What the FCA proposals mean for exempt CAD firms

September 2020

CONTENTS

1. Executive Summary **3**

2. Proposals Explained **4**

2.1. Firm Categorisation *4*

2.2. New Requirements *4*

3. Transition and Implications **7**

3.1. Transition Arrangements *7*

3.2. Implications *7*

4. Next Steps **8**

Annex I - K-Factor Calculations **9**

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1. EXECUTIVE SUMMARY

Across European Union (EU) member states, there is a wide variation in how investment firms are prudentially supervised. In the UK, for example, there are three prudential sourcebooks for investment firms – BIPRU, IFPRU and IPRU(INV). Plus, of course, the prudential regime in the Capital Requirement Regulations and Directive (CRR/CRD IV) imposes methodologies, but these are not very well suited to the business of investment firms and the risks they face.

The European Commission has therefore put in place a revised prudential framework – the Investment Firms Regulation (IFR) and the Investment Firm Directive (IFD) – to address the aforementioned issues. The text of the new regulations is now included in the EU's Official Journal with the rules set to apply from 26 June 2021. To ensure a smooth transition for firms, there are some transitional provisions that will allow a gradual build-up of capital resources to the new required levels.

The UK will be implementing the new regime. In other words, this is unaffected by Brexit. The Financial Conduct Authority (FCA) published a Discussion Paper on 23 June 2020 indicating that their approach to implementing the new regime will be very similar to that of the EU. Final rules are expected to be published in Q1 2021.

This means that a new prudential framework will apply to authorised investment firms providing advisory and arranging services. These firms, currently categorised as exempt CAD firms for prudential purposes, will see their base capital requirement increase significantly (from GBP5,000 in some cases to EURO75k). This paper describes the background to the changes, what they mean for your firm and what changes need to be made in preparation for the coming changes.

If you have any questions regarding the new prudential framework then please contact us and we will be happy to assist. Please also look out for further updates that we will issue once the FCA publishes more information.

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2. PROPOSALS EXPLAINED

2.1. Firm Categorisation

Investment advisors and arrangers will be in one of two categories depending on size.

<table>
<tr><th>Small and Non-interconnected Firms (SNIs)</th><th>Non-SNIs (Investment Firms)</th></tr>
<tr><td>These are firms who meet the following characteristics:
AUM < EURO1.2billion
Daily Client Orders handled ≤ EURO100m (cash trades) or EURO1bn (derivative trades)
Client assets safeguarded and administered) = zero
Client money held (CMH) = zero
Daily trading flow (DTF) = zero
Net position risk (NPR) or Clearing margin given (CMG) = zero
Trading counterparty default (TCD) = zero
On- and off-balance sheet total ≤ EURO100m
Total revenues from investment services and activities ≤ EURO30m</td><td>Firms which exceed the SNI thresholds</td></tr>
</table>

2.2. New Requirements

The requirements in the IFR/IFD will apply to differently to SNIs and non-SNIs. A summary of the requirements as currently proposed by the FCA in its June 2020 Discussion Paper is as follows:

<table>
<tr><th></th><th>Small and Non – interconnected Firms (SNIs)</th><th>Non-SNIs (investment Firms)</th><th>Comparison with current rules (exempt CAD firms)</th></tr>
<tr><td>Definition of Capital</td><td colspan="2">This is the same for both categories of firms as present. Capital comprises Common Equity Tier (CET) 1 Capital, Additional Tier 1 (AT1) capital and Tier 2 capital.</td><td>There have been some changes to what deductions need to be made and the amounts.</td></tr>
<tr><td>Capital Mix</td><td colspan="2">CET1 capital ≥ 56% of Own Funds Requirement (see below)
Total Tier 1 capital (i.e. CET1 + AT1) ≥ 75%
Total capital ≥ 100%</td><td>Not currently applicable.</td></tr>
<tr><td>Own Funds Requirement</td><td>The higher of:
Fixed overhead requirement (FOR); and
Permanent minimum requirement</td><td>The higher of:
Fixed overheads requirement
Permanent minimum requirement; and
K-factor requirement (KFR)</td><td>Not currently applicable.</td></tr>
<tr><td>Fixed overhead requirement</td><td colspan="2">Same as current rules which is a quarter of annual fixed overheads for the previous year.</td><td>Not currently applicable</td></tr>
</table>

	Small and Non – interconnected Firms (SNIs)	Non-SNIs (investment Firms)	Comparison with current rules (exempt CAD firms)
Initial / Permanent minimum requirement	EURO75,000	EURO75,000	Either GBP5,000 + PII or EURO50,000
K Factor Requirement (KFR)	Not applicable	A new way of accounting for the potential harm that an investment firm can do to its clients, the markets in which it operates and to itself. See Annex I for more details.	Not currently applicable.
Group capital requirements	The relevant own funds requirements will have to be applied on a solo and on a consolidated basis. If a group is sufficiently simple and does not pose a significant threat to clients or the markets, the parent could apply to use a group capital test instead of the consolidated own funds requirements.		Not currently applicable.
Liquidity requirement	Firms are required to hold a third of the amount of the fixed overhead requirement in liquid assets.		Not currently applicable.
Capital Adequacy Assessment (Similar to the old ICAAP, now known as Internal Capital Adequacy and Risk Assessment (ICARA))	Required. No mandatory review by the FCA though it may be requested. ICARAs must include wind-down plans.	Required. Assessments will be reviewed periodically by the FCA. ICARAs must include wind-down plans.	Not currently applicable.
Public disclosures	Do not need to disclose unless they issue AT1 Capital.	Firms need to disclose risk management objectives, own funds and own funds requirement, remuneration, and governance arrangements (similar to current Pillar 3 obligations). Larger non-SNIs will also need to disclose ESG risks and investment policy.	Not currently applicable.

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	Small and Non – interconnected Firms (SNIs)	Non-SNIs (investment Firms)	Comparison with current rules (exempt CAD firms)
Remuneration Rules	No additional requirements.	Remuneration principles apply in relation to variable remuneration. Provisions on bonus pay outs, deferral and retention periods, and establishing risk committees only apply to firms with average four-year balance sheet size > EURO300m.	Overarching requirement under MIFID II to not remunerate staff in a way that conflicts with the duty to act in the client's best interest.
Regulatory reporting	Annual. On balance sheet, income statement, capital adequacy and confirmation of staying within the SNI thresholds.	Quarterly. In addition to SNI information, will also report on risk, liquidity and remuneration.	Quarterly. On balance sheet, income statement and capital adequacy.

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3. TRANSITION AND IMPLICATIONS

3.1. Transition Arrangements

A five-year transition period is in place under the rules to allow firms build up the required capital. Exempt CAD firms, during this transition period, may limit the increase in their permanent minimum capital requirement to EURO5k per annum until the new EURO75k amount is reached. The amount of the own funds requirements is not subject to any such transitional limits, although the FCA have indicated that they are aware of this anomaly as compared to BIPRU and IFPRU firms and is consulting on it.

3.2. Implications

- **Systems and Processes to track K-factors:** It is reasonable to anticipate that the K-factors (Annex I below) will be new for many firms. Some work therefore needs to be done to calibrate IT and Accounting systems and ensure they are able to produce the numbers required for the capital requirement calculations. For some metrics like client orders handled, these would need to be tracked daily
- **Business model review:** In light of the significant changes being brought about by the new prudential framework, some businesses may find that they are not able to meet the new requirements and may then look to amend their business model to streamline risks and consequently lower their K-Factor Requirement. In other cases, firms may opt to restructure their operations internationally
- **Capital assessments (ICARA):** Most exempt CAD firms have probably never had to carry out a formal capital adequacy assessment. In addition, many firms may not have previously carried out a robust wind-down assessment. New skills and processes may therefore need to be brought into the business to ensure the assessments are fit for purpose
- **Capital infusion:** For most exempt CAD firms, their minimum capital requirements will increase. New capital may then need to be introduced by the shareholders. Early planning and engagement with shareholders is therefore crucial
- **Remuneration:** For some firms, there will be new remuneration rules to consider in relation to variable pay. For firms above the EURO300m threshold, how employees receive variable remuneration will be affected. Boards, HR and legal teams may therefore need to reconsider compensation structures and plan for employee engagement to minimise disruption and impact on employee morale
- **Liquidity planning:** We expect this to be of minimal impact, however, the rules now require a minimum of 1-month fixed costs to be held in liquid assets, primarily cash. Cashflow forecasts and monitoring systems therefore need to ensure these limits are not breached

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4. NEXT STEPS

The FCA's Discussion Paper is currently open for comment up to 25 September 2020. Following the Discussion Paper, a Consultation Paper will be issued by the FCA later this year and then a Policy Statement with final rules is expected in Q1 2021.

In the interim, firms are encouraged to acquaint themselves with the FCA's initial proposals on the implementation of the IFR/IFD in the UK and respond accordingly. Firms should determine what IFR category their firm will fall into and begin planning towards meeting the new requirements for that category. The level of effort required to comply should not be underestimated, particularly for non-SNIs.

In summary, the new rules have been designed to ensure firms hold capital better aligned to the risks they face. While some firms will see lower regulatory costs as a result, others will experience higher requirements and costs to comply. Early planning and review will ensure firms are ready to meet the obligation next year and grow their capital requirements over the transition period.

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ANNEX I - K-FACTOR CALCULATIONS

The K-Factor Capital requirement is the sum of K-factors in the following areas:

- Risk-to-Client (RtC);
- Risk-to-Market (RtM); and
- Risk-to-Firm (RtF)

	Criteria	Symbol	Co-efficent	Comments
Risk to Client (RtC)	Assets under management (AUM) - Discretionary and Non-Discretionary (advisory)	K-AUM	0.02%	Calculated as 12-month average of the AUM as of the last business day of each calendar month for the previous 15 months and excluding the three most recent months. Includes AUM delegated to another manager but excludes AUM managed on delegated authority from another Investment entity. Calculated on the first business day of each month.
	Client money held	K-CMH (on segregated accounts)	0.4%	Calculated as six-month daily rolling average of the value of total daily client money held, measured at the end of each business day for the previous nine calendar months, excluding the three most recent calendar months. Calculated on the first business day of each month.
		K-CMH (on non-segregated accounts)	0.5%	
	Assets under safekeeping and administration	K-ASA	0.04%	Calculated as six-month average of the AUM as of the last business day of each calendar month for the previous nine months and excluding the three most recent months. Calculated on the first business day of each month.

	Criteria	Symbol	Co-efficent	Comments
				Includes all assets safeguarded on a delegated basis and those delegated to another investment firm.
	Client orders handled	K-COH	0.1% (cash trades)	Calculated as three-month daily rolling average of the value of total daily client orders handled, measured at the end of each business day for the previous six calendar months, excluding the three most recent calendar months. Calculated on the first business day of each month. COH is the sum of absolute values of buys and sells. Absolute value is amount paid/received for cash trades and notional value for derivative trades. This shall include values executed by firms providing portfolio management on behalf of clients unless already included in K-AUM above. Excludes transactions executed in the firm's name.
		K-COH	0.01% (derivatives)	
Risk to Market (RtM)	Net Position Risk; or	K-NPR	NA (As per CRR approaches)	Applies to all trading book positions. Firms shall also include non-trading book positions where these give rise to foreign exchange risk or commodity risk.
	Net Client Margin	K-CMG	1.3 x third highest amount of total margin required on a daily basis by the clearing member or qualifying central counterparty over the preceding 3 months	Calculated on all positions subject to margin or on a portfolio basis subject to specified criteria.
Risk to Firm (RtF)	Trading Counterparty Default	K-TCD	1.2 x Exposure Value x Risk Factor x Credit Valuation Adjustment	K-TCD and K-CON shall be based on all dealing on own account transactions (for itself or for clients); K-DTF shall be based on all dealing on own account (for itself or for clients) and dealing as agent transactions which it enters into in its own name.

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	Criteria	Symbol	Co-efficent	Comments
				Risk Factor is 1.6% for credit institutions and investment firms; and 8% for other firm types. Exposure value is Replacement Cost (RC) + Potential future exposure (PFE) - Collateral (C). RC is Current Market Value (derivative contracts). Other criteria apply for long settlement transactions, margin lending transactions, repo transactions and securities financing transactions. PFE is Effective Notional (EN) x Supervisory Factor (SF) where EN is Notional amount x Duration x Supervisory Delta.
	Daily trading flow	K-DTF	0.1% (cash trades) 0.01% (derivatives)	DTF calculated as six-month daily rolling average of the value of the total daily trading flow, measured throughout each business day for the previous nine calendar months, excluding the three most recent calendar months. Calculated on the first business day of each month. DTF is the sum of absolute values of buys and sells. Absolute value is amount paid/received for cash trades and notional value for derivative trades. Includes transactions executed in the firm's name (either for itself or on behalf of clients). Excludes transactions executed as part of providing portfolio management services.
	Concentration risk excess	K-CON	Capital requirement for individual exposures / Total Exposure value x Exposure value excess (EVE)	CON calculates the own funds requirements for exposures to clients or groups of connected clients which are greater than 25% of the firm's own funds or EURO150m. The firm must notify the regulator if those limits are breached.

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