New Prudential and Remuneration Regime for Investment Firms
What Asset Managers Need to Know

Key impacts

1. The prudential treatment of investment firms is changing from being mainly based on regulatory licences held, to being heavily influenced by firm size and volume of activity.

2. Most MiFID asset managers are BIPRU firms today, or in some cases Exempt CAD firms subject to lighter standards – under the new rules many of these firms will fall within the more stringent “Class 2” categorisation rather than the less onerous “Class 3” categorisation.

3. Class 2 categorisation imposes more onerous capital, monitoring and public disclosure requirements.

4. Class 2 firms are also subject to much stricter remuneration rules than Class 3 firms, which will require significant changes to how many asset managers remunerate high earners and material risk takers.

What is the Investment Firms Review?

Currently different MiFID licensed investment firms are subject to a number of different prudential regimes which primarily depend on the activities the firm carries out and whether it holds client money. Some are effectively subject to prudential requirements that are similar to those that apply to banks (having to comply with CRR and CRD IV), whereas others such as the UK’s so-called “BIPRU” and “Exempt CAD” firms (which make up a large proportion of asset managers) are subject to much more limited requirements.

Since 2015, the EU has been working towards reforming the prudential regime applicable to investment firms and making it more proportionate to the risks posed by investment firms to the market rather than focusing on licences alone – this has been dubbed the “Investment Firms Review”. This has recently resulted in political agreement being reached on an Investment Firms Regulation (IFR) and Investment Firms Directive (IFD), which are expected to be published in the Official Journal in the autumn of this year. The new rules are expected to generally start to apply in mid-2021 (subject to phase in provisions).

It is worth noting that despite Brexit, it is anticipated that the UK will align with these reforms. Notably the FCA stated in their 2019/2020 Business Plan that they will consult on introducing the regime in the UK in the second half of 2019.
New prudential classification system

Under the current prudential regimes for MiFID investment firms, the strictness and compliance burden of prudential and remuneration requirements are largely determined by the activities a firm undertakes. For example, so called “Exempt CAD” firms that only provide investment advice and/or reception and transmission of orders are not subject to any variable capital requirements, whilst at the other end of the spectrum firms which deal on own account can be subject to substantial capital, liquidity, remuneration and reporting requirements which do not necessarily reflect the actual risks posed by such firms. The current prudential classification system is also extremely complicated, with more than 10 different prudential categories.

The new rules will introduce a new classification system that divides MiFID investment firms into four classes. The first two categories, “Class 1” and “Class 1 minus”, are unlikely to be relevant to most asset managers as they are only applicable where an investment firm holds dealing on own account or underwriting permissions – but if your consolidation group includes such entities, you may be indirectly impacted. The current prudential classification system is also extremely complicated, with more than 10 different prudential categories.

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For the purposes of this distinction, Class 2 is the “default” categorisation, with a firm having to satisfy certain conditions to fall within Class 3, specifically falling below certain thresholds in relation to “K Factors” which consider the risks posed by the firm, based on the volume and nature of activities of a firm in certain areas. To be a Class 3 firm, a firm cannot hold client money or safeguard/administer client assets, and some other K-Factors must be zero (eg those relating to net position risk, clearing margin given, trading counterparty default and daily trading flow). For most Exempt CAD and BIPRU firms, these requirements are likely to be met. However, some other thresholds will be trickier. Specifically, to be a Class 3 firm:

> **Assets under management** as well as those subject to non-discretionary arrangements which constitute ongoing investment advice must be below €1.2bn on an individual and group basis;
> **“Client orders handled”** must be below €100m/day for cash trades or €1bn/day for derivatives on an individual and group basis;
> **Total annual gross revenue** must be below €30m on an individual and group basis; and
> **On- and off-balance sheet total** must be below €100m on an individual and group basis.

These thresholds are likely to be exceeded by a number of Exempt CAD and BIPRU firms, which will result in them falling into Class 2.

Why is it relevant to asset managers?

Asset management groups operating within Europe will generally have one or more MiFID investment firms within their group performing portfolio management, investment advice and/or execution activities. As the licences held by these asset managers have historically been perceived as lower risk, they have tended to benefit from lighter standards under the existing prudential regimes notwithstanding the complexity of their business.

This will change under IFR/IFD as these firms will become subject to more onerous capital, remuneration and governance standards.

The new regime also contains consolidation rules, which mean that some asset management groups containing investment firms will need to comply with the requirements on a “consolidated basis” (ie as if the group was one entity). If your group includes European banks or entities that will be reclassified as credit institutions under the upcoming CRD V/CRR II reforms, you should also be mindful of consolidation implications under those rules.

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Class 2 and Class 3 requirements
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Firms falling into Class 2 face a significantly enhanced compliance burden compared to Class 3 firms. Class 3 firms will be subject to a permanent minimum capital requirement of €75,000, and a variable capital requirement which is the higher of their minimum capital requirement and one quarter of the previous year’s fixed overheads. In contrast, Class 2 firms can be subject to a permanent minimum capital requirement of up to €150,000 (if they do not deal on own account or underwrite/place on a firm commitment basis), with much more complex variable capital requirements, that take into account “K-Factors” as well as fixed overheads. These variable capital requirements can in turn result in Class 2 firms having to hold capital significantly in excess of their permanent minimum capital requirements.

Class 2 firms are also subject to a number of other prudential requirements under the new rules, including liquidity rules, large exposures, ICAAP (internal capital adequacy assessment process), “Pillar 3” public disclosure and granular regulatory reporting requirements. In contrast, Class 3 firms (depending on national regulators) may be subject to certain liquidity requirements, are subject to annual reporting requirements to local regulators, and have to comply with “Pillar 3” public disclosure requirements but only if they issue “Additional Tier 1” capital (ie hybrid instruments/CoCos). Firms which are currently Exempt CAD or BIPRU firms will therefore have to grapple with a much more significant compliance uplift if they find themselves in Class 2 in particular.

Class 2 firms will be subject to concrete and onerous remuneration requirements. While the IFD remuneration requirements look similar to the remuneration requirements of some current regimes (including CRDIV, AIFMD and UCITS V), they may have a very significant impact in practice as many Class 2 firms will be required to apply the rules in full. These requirements include, for high earners/material risk takers, pay deferral requirements, requirements for some pay to take the form of non-cash instruments, malus and “hard” clawback (ie repayment) provisions and requirements to put in place a gender-balanced remuneration committee. The IFD will also mean that Class 2 firms will become subject to more onerous public disclosure requirements than currently, being required to publicly disclose certain remuneration information and report certain information to regulators such as a “high earners report”. These remuneration requirements will therefore require significant effort to implement for firms which are currently Exempt CAD or BIPRU firms, as well as impacted AIFMs or UCITS Mancos, given the significant compliance uplift and sensitivities around remuneration of staff. By contrast, Class 3 firms will (on a solo basis) only be subject to MiFID II remuneration and governance requirements (in the absence of local gold-plating), which impose fairly non-prescriptive obligations. Alongside IFD, any investment firms within wider banking groups need to carefully consider the new CRDV remuneration requirements, and the potential impact of those provisions (including the bonus cap) on investment firm staff.

What should I do to prepare?

> **Assess your likely prudential classification** – whether you are Class 2 or Class 3 will significantly affect your compliance requirements.

> **Consider impact on group structuring and activities** – consider whether it is possible to restructure your business to optimise compliance requirements under the new regime.

> **Prepare for Class 2 compliance uplift (if applicable)** – some Class 2 rules will be particularly onerous for Exempt CAD and BIPRU firms eg. additional regulatory capital, ongoing monitoring, governance, disclosure and remuneration requirements.

> **Review remuneration arrangements** – you may need to restructure these to meet the new Class 2 pay rules including deferral, non-cash instruments, malus/clawback, and setting an appropriate fixed/variable pay ratio. See this note from our Employee Incentives team for more detail on this aspect.

Additional resources and contacts

A more detailed overview of the new rules can be found in our full report “A new EU prudential and remuneration regime for investment firms”.

If you are interested in some of the potential impacts of CRR2 and CRDV mentioned in this note, further detail can be found in our report “CRR2 and CRDV – The New EU Prudential Regulatory Landscape”.

If you would like to discuss any aspect of this note, please reach out to your usual Linklaters contact or any of those on the next page.
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