subject to the new regime.

MiFID Investment Firms in the EU as at 2015



Source: Annex to EBA Opinion EBA-OP-2017-11: In response to the European Commission's call for advice of 13 June 2016

NEW CLASSIFICATION OF INVESTMENT FIRMS

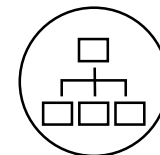


New classification system based on activities, systemic importance, size and interconnectedness	Each class will be subject to a different set of prudential requirements	Summary of classification requirements on following slides
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Class 1: New credit institutions	Class 1a: Treated as institutions	Class 1b: Treated as institutions	Class 2 & 3: IFR/IFD	Commodity and emission allowance dealers
<p>Some systematically important or large investment firms will be reclassified as credit institutions.</p> <p>Will be reclassified if business is to carry out own account dealing, underwriting or placing on a firm commitment basis and if assets meet certain size thresholds or designated by supervisor.</p> <p>Class 1 firms remain subject to Basel-derived prudential requirements under CRR/CRD, but reclassification may be direct and indirect effects.</p>	<p>Authorised investment firms that carry out the MiFID regulated activities of own account dealing, underwriting or placing on a firm commitment basis but do not meet the size thresholds to constitute Class 1 firms.</p> <p>Treated as “institutions” subject to CRR/CRD if their assets meet lower size thresholds or designated by consolidated supervisor.</p>	<p>Authorised investment firms that carry out the MiFID regulated activities of own account dealing, underwriting or placing on a firm commitment basis but do not meet the size thresholds for Class 1 or 1a firms.</p> <p>Treated as “institutions” subject to CRR/CRD if part of a group containing a credit institution subject to consolidated supervision under that regime and elects to be subject to CRR/CRD (subject to override by competent authority).</p>	<p>All other investment firms will be subject to IFR/IFD.</p> <p>Class 2: Larger and interconnected firms subject to more extensive and burdensome requirements.</p> <p>Class 3: Smaller and non-interconnected firms subject to less extensive requirements.</p>	<p>Will not be treated as Class 1 or 1a firms even if they meet the relevant size thresholds.</p> <p>Unless they are part of a consolidated group and elect to be treated as Class 1b, will be treated as either Class 2 or 3 firms depending on which thresholds they meet.</p>

SUMMARY TABLE OF CLASSIFICATION OF FIRMS UNDER IFR/IFD

CLASS 1, 1A AND 1B FIRMS



Class	Covered firms
1	<p>Own account dealer/underwriter firms* if:</p> <ul style="list-style-type: none"> • their consolidated assets are equal to or exceed €30bn; • they are part of a group where the total consolidated assets of all own account dealer/underwriter firms that have consolidated assets of less than €30bn are equal to or exceed €30bn†; or • they are part of a group where the total consolidated assets of all own account dealer/underwriter firms are equal to or exceed €30bn‡ and their consolidated supervisor designates them as Class 1 to address circumvention or financial stability issues.
1a	<p>Authorised investment firms that are own account dealer/underwriter firms* if:</p> <ul style="list-style-type: none"> • their consolidated assets are equal to or exceed €15bn‡ (excluding assets of non-EU subsidiary own account dealer/underwriter firms); • they are part of a group where the total consolidated assets of all own account dealer/underwriter firms that have consolidated assets of less than €15bn are equal to or exceed €15bn‡ (excluding assets of non-EU subsidiary own account dealer/underwriter firms); or • their consolidated assets are equal to or exceed €5bn (excluding assets of non-EU subsidiary own account dealer/underwriter firms)‡ and their competent authority designates them as Class 1a based on systemic risk, clearing member status or economic importance, cross-border significance or interconnectedness.
1b	<p>Authorised investment firms that are own account dealer/underwriter firms if:</p> <ul style="list-style-type: none"> • they elect to be subject to CRR; • they are part of a group containing an EU credit institution and subject to consolidated supervision under CRR; and • the competent authority is satisfied that the election does not reduce own funds requirements and is not for purposes of regulatory arbitrage.

‘Own account dealer/underwriter firms’ are firms whose business it is to carry out (Class 1 firms) or that carry out (other firms) dealing on own account, underwriting or placing on a firm commitment basis.

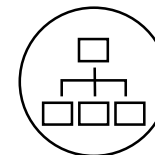
* Excluding commodity and emission allowance dealers, collective investment undertakings and insurance undertakings.

† For third-country groups, includes total assets of all EU branches of the group.

‡ Calculated on the basis of a 12-month average.

SUMMARY TABLE OF CLASSIFICATION OF FIRMS UNDER IFR/IFD

CLASS 2 AND 3 FIRMS



Class	Covered firms	
2	Other authorised investment firms meeting any of the following tests:	
	• AUM (assets under management, discretionary and ongoing non-discretionary advisory) [§]	≥ €1.2bn
	• Daily COH (client orders handled) [§]	≥ €100m (cash trades) or €1bn (derivatives)
	• ASA (assets safeguarded and administered)	> zero
	• CHM (client money held)	> zero
	• DTF (daily trading flow)	> zero
	• NPR (net position risk) or CMG (clearing margin given)	> zero
	• TCD (trading counterparty default)	> zero
	• On- and off-balance sheet total [§]	≥ €100m
	• Total revenues from investment services and activities (average of last 2 years) [§]	≥ €30m
3	Other authorised investment firms.	

§ Calculated on a combined basis for all investment firms that are part of a group.

IFR INDIVIDUAL PRUDENTIAL REQUIREMENTS

REGULATORY CAPITAL REQUIREMENTS



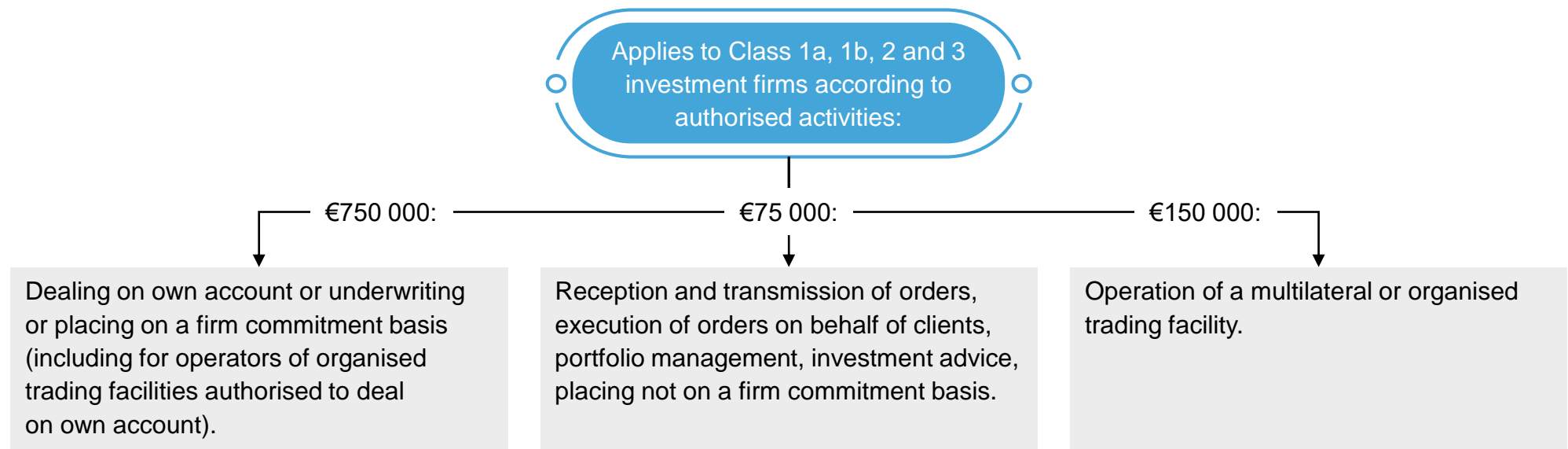
Class 1a and 1b firms

- Initial capital requirements under IFR.
- Otherwise subject to prudential requirements under CRR/CRD.

Class 2 and 3 firms

- Subject to newly calibrated requirements under IFR to maintain regulatory capital on an individual basis.
- Requirements can be met by maintaining Common Equity Tier 1, Additional Tier 1 and Tier 2 capital, as defined for CRR purposes (with limited modifications).
- Other requirements regulating reductions of capital or redemptions or repurchases of capital instruments similar to those in CRR.

Initial capital requirements under IFR/IFD



IFR INDIVIDUAL PRUDENTIAL REQUIREMENTS

REGULATORY CAPITAL REQUIREMENTS (CONTINUED)



Class 2 firms

- Subject to new risk-based regulatory capital requirements – assessed as the higher of the sum of K-factor requirements, one-quarter of their annual fixed overheads and their initial capital requirement.

Class 3 firms

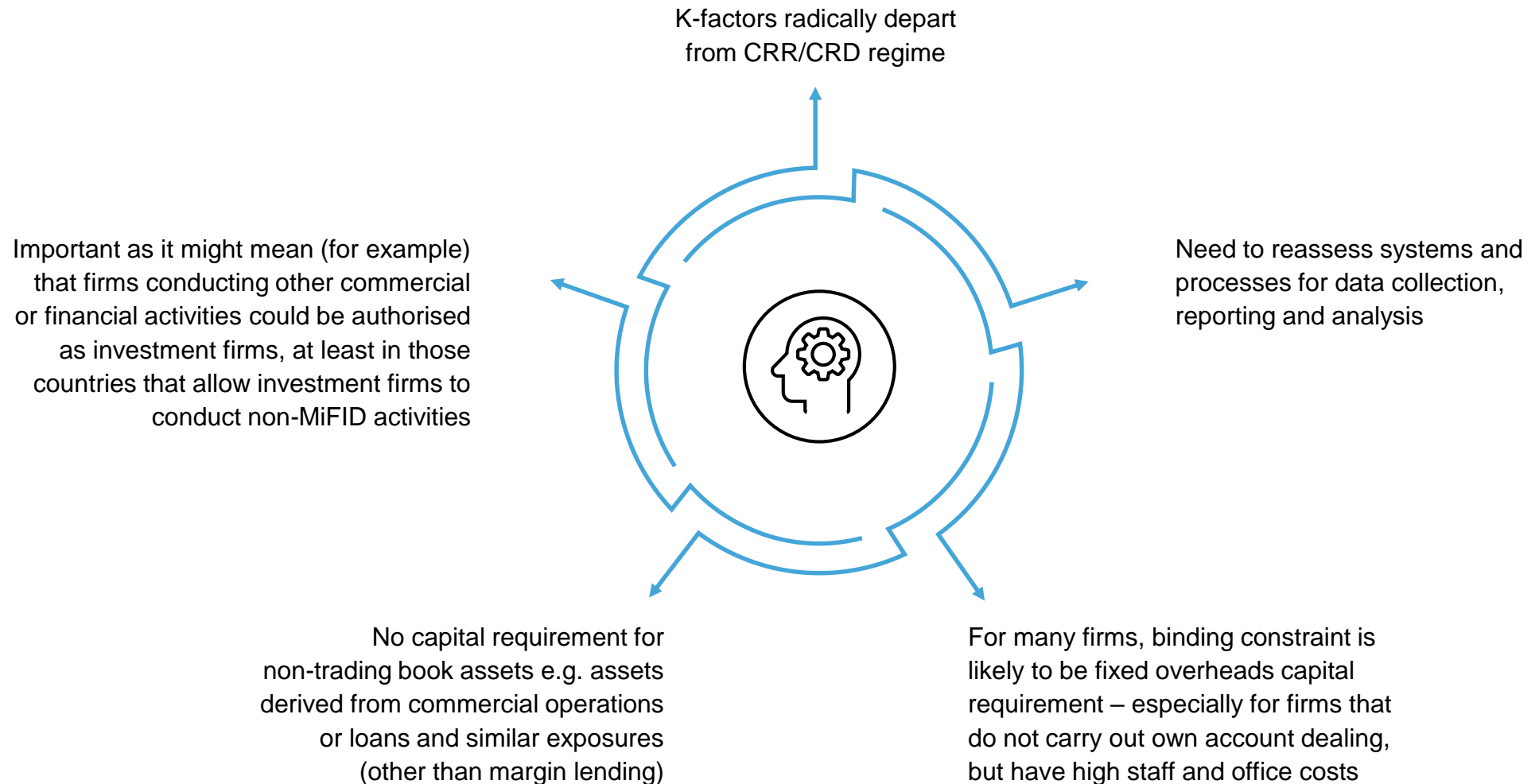
- Capital requirements will be the higher of one-quarter of their annual fixed overheads, and their initial capital requirement.
- No need to assess capital based on K-factors but must monitor some K-factors to assess whether they become Class 2 investment firms.

Category	K-factor		Co-efficient (or method)
Risk-to-Client (RtC)	Assets under management (discretionary and ongoing non-discretionary advisory).	K-AUM	0.02%
	Client money held (on segregated or non-segregated basis).	K-CMH	0.4% (seg'd)
		K-CMH	0.5% (non-seg'd)
	Assets under safeguarding and administration.	K-ASA	0.04%
	Client orders handled (cash trades and derivatives).	K-COH	0.1% (cash trades)
		K-COH	0.01% (derivatives)
Risk-to-Market (RtM)	Net position risk on own account trading book positions (unless K-CMG applies).	K-NPR	N/A (capital as per CRR simplified or standardised approach)
	Total margins required by firm's clearing member (if permitted by competent authority).	K-CMG	N/A (capital = 3 rd highest total daily margin requirement over last 3 months)
Risk-to-Firm (RtF)	Trading counterparty default (own account trading book exposures).	K-TCD	N/A (capital = $\sum 1.2 \times \text{exposure value} \times \text{risk factor} \times \text{CVA}$).
	Daily trading flow for cash trades or derivatives (trading book own account transactions + transactions executed for clients in firm's name).	K-DTF	0.1% (cash trades)
		K-DTF	0.01% (derivatives)
Concentration risk on own account trading book transactions.	K-CON	N/A (capital = $\sum [\text{exposure capital requirement} / \text{exposure value}] \times \text{exposure value excess}$)	

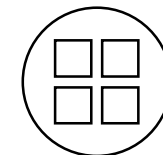
Exceptions and derogations may apply in some cases.

IFR INDIVIDUAL PRUDENTIAL REQUIREMENTS

SOME CHALLENGES



AMENDMENTS TO MIFIR CROSS-BORDER REGIME (1)



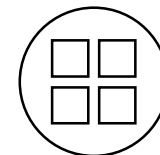
Article 46 cross-border services regime

- Third-country firms may use national regimes where:
 - no equivalence decision
 - equivalence decision has been withdrawn
 - equivalence decision does not cover the relevant services
- Intragroup transactions
- Article 46(6a) – requirement for registered firms to report to ESMA annually on:
 - Scale and scope of services in the EU;
 - For firms who deal on own account, their monthly minimum, average and maximum exposure to EU counterparties;
 - For firms who carry on underwriting, the total value of financial instruments originating from EU counterparties underwritten or placed on a firm commitment basis;
 - Turnover and aggregated value of assets corresponding to services and activities in the EU;
 - Investor protection arrangements;
 - Risk management policy and arrangements;
 - Governance arrangements;
 - Any other information necessary for ESMA to carry out its tasks

ESMA powers

- May request additional information from registered firms;
- May temporarily prohibit or restrict a firm from providing investment services where:
 - The firm has failed to comply with a prohibition or restriction imposed by ESMA or EBA under Art 40 / 41 MiFIR or by an NCA under Art 42;
 - The firm has failed to comply with a data request from ESMA or does not cooperate with an investigation or on-site inspection
- Shall withdraw registration in the following circumstances if ESMA has referred the matter to the home state regulator and that regulator has not taken appropriate measures to protect investors or the proper functioning of EU markets:
 - Firm is acting in a manner clearly prejudicial to the interests of investors or the orderly functioning of markets;
 - Firm has seriously infringed the provisions applicable to it in its home jurisdiction and upon which the Commission's equivalence decision was based.

AMENDMENTS TO MIFIR CROSS-BORDER REGIME (2)

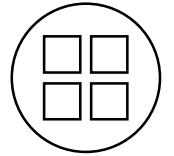


Commission powers

- The Commission may adopt an equivalence decision in relation to a third country where the legal and supervisory arrangements ensure:
 - That firms authorized in that third country comply with legally binding prudential, organizational and business conduct requirements equivalent to those in certain EU legislation;
 - That firms authorized in that third country are subject to effective supervision and enforcement ensuring compliance with the applicable legally binding prudential, organizational and business conduct requirements; and
 - That the legal system of that third country provides for an effective equivalent system for recognition of firms authorized under foreign legal regimes.
- Where the scale and scope of the services and activities performed by third country firms are likely to be of systemic importance to the EU, the Commission must conduct a “detailed and granular assessment” in order to give an equivalence decision. The Commission may take into account supervisory convergence between the third country and the EU.
- The Commission may attach specific operational conditions to equivalence decisions if the scale and scope of services and activities are likely to be of systemic importance.
- The prudential, organizational and business conduct framework of a third country may be considered to be equivalent where it fulfils all of the following conditions:
 - Firms providing investment services in the third country are subject to:
 - Authorization and effective supervision and enforcement on an ongoing basis;
 - Sufficient capital requirements;
 - Appropriate requirements applicable to shareholders and members of the management body;
 - Adequate business conduct and organizational requirements;
 - Market transparency and integrity is ensured by preventing market abuse in the form of insider dealing and market manipulation.

OTHER IMPACTS

OVERVIEW OF SOME OTHER IMPACTS OF IFR/IFD



Impact on the CRD 5 IPU Requirement

- CRD 5 Intermediate parent undertaking (IPU) requirement will be extended to cover all investment firms authorised in the EU under MiFID as if they were “institutions”.

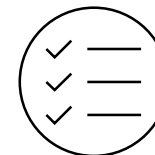
MiFID tick size regime

- MiFIR amended to require systematic internalisers in equities and similar instruments to comply with the tick-size regime applicable to trading venues (with effect from 26 March 2020).

Insolvency and resolution rules

- Amended definition of “investment firm” may also bring all MiFID firms within the scope of the EU Credit Institutions Winding Up Directive, thus affecting their treatment in insolvency.
- However, outcome will depend on how Member States implement the changes in their national laws.
- Change of criteria for application of Bank Recovery and Resolution Directive (BRRD).

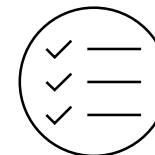
KEY PRELIMINARY ACTION POINTS



Identify affected entities	Identify existing/proposed: <ul style="list-style-type: none">• EU/UK group companies currently classified as investment firms under MiFID• EU/UK group companies currently exempt from MiFID (impact on thresholds and potential spill-over effects of rules)• group structures in EU/UK for affected entities• business activities, solo/sub-consolidated asset size and other relevant threshold criteria for affected entities and relevant group companies.
Classify affected entities	Assess: <ul style="list-style-type: none">• likely classification of affected entities• application of other thresholds (e.g., for application of remuneration rules)• key uncertainties/dependencies.
Carry out impact assessment	Assess: <ul style="list-style-type: none">• where groups/sub-groups that include affected entities will be subject to new/different consolidation requirements• likely scale of capital impact on affected entities (or groups) compared to current requirements• likely key changes to solo and consolidated requirements for affected entities (gap analysis)• need to change terms of existing capital instruments to meet new requirements• likely requirements for systems changes for affected entities and groups• impact on requirements to establish an EU/UK intermediate parent undertaking under CRD5 or to authorise EU/UK financial holding companies.

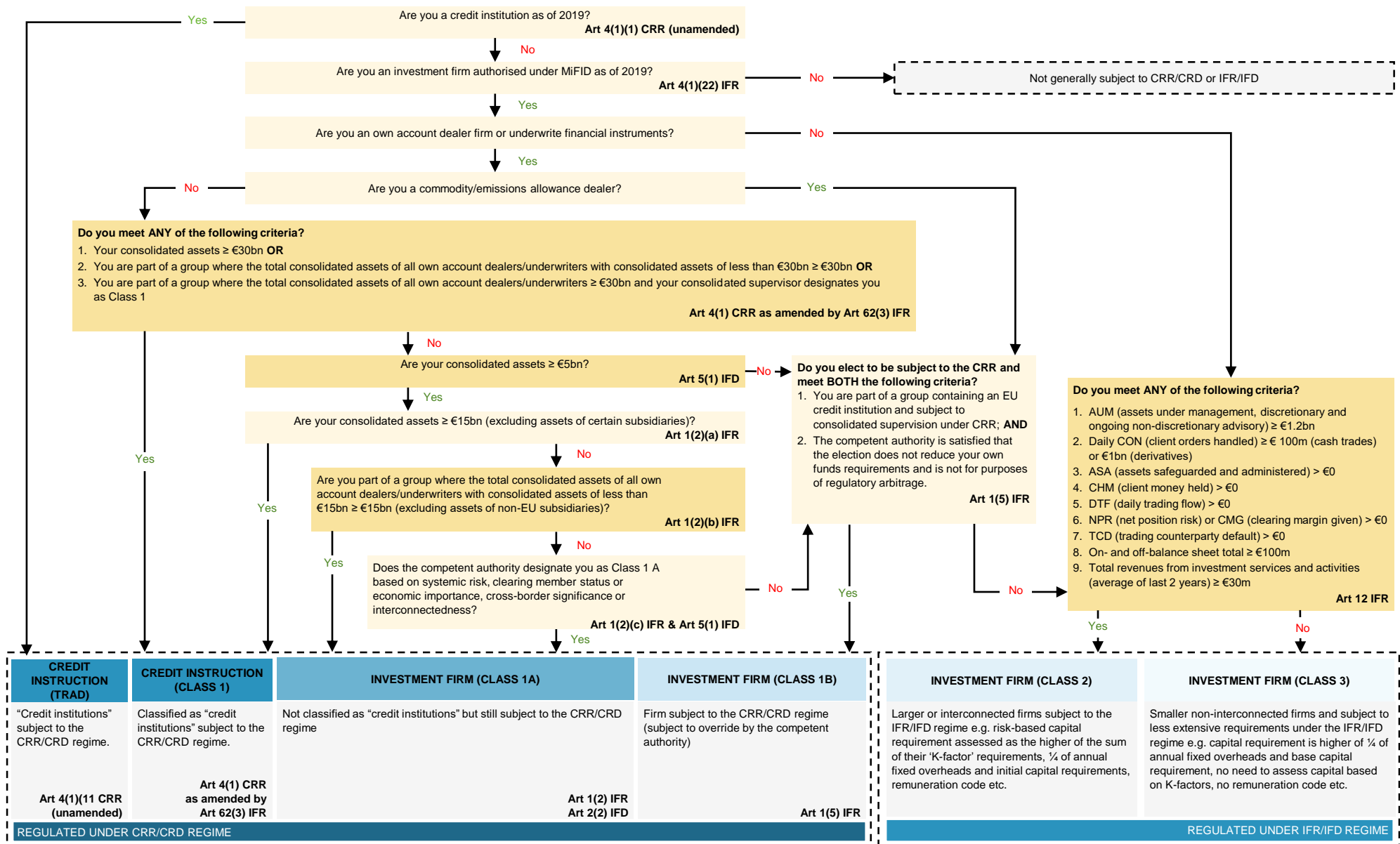
KEY PRELIMINARY ACTION POINTS

(CONTINUED)



Review available mitigating actions	<p>Review:</p> <ul style="list-style-type: none">• transferring activities to existing credit institutions• transferring portfolio management/investment advice activities to AIFMs or UICTS management companies• changes to business activities to reclassify affected firms as Class 3 firms or MiFID exempt firms• other changes to business activities or group structure (e.g., to facilitate classification of affected firms as Class 1a firms).
Plan engagement with regulators	<p>Plan engagement with regulators on:</p> <ul style="list-style-type: none">• clarification of key uncertainties as to application of IFR/IFD• application of discretionary assessments of affected entities as Class 1 or 1a investment firms• decisions to allow election by affected entities to be treated as Class 1b investment firms• availability of possible waivers of solo or consolidated requirements under IFR• content of EU technical standards and any Q&A (the Commission/ESMA)• UK proposals for an aligned regime/possible divergences from EU regime (HM Treasury/FCA).
Prepare implementing actions	<p>Prepare for:</p> <ul style="list-style-type: none">• submission of applications by Class 1 investment firms for authorisation as credit institutions by 27 December 2020 (and related passporting actions)• notifications by affected firms to competent authorities seeking classification as a Class 1b investment firm• possible issues arising if future changes in volumes of business results in affected entities changing classification• implementation of new requirements and systems changes.

APPENDIX: FLOWCHART SHOWING EU FIRM CLASSIFICATION AFTER IMPLEMENTATION OF IFR/IFD



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