BRIEFING

EU Legislation in Progress

European Parliament

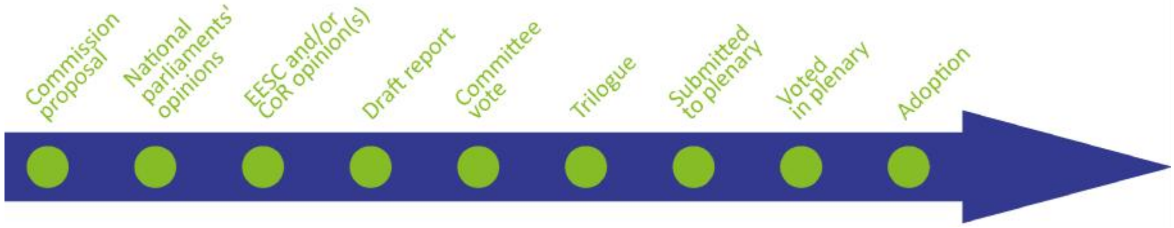
Prudential requirements and supervision of investment firms

OVERVIEW

Investment firms play an important role in capital markets, facilitating savings and investment flows across the EU. However, the current EU rules are seen as fragmented, overly complex, inconsistently applied and often a poor fit for the actual risks taken by the various types of investment firms. The Commission proposed a new regulation on the prudential requirements of investment firms and a new directive on the prudential supervision of investment firms. These proposals update the framework for investment firms, making it more effective and more closely calibrated to the size and nature of the various investment firms and their risks. Parliament's Committee on Economic and Monetary Affairs (ECON) agreed its report and negotiating mandate on 24 September 2018. On 20 March 2019, provisional agreements were reached by Parliament and Council negotiators. Parliament adopted the texts at first reading on 16 April 2019. Following linguistic corrections, corrigenda were endorsed by Parliament in October, and the regulation and directive were adopted by the Council then signed into law on 27 November. Both will apply in full from 26 June 2021.

Proposal for a regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010;
Proposal for a directive of the European Parliament and of the Council on the prudential supervision of investment firms and amending Directives 2013/36/EU and 2014/65/EU

Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2017) 790 COM(2017) 791 20.12.2017
Rapporteur:	Markus Ferber (EPP, Germany)	
Shadow rapporteurs:	Mady Delvaux (S&D, Luxembourg) Bernd Lucke (ECR, Germany) Nils Torvalds (ALDE, Finland) Miguel Viegas (GUE/NGL, Portugal) Sven Giegold (Greens/EFA, Germany) Barbara Kappel (ENF, Austria)	2017/0359 (COD) 2017/0358 (COD) Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')
Procedure completed.	Regulation (EU) 2019/2033 Directive (EU) 2019/2034 OJ L 314, 5.12.2019, pp.1-114	



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Author: Monika Kiss
Members' Research Service
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Introduction

The Commission is seeking to strengthen the European Union's (EU's) capital markets by means of the capital markets union (CMU) initiative. Better and more efficient capital markets will help to increase financing for companies, promote investment and strengthen economic and monetary union. Investment firms play an important role in capital markets through facilitating savings and investment flows across the EU. They provide a range of services that give investors access to securities and derivatives markets through investment advice, portfolio management, brokerage, execution of orders, proprietary trading, underwriting, etc.

According to a 2015 report on investment firms by the European Banking Authority (EBA) there are just over 6 500 investment firms initially authorised and regulated by the Markets in Financial Instruments Directive (MiFID - since superseded by MiFID2/MiFIR, see 'existing situation' below). Over 70 % of European Union (EU) investment firms are based in either the United Kingdom (UK), Germany or France – with a little over 50 % in the UK alone.[1] The only other Member States numbering over 200 investment firms, Spain and the Netherlands, also have significant numbers of investment firms covered by MiFID.[2] Whilst most investment firms in the EU are small or medium-sized, the EBA estimates that some eight investment firms, largely concentrated in the UK, control around 80 % of the assets of all investment firms.[3]

Investment firm regulations seek to preserve financial stability, protect investors and ensure orderly failure where a firm can no longer continue as a going concern. However, current rules (see below) are seen as fragmented, overly complex, not always consistently applied and often a poor fit for the actual risks taken by the various types of investment firms that they seek to manage. For this reason the Commission has proposed a new regulation on the prudential requirements for investment firms and a new directive on the prudential supervision of investment firms. These proposals aim to update the prudential and supervisory framework for investment firms, making it more effective and more closely calibrated to the size and nature of the different investment firms and their risks.

Existing situation

The current EU framework governing the authorisation and conduct of investment firms is set out in the Markets in Financial Instruments Directive (MiFID2) and Regulation (MiFIR). These became applicable as from 3 January 2018 (taking over from the regime set out in the original MiFID). In addition, investment firms are subject to prudential rules under the Capital Requirements Directive (CRR) and Regulation (CRD4), designed to ensure that they have sufficient resources to face the risks they undertake. Over time, these requirements have undergone significant changes as a result of the evolving risks faced by credit institutions (banks) and revisions to global banking standards, becoming more complex and requiring further derogations for investment firms. Depending on the size and risk profile, some firms are largely exempt from prudential regulation, some are subject to varying combinations of lighter prudential rules, and others are subject to the full rulebook.

According to the EBA, based on the CRR, it is possible to identify at least 11 different prudential categories of investment firms.[4] This categorisation largely depends on the services the particular firms provide and the kinds of clients they have. Such services may include simple reception/transmission of orders, or giving investment advice. In other cases it may extend to execution of orders and portfolio management. Other firms may engage in dealing on their own account. Some firms hold client funds/securities whilst others do not. Around 85 % of European Economic Area (EEA) investment firms limit their activities to: offering investment advice; receiving and transmitting orders; managing portfolios; and executing orders.

In the EBA's view, there are a number of issues with the existing regime, notably: inconsistencies due to differing national interpretations; inadequacy of risk sensitivity in the current framework; complexity of the legal framework; and the treatment of commodity derivatives firm where various waivers apply.

As part of the mid-term review (MTR) of the CMU action plan, the Commission announced it would propose a more effective prudential and supervisory framework for investment firms. This would be better tailored to the size and nature of investment firms and improve options for investors. The MTR noted that the United Kingdom's decision to leave the EU underlined the need to strengthen the EU's capital market framework, notably including that for investment firms.

Parliament's starting position

The Parliament, as co-legislator, agreed the Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRD4). Recognising that these rules are largely geared towards credit institutions (i.e. banks), this legislation included the requirement to review the framework for investment firms and follow this up with legislation, where appropriate.[5]

Council's starting position

As with the Parliament, the Council had recognised the need to review the framework for investment firms when agreeing to the CRR.

Preparation of the proposal

As noted above, the proposal stemmed from a requirement to review the framework for investment firms mandated by the CRR. This set out that the review should be completed by 31 December 2015 and informed by discussions with the competent authorities and public consultation. The review should then be followed by legislation, where appropriate.

Accordingly the proposal was developed with input from national competent authorities, the European Securities and Markets Authority (ESMA) and in particular (given its competence for the prudential framework for investment firms) the European Banking Authority (EBA). The Commission issued a call for advice to the EBA in December 2014. It asked it to assess whether the prudential requirements applicable to investment firms (including exemptions therefrom) laid down in the CRR and the CRD were appropriate or whether they should be modified, and, if so, how.

This led to the Report on investment firms, prepared by the EBA in collaboration with ESMA, published in December 2015. The report presented a detailed overview of the categorisation of investment firms, an analysis of the risks they face and the prudential requirements they are subject to. The report went on to set out recommendations for changes to the framework governing investment firms. Two of the main recommendations made were:

- to develop a new categorisation of investment firms, i.e. (i) systemic and 'bank-like' investment firms to which the full CRR/CRD4 requirements should be applied (ii) other ('non-systemic') investment firms with a more limited set of prudential requirements; and (iii) very small firms with 'non-interconnected' services;
- to develop a prudential regime for 'non-systemic' investment firms.

A subsequent call for advice, issued by the Commission on 13 June 2016 focusing on these two recommendations, led to the EBA issuing a discussion paper Designing a new prudential regime for investment firms, which it published on 4 November 2016. The paper posed 35 specific questions and the consultation period ran for three months. A total of 47 responses were subsequently published on the EBA site (59 written responses were received in total). Alongside this consultation, national competent authorities, at the behest of the EBA, undertook a data gathering exercise from investment firms to underpin stakeholders' input. Data was received from 1 764 firms.

On 3 July 2017, the EBA also held a public hearing to update stakeholders on the progress of their work including the preliminary results of its data collection and the calibration of the underlying methodology.

Given this work, the Commission decided to forego running its own general public consultation in parallel and instead engaged in a targeted consultation with stakeholders. This included a roundtable with industry stakeholders on 27 January 2017, a workshop on the costs of the current regime on 30 May 2017 and a workshop on the EBA's draft final recommendations on 17 July 2017. An inception impact assessment was also published for consultation on 22 March 2017 and attracted eight responses. The review was also discussed with Member States in the Financial Services Committee in March and October 2017 and in the Experts Group on Banking, Payments and Insurance in June and September 2017.

The EBA set out its final recommendations in response to the Commission's call for advice in its Opinion of 29 September 2017. The Opinion made 62 recommendations in total and was accompanied by a detailed Annex providing the underpinning data and analysis supporting the Opinion. In essence this recommended the development of a consolidated single rulebook for all investment firms covered by MiFID, except for systemic investment firms or investment firms that are exposed to the same types of risks as credit institutions (i.e. banks). This latter category (which the EBA termed 'Class 1') would be subject to the full CRR/CRD4 requirements. The remainder – the vast majority of investment firms – would be divided into two classes. Class 2 would be for other non-systemic investment firms above specific thresholds that should be subject to a more tailored prudential regime. Class 3 would be for small and non-interconnected investment firms providing limited services which should have a very simple regulatory regime.

On 20 December 2017, the Commission proposed a revised framework for investment firms consisting of a new regulation on the prudential requirements for investment firms and a new directive on the prudential supervision of investment firms. Alongside the proposals the Commission published a Commission staff working document Review of the prudential framework for investment firms. Notwithstanding the fact that a draft impact assessment had been produced and examined by the Regulatory Scrutiny Board (apparently on 7 September 2016), there was ultimately no final impact assessment. A staff working document was preferred instead on the basis that this was a more appropriate format 'given that the specific mandate of the review is based on the advice of the European supervisory authorities and their stakeholder consultation and technical work'. The staff working document also noted that 'According to the Better Regulation toolbox (tool #9), no Commission impact assessment is necessary whenever an EU agency has been mandated to carry out policy-design work and related analysis ...' provided the Commission proposal does not deviate substantially from the agency's recommendations.[6]

The changes the proposals would bring

For the draft regulation on prudential requirements for investment firms, in line with the EBA opinion (building on earlier work), investment firms are split into three broad categories:

- Class 1 – systemic investment firms, or firms that are exposed to the same types of risks as credit institutions (i.e. banks). This includes investment firms with total assets above €30 billion that provide underwriting services and/or deal on their own account. These would be subject to the full CRR/CRD4 requirements applicable to credit institutions (banks);
- Class 2 – non-systemic investment firms exceeding any of a number of specific thresholds (e.g. assets under management under both discretionary portfolio management and non-discretionary (advisory) arrangements higher than €1.2 billion; client orders handled of at least €100 million per day for cash trades and/or at least €1 billion per day for derivatives; a balance sheet total higher than €100 million; total gross revenues higher than €30 million; exposure to risks from trading financial instruments higher than zero; client assets safeguarded and administered higher than zero; and client money held higher than zero). Such firms would be subject to a more tailored prudential regime involving the use of so-called 'K-factors', which set capital requirements according to the

volume of certain services and business practices that can generate risks to the firm, its customers and counterparties[7]; and

- Class 3 – smaller and less complex firms, not passing the thresholds for Class 1 or 2, representing lower risk and subject to the least onerous regulation.

Firms categorised as **'Class 1'** would remain under the CRR/CRD4 regime and be treated like credit institutions (banks). Such firms underwrite risks and are the largest and most interconnected investment firms with risk profiles similar to those of significant credit institutions. The proposal (article 60) changes the definition of 'credit institution' in Article 4(1)(1) of the CRR to bring certain investment firms within it; such firms being those with total assets above €30 billion that also deal on their own account and/or underwrite financial instruments and/or place financial instruments on a firm commitment basis. In this way, investment firms that meet these criteria would be authorised as credit institutions, be subject to CRR/CRD4 requirements and overseen by banking supervisors. Hence the operations of large investment firms established in Member States participating in the banking union could be subject to direct supervision by the European Central Bank (ECB) in the framework of the single supervisory mechanism. Aligning the regulatory and supervisory treatment of systemic investment firms with that of credit institutions ensures a level playing field and is in line developments in other jurisdictions (e.g. the United States, Switzerland and Japan). In the EU, most such firms are currently located in the United Kingdom, though many are in the process of relocating parts of their operations to the EU-27.

For **'Class 2'** firms – non-systemic firms that nonetheless exceed the thresholds to qualify as small and non-interconnected 'class 3' firms – a new approach to capital requirements determined by so-called 'K-factors' is proposed (Title II). Essentially this sets a formula for determining an investment firm's capital requirements in accordance with the volume of its services and business practices that are most likely to generate risks to the firm, to its customers and to counterparties. Metrics covering a range of risk factors are calculated in accordance with the terms of the regulation to ensure consistency. These metrics can then be multiplied by specific coefficients (as for instance set out in article 15 (2)) to appropriately weight each of the risks, producing the K-Factor for that particular risk.

K-Factor example

For instance 'client money held' (CMH) represents a risk. The level of CMH is calculated in accordance with article 18 of the draft regulation to ensure it is consistently done. For example article 18 specifies that CMH is the rolling average of the value of total daily client money held, measured at the end of each business day for the previous three calendar months. Having calculated CMH, the K-Factor for CMH (known as K-CMH) is then determined by multiplying CMH by the coefficient set out in article 15(2) – 0.45 % in this case – to give it an appropriate risk weighting. K-CMH will then be added to other K-Factors to set the overall capital requirement.

K-factors capture three types of risk: risks to customer (RtC), risks to market (RtM) and risks to firm (RtF). The sum of these three sets of risks is the capital requirement.

RtC (articles 16 to 20, Chapter 2) is comprised of the sum of four K-factors:

- K-AUM (assets under management under both discretionary portfolio management and non-discretionary (advisory) arrangements. These are calculated as a rolling average based of 12 monthly readings (**see article 17 for precise terms**) multiplied by the set coefficient);
- K-CMH (client money held, calculated on the basis of a rolling average from the previous three months (**see article 18 for precise terms**) multiplied by the set coefficient);

- K-ASA (assets under safekeeping and administration, calculated on the basis of a rolling average over three months (**see article 19 for precise terms**) multiplied by the set coefficient); and
- K-COH (client orders handled, calculated on the basis of a rolling average over three months (**see article 20 for precise terms**). Different coefficients apply when calculating K-COH for cash trades and derivatives).

RtM (articles 21 to 23 Chapter 3) has two *alternate* K-Factors. Whichever of the two (where the competent authority permits it) gives the highest level is the one used:

- K-NPR (net position risk, based on the market risk requirements of the CRR (Title IV of Part Three) **see article 22 for precise terms**); and
- K-CMG (clearing member guaranteed, alternative to K-NPR, if permitted by the competent authority, one based on margins posted with clearing members for trades guaranteed by the latter. **See article 23 for precise terms**).

RtF is comprised of the sum of three K-Factors:

- K-TCD (trading counterparty default. This is calculated using a simplified application of the corresponding requirements under CRR for counterparty credit risk. **See articles 25 to 31 for precise terms**);
- K-DTF (daily trading flow, calculated on the basis of a rolling average from the previous three months. Different coefficients apply when calculating K-DTF for cash trades and derivatives. **See article 32 for precise terms**); and
- K-CON (concentration risk. This is calculated using a simplified application of the corresponding requirements under CRR for the treatment of large exposures in the trading book. **See Part Four and article 38 for precise terms**).

The sum of RtC, RtM and RtF gives the overall K-Factor requirement, i.e. the minimum capital requirement for the specific class 2 investment firm presenting these risks.

For **'Class 3'** investment firms, which are small and non-interconnected (as per the criteria set out in article 12), their minimum capital will be set at the higher of their initial authorisation capital or a quarter of their fixed overheads for the previous year. The calculation of the latter is set out in article 13 which includes the EBA developing draft technical standards in consultation with ESMA and taking account of a Commission delegated regulation on own funds requirements for firms based on fixed overheads.

The draft regulation also states that investment firms must monitor and control their **concentration risk** (article 33). Firms that are not exempt (on account of being small and non-interconnected) also need to report their concentration risk at least annually to the competent authorities (article 34). A limit on exposure to a single client (or group of connected clients) of 25 % of regulatory capital is placed on those firms dealing on their own account or for clients (article 36). Rules on **liquidity** (articles 42 to 44) notably include that firms are required to hold at least one third of their fixed overheads requirements in liquid assets.

Investment firms will be subject to **reporting requirements** to the competent authorities on their compliance with the prudential framework. These will be more onerous for those firms covered by the K-Factor approach, which will be required to publically disclose their levels of capital, their capital requirements, remuneration policies and practices, and their governance arrangements.

To facilitate a **smooth transition** to the new regime, investment firms facing an increase of more than double the capital requirements previously required, benefit from a cap for the first five years that the regulation applies. New firms are likewise permitted to apply a limit at twice their fixed overheads, while investment firms that were only subject to a requirement for initial capital under CRR/CRD4 could limit their capital requirement to twice this requirement to mitigate such increases.

The draft directive on supervision of investment firms, meanwhile, sets rules on **initial capital** for investment firms, depending on the activities and services they are authorised to provide under the MiFID regime, in order to harmonise them and revise them to take account of inflation (article 8). **Prudential supervision** (Title IV, Chapter 1) covers home/host powers, exchange of information, penalties and investigatory powers. This includes Member States establishing administrative **penalties** and other measures to ensure compliance with the rules (article 16).

Title IV Chapter 2 covers the process for **internal assessments of capital adequacy, internal governance, transparency, treatment of risks and remuneration** together with the supervisory review and evaluation process, measures and powers. Notably this sets out **simplified requirements**, based on those in CRD4, to **assess the adequacy of arrangements and procedures** in order to ensure that firms comply with the provisions of this directive and the regulation. Supervisory authorities should have **powers to require changes** in areas such as internal governance and controls, risk management processes and procedures and, where necessary, set additional requirements, including in particular capital and liquidity requirements. On **remuneration**, rules are revised in line with the EBA's advice to ensure the orderly functioning of investment firms and prevent excessive risk-taking by their staff. These rules also recognise the different nature of investment firms and credit institutions, the need for some flexibility and that for reasons of proportionality, small and non-interconnected firms should be exempted. Such 'class 3' firms are of course still covered by rules under MiFID, such as ensuring sales staff are not incentivised through the remuneration structure to recommend unsuitable products, in order to protect investors and consumers.

Taken together, the proposed regulation and directive are expected to provide better support for the activities of investment firms, enhancing competition and lowering compliance costs, including through more tailored and appropriate prudential standards and oversight.

Advisory committees

The European Economic and Social Committee (EESC) adopted its opinion (rapporteur: Jarosław Mulewicz, Employers – Group 1, Poland) on these two proposals on 19 April 2018. The opinion welcomed the Commission proposals. It noted that the relocation of UK-based investment firms would tend to be to Member States in the banking union or euro area and in particular existing financial services centres. The EESC was pleased that investment firms that were small and medium sized enterprises (SMEs) would be expected to derive particular benefit from reduced regulatory burdens and greater opportunities for innovation. This in turn would benefit other SMEs and savers. Noting the unilateral introduction by the EU of a specific legal framework for investment firms, it stressed the need to monitor the new rules closely and amend them in a flexible way should financial markets respond negatively (e.g. UK investment firms relocating to the USA rather than the EU).

National parliaments

The deadline for issuing reasoned opinions on the grounds of subsidiarity (in the case of both the proposed regulation and directive) was 9 March 2018; none were received.

Stakeholders' views[8]

Stakeholders have been engaged at various points during the development of the new prudential and supervisory regime for investment firms. Notably the formal consultation on the EBA's discussion paper (see above 'preparation of the proposal') attracted 59 responses (with 47 responses available on the EBA website). Given this work by the EBA, the Commission decided to engage in a targeted consultation, rather than run a parallel public consultation. However its inception impact assessment did attract eight responses. There are no formal summaries from the Commission or EBA of these consultation responses. However, the EBA's Annex to its formal Opinion noted at various points some of the opinions expressed during consultations. These included:

- concerns about certain of the categorisation criteria that, in respondents' views, focused less on the risk posed by firms and were overly restrictive in particular in terms of achieving 'class 3' status. A number of these points were accepted by the EBA and led to a revision of the criteria (pages 14 to 15);
- general support for the proposed approach to addressing group risk in investment-firm-only groups, while also recognising the need for consolidated supervision in the case of systematically important groups (page 21);
- the view that fixed overheads requirements (FOR) should be kept in the regime as a minimum requirement; some however felt these could be inappropriately high for some and too low for others and hence further work was needed (pages 37 to 38);
- on liquidity, little support for option ii) of the three options put forward in the discussion paper, namely (i) counterbalancing capacity (ii) liquidity buffer and (iii) regulatory requirement, with options (i) and (iii) both winning some support (page 73);
- on concentration risk, no consensus with some respondents feeling a reporting regime would be beneficial, while others thought that it would be unduly burdensome (page 79); and
- concern from most respondents about the appropriateness of the proposed regime for commodity derivatives investment firms. They felt that commodity derivatives investment firms[9] were different from banks and most investment firms, and the introduction of prudential requirements should be based on an evidenced-based approach (page 90).

The Commission staff working document 'Review of the prudential framework for investment firms' published alongside the proposals, gives an overview of the various procedural consultation steps taken by the EBA and the Commission in Annex III (pages 45 to 46), although there is no information given on the content of the consultation feedback itself. The Commission notes that several replies submitted in its wider 2015 call for evidence on the efficiency, consistency and coherence of the overall EU regulatory framework for financial services, pointed to various issues relevant for the review on investment firms.

Some views expressed in the responses to the EBA consultation included: Blackrock (a very large investment firm) that supported the development of a prudential regime tailored to investment firms in general, and asset managers in particular, rather than relying on a 'one-size-fits-all' set of rules originally designed to apply to banks. Finance Watch (a public interest association dedicated to making finance work for society) agreed that the categorisation of investment firms should be simplified and the burden on small, independent firms be reviewed. However, it felt this could be achieved within the existing CRR/CRD4 framework and disagreed with the EBA's conclusion that only systemically important firms should be governed by that regime. JP Morgan Asset Management (an asset manager) supported the creation of a new regime for investment firms that were not bank like, but felt classes 2 and 3 should not distinct. Vanguard Asset Management (a very large investment management company) did not think that the current CRR/CRD4 regime was appropriate for asset managers and supported the development of a separate proportionate regime to take into account the specific risks associated with investment firms. They supported an activities-based approach to identifying risk to ensure that all investment firms are subject to the same rules regardless of their size.

Looking at some reactions to the final proposals made by the Commission, the European Fund and Asset Management Association (EFAMA – the representative association for the European investment management industry) welcomed the European Commission's proposal for a directive and a regulation establishing a self-standing prudential regime for investment firms. It noted its support for a clear demarcation between the prudential regime for credit institutions (banks), and a more proportionate regime for non-bank actors. It felt the remuneration provisions in the draft directive would help achieve a proportionate regime for investment firms' non-bank staff. EFAMA also welcomed the move towards a closer alignment of the existing MiFID regime for discretionary portfolio managers and advisors with the standards of the UCITS/AIFMD frameworks. It flagged remaining uncertainties relating to the continuing oversight role of banking authorities, while welcoming this step towards a gradually harmonised and unique EU regime for asset management companies. Noting the possible need for further refinement in some technical areas, it supported the speedy introduction of the new regime.

The Association for Financial Markets in Europe (AFME - the association of all Europe's wholesale financial markets) also welcomed the proposals noting that prudential rules that are specifically tailored to the business models and risks assumed by investment firms should further the development of capital markets union. It noted that the requirement for class 1 firms to remain subject to the prudential rules of CRR/CRD4 and be overseen directly by the ECB for their euro-area activities was welcome as it would foster a level playing field.

Legislative process

In January 2018 the European Parliament and the Council of the European Union requested that the European Central Bank (ECB) deliver an opinion on the proposed regulation and directive, as they affect the ECB's tasks. This opinion was delivered on 22 August 2018 and supports the proposals aim of setting out a prudential framework that is better adapted to the risks and business models of different types of investment firms. The opinion suggests a number of points and amendments to the proposals, offering for instance further criteria for classifying investment firms as class 1 (systemic institutions and hence falling under ECB prudential supervision) and clarity on wider banking authorisations and cooperation between various supervisory bodies. Other points raised include: consistency of statistics; a macro prudential (i.e. holistic) perspective to regulating investment firms; provision of services by third country firms; and alignment with existing credit institution rules and definitions to avoid unintended consequences.

The European Parliament's Committee on Economic and Monetary Affairs (ECON) (rapporteur Markus Ferber, EPP, Germany) has been leading on this file covering both draft regulation and draft directive. Separate draft reports, one for the regulation and one for the directive, were published on 11 April.

For the draft regulation on prudential requirements for investment firms, whilst broadly supporting the draft proposal the rapporteur suggested some changes guided by the three aims of increasing regulatory certainty, introducing more flexibility, and providing a level playing field towards third-country firms. He proposed 36 amendments in his draft report and the changes included:

- allowing the smallest firms (i.e. 'class 3' firms which, among other things, have assets under management no higher than €1.2 billion) to hold limited (rather than zero) client money or assets without falling into class 2;
- allowing for greater legal clarity, more notice and smoother movement between class 2 (larger firms, for instance those with over €1.2 billion of assets under management) and class 3 firms and vice-versa;
- changes to capital and liquidity requirements and K Factors (K Factors is the new approach which can apply to class 2 firms and which sets capital requirements according to the volume of certain services and business practices which can generate risks to the firm, its customers and counterparties). These changes include: smoothing of certain K-Factors by taking the measurements over longer periods; removing advice activity risks from the assets under management risks; and better aligning actual risks by e.g. taking into account the protections already afforded by segregating client money;

- allowing the smallest (class 3) investment firms to fulfil requirements for own funds using different instruments than those listed in CRR;
- ensuring Parliament has a say in any adjustment to for instance the conditions for investment firms to qualify as small and non-interconnected firms;
- clearer and less prescriptive and burdensome rules on remuneration and disclosure thereof;
- changes to the third-country regime and equivalence to ensure Parliament has a say on decisions on equivalence through the delegated act procedure, that equivalence is assessed across the full range of areas applicable to EU institutions and that typical banking services are not subject to an equivalence decision, so that EU banks are not potentially placed in a less favourable position than third country investment firms.

Voting on the report (33 for, 8 against, 0 abstentions) and negotiating mandate (34 for, 8 against, 0 abstentions) took place on 24 September 2018. The decision to enter into interinstitutional negotiations was confirmed by plenary on 3 October 2018.

For the draft directive on supervision of investment firms, the rapporteur's draft report proposed 13 amendments. The changes were mostly concerned with simplifying and reducing the rules on reporting, governance and remuneration to lighten the burden for the firms covered, given their (smaller, non-systemic) nature.

The ECON committee vote on the report took place on 24 September 2018 (35 for, 9 against, 0 abstentions) and the negotiating mandate was agreed (35 for, 9 against, 0 abstentions). The decision to enter into interinstitutional negotiations was confirmed by plenary on 3 October 2018.

In the press release issued on the day the two reports were voted through, ECON MEPs highlighted the proportional, risk-based nature of the new rules for investment firms, including tightening the equivalence rules for third country investment firms to ensure a level playing field. They also noted efforts to smooth the transition between classes of investment firm amongst other things.

Consideration of the proposals in **Council** began on 25 January 2018 in the Working Party on Financial Services. On 15 October 2018, the Council Working Party considered presidency compromise proposals on the regulation and directive.

On 20 March 2019, a provisional agreement was reached between the European Parliament and the Council on the two texts. On 1 April 2019, the ECON committee approved the outcome of the negotiations. On the basis of the compromise texts agreed with the Council, Parliament voted at first reading on both the regulation (by 534 votes to 70, with 45 abstentions) and the directive (by 534 votes to 63, with 55 abstentions) on 16 April 2019. Given the tight timeline for finalisation before the end of the parliamentary term, linguistic corrections to the voted text were still needed, and thus the two texts would be subject to the corrigendum procedure.

According to the agreed regulation,

- investment firms that provide ‘bank-like’ services (dealing on own account or underwriting financial instruments), with consolidated assets exceeding €15 billion will automatically be subject to CRR/CRD4;
- investment firms engaged in ‘bank-like’ activities with consolidated assets between €5 and 15 billion can be requested by their supervisory authority to apply CRR/CRD4, in particular if the firm's size or activities involve risks to financial stability;
- competent authorities could, on a case by case basis, allow to continue applying banking requirements to certain firms in order to avoid disrupting their business model. Such an option will be framed with a safeguard preventing regulatory arbitrage, in particular through a disproportionate application of lower capital requirements under CRR/CRD4 as compared to IFR.

Small non-interconnected investment firms (where the total balance sheet and off-balance sheet items of the firm are less than €100 million and where the firm is part of an insurance group) could benefit from an exemption from the concentration, publication and reporting requirements. They would only be required to provide information on liquidity requirements where applicable.

The regulation requires investment firms to disclose information regarding their remuneration policy and practices, including aspects related to gender neutrality and the gender pay gap, for those categories of staff whose professional activities have a material impact on an investment firm's risk profile.

Member States must ensure that investment firms disclose: (i) the proportion of voting rights attached to the shares held directly or indirectly by the investment firm, broken down by Member State and sector; (ii) the complete description of voting behaviour in the general meetings of companies in which they hold shares.

The regulation sets a strong equivalence regime applicable to third-country investment firms. It sets out in great detail some of the requirements for giving them access to the single market, and grants additional powers to the Commission (such as assessing capital requirements applicable to firms providing bank-like services to make sure that those are equivalent to those applicable in the EU).

ESMA may temporarily prohibit or restrict a third-country firm from providing investment services or performing investment activities with or without any ancillary services where the third-country firm has failed to comply with any prohibition or restriction imposed by ESMA or EBA or by a competent authority or on a request from ESMA in due time and manner, or where the third-country firm does not cooperate during an investigation or when an on-site inspection is being carried out.

The agreed directive states that

- Competent authorities may decide to apply the requirements of the Regulation and the Capital Requirements Directive (CRR/CRD IV) to an investment firm that carries out any of the activities where the total value of the consolidated assets of the investment firm exceeds €5 billion, in particular where the firm carries out these activities on such a scale that the failure or distress of the investment firm could lead to a systemic risk.
- Competent authorities should ensure that investment firms have appropriate strategies and processes in place to assess and maintain the adequacy of their internal capital. Competent authorities should also be able to request small and non-interconnected firms to apply similar requirements where appropriate.
- Competent authorities can define additional requirements, in particular with regard to capital and liquidity requirements, in particular for investment firms that are not considered to be small non-interconnected investment firms and, where the competent authority considers it justified and appropriate, for small non-interconnected investment firms.
- Member States shall ensure that investment firms provide the competent authorities, on request, with the total amounts of remuneration for each member of the management body or general management.
- EBA shall prepare a report on the introduction of technical criteria related to exposures to activities associated substantially with environmental, social, and governance (ESG) objectives for the supervisory review and evaluation process of risks, with a view to assessing the possible sources and effects of such risks on investment firms.
- The competent authorities of different Member States should cooperate closely in carrying out their tasks under the Directive, in particular by exchanging information on investment firms without delay.
- To safeguard compliance with the obligations laid down in the Directive, Member States should provide for administrative sanctions and other administrative measures which are effective, proportionate and dissuasive.

Following linguistic revision, corrigenda were endorsed by the ECON committee and then by Parliament in October 2019, enabling the Council to complete adoption of the two proposals. Both were signed on 27 November 2019, and published in the Official Journal on 5 December. The regulation is fully applicable as of 26 June 2021, while Member States have to transpose the measures under the directive into national law and apply them as of the same date.

EP SUPPORTING ANALYSIS

EPRS, Implementation Appraisal Revised framework for investment firms, December 2017.

OTHER SOURCES

Prudential requirements of investment firms, European Parliament, Legislative Observatory (OEIL).

Prudential supervision of investment firms, European Parliament, Legislative Observatory (OEIL).

ENDNOTES

[1] See page 5 of 'Report on investment firms', 2015, EBA.

[2] Ibid, Table 12, page 96.

[3] Ibid, table 5, page 27.

[4] Ibid, page 14 and Table 2 page 15.

[5] The current proposals are therefore the outcome of the review mandated by Articles 493(2), 498(2), 508(2) and 508(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation, or CRR).

[6] See page 1.

[7] So-called 'K-Factors' are the name given to a set of factors proposed by the EBA to measure the risk to customers, to markets and to investment firms themselves. The result of this approach is a capital regime for 'Class 2' investment firms using these K-Factors to determine the required regulatory capital they must hold. More information is provided in the Annex to the EBA's Opinion (Chapter 5, starting on page 33) and in the Commission staff working document e.g. page 19.

[8] This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.

[9] Firms that essentially engage in hedging activity using commodity derivatives. Under MiFID, many entities trading commodity derivatives relied on exemptions to avoid the need for authorisation as an investment firm. MiFID II severely restricts those exemptions. As the Commission's staff working document notes 'The business of many of these firms involving financial instruments tends to revolve around hedging the risks of their parent companies related to the physical production, transmission, storage or purchase of the underlying physical commodities. Other relevant EU regulatory provisions have already taken the specificities of commodity firms into account but the determination of the prudential rules for firms which would fall under the current framework has simply been postponed until now'.

eprs@ep.europa.eu (contact)

www.eprs.ep.parl.union.eu (intranet)

www.europarl.europa.eu/thinktank (internet)

http://epthinktank.eu (blog)

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