New Prudential and Remuneration Regime for Investment Firms
What Private Equity Firms 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 private equity firms are BIPRU firms or Exempt CAD firms, which are subject to lighter standards – under the new rules many of these firms may 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 private equity firms 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 private equity firms) 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 focussing on licences alone – this has been dubbed the “Investment Firms Review”. This has 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 December. 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.

Why is it relevant to private equity firms?

Private equity firms 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 private equity firms 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 private equity 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 portfolio companies include European banks or entities that will be classified as credit institutions under the upcoming CRD V/CRR II reforms, you should also be mindful of consolidation implications under those rules.

There are no exemptions to the regime for MiFID investment firms, although Article 3/MiFID optional exemption firms will fall outside the regime as a result of not being MiFID investment firms in the first place. Nonetheless, the FCA or other relevant regulators may choose to apply some or all of the requirements from the Investment Firms Review to them.
**New prudential classification system**

The new rules will introduce a new classification system that divides MiFID investment firms into four categories. The first two categories, “Class 1” and “Class 1 minus”, are unlikely to be relevant to most private equity firms 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 distinction between the final two categories, “Class 2” and “Class 3” is therefore likely to be the key dividing line for private equity firms.

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 (e.g. 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 handed* 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 €60m 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.

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**Class 2 and Class 3 requirements**

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 this 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, 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 only have to comply with “Pillar 3” public disclosure requirements 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 (see below). These remuneration requirements will therefore require significant effort to implement for firms which are currently Exempt CAD or BIPRU firms, 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 CRDIV remuneration requirements, and the potential impact of those provisions (including the bonus cap) on investment firm staff.

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**Remuneration rules for Class 2 firms**

Class 2 firms will be subject to more extensive remuneration requirements than Class 3 firms. These include, for high earners/material risk takers:

- A requirement for at least 50% of upfront and deferred variable pay to be in non-cash instruments and to be subject to an appropriate retention period;
- Deferral of 40% of variable pay (or 60% of high variable pay) over three to five years – but only where the firm has assets of €100m or more, and only for staff members whose variable pay is at least €50k (which is more than ¼ of total pay). Member States have power to change some of these thresholds in certain circumstances;
- Malus and clawback must apply to 100% of variable pay where the firm’s performance is “subdued or negative”;
- Firms with assets of at least €100m will need to have a remuneration committee. The committee should be gender-balanced, but can be a group-wide committee;
- Member States must ensure that remuneration committees are responsible for remuneration decisions. When taking remuneration decisions, the committee must take into account the public interest and the long-term interests of shareholders, investors and other stakeholders; and
- Firms are required to publicly disclose certain information, e.g. the design and terms of their remuneration system, disapplicability rules, and fixed and variable pay awarded. There is also the “high earners report” to the regulator.
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 e.g. 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.

What does this mean for deals?

Where private equity firms are carrying out due diligence on targets that are subject to the new rules, they will want to do due diligence on the firm’s approach to complying with the requirements. This should include both the capital requirements and the remuneration rules, which has been an area of significant scrutiny by regulators recently. Firms should also consider whether current or target portfolio companies that are investment firms capture the private equity house in their consolidation group.

### 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 listed on the next page.

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