Preparing for IFR and IFD What next on the road to June 2021?

A Background Briefing from Dentons' Eurozone Hub

April 29, 2020

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Quick Take

The EU's new IFR/IFD framework reshapes how investment firms and others with MiFID top-up permissions calculate their regulatory capital requirements and at what level these need to be maintained from June 2021. All firms in scope of the IFR/IFD need to fall within specific class, based on their regulated activity but also certain quantitative metrics in the form of K-Factors. Systemically important and larger risky investment firms will be treated either as credit institutions or be held to the same rules under the CRR 2/CRD V framework. Those in the Eurozone and its Banking Union will become subject to SSM and SRM supervision. All others will become subject to the IFR/IFD framework, which includes a consolidated set of regulatory capital and liquidity requirements with limited waivers along with rules on internal models, governance, remuneration and disclosure. Firms, in particular those in groups, will want to take prompt action well ahead of the June 2021 start date.

The new prudential rules relevant to investment firms introduced by Regulation (EU) 2019/2033[1] - Investment Firms Regulation (**IFR**) and Directive (EU) 2019/2034[2] - Investment Firms Directive (**IFD**) have now entered into force. The European Parliament and Member States agreed on the proposal on February 26, 2019 and it was then endorsed on April 18, 2019. The rules were then published in the Official Journal on December 5, 2019 and entered into force twenty days later.

This Background Briefing looks at what has happened since January 2019 and updates the second part of our Eurozone Hub's coverage on this development.[3] This can also be read in conjunction with the first part in the series.[4] While there have been no substantial changes since the proposed amendments were analyzed last January[5], some minor revisions have been made and thus it is worth restating the rules as enacted and now applicable. Moreover, the IFD amends a range of other pillars of the EU's financial services legislative acts.[6]

For financial services firms, the IFR/IFD framework not only changes how capital requirements are calculated but also the minimum levels that need to be held along with copying over a number of compliance obligations that have been commonplace in the EU's banking sector, as reinforced by efforts in the Banking Union. It is important to note that the IFR/IFD framework applies across the entire EU-27 and also has extraterritorial effect to non-EEA jurisdictions i.e., third-countries and that it will also be supplemented by EU-wide delegated acts from EU authorities. The IFR/IFD framework is also likely to be supplemented within, by those jurisdictions that are part of the Banking Union, as well as by rules and further supervisory expectations by Banking Union authorities at the EU and national level.

1 Available here.
2 Available here.
3 Available here.
4 Available here.
5 Available here.
6 This includes, by way of non-exhaustive example:
- AIFMD (including a manager's regulatory capital not being permitted to be lower than the IFR/IFD framework)
- CRD IV (including, amongst other changes, powers to coordinate supervision and changes to the determination of the consolidating supervisor)
- BRRD
- MiFID II (requiring an authorization is not granted unless it has met its initial capital requirements in the IFR/IFD framework and that EU branches of third-country firms are only authorized if MiFID II obligations are met as well as clarifying the reverse solicitation rules for third-country firms providing services to an EU domiciled/resident client.

Where are we now?

The IFR becomes directly applicable from June 26, 2021 and Member States have until that date to adopt and publish the measures necessary to transpose the IFD. Certain limited transitional provisions permit the hardest hit investment firms to apply lower capital requirement for a period of five years from June 26, 2021.[7] The EU supervisory authorities, European Banking Authority (**EBA**) and the European Securities and Markets Authority (**ESMA**) are expected to deliver a range of implementing and regulatory technical standards ahead of but also following that date thus placing firm moving to this new regime under considerable compliance pressure. The same is also expected to be copied in the Banking Union by the efforts of both the European Central Bank in its Single Supervisory Mechanism role (**ECB-SSM**) along with the actions of the Single Resolution Board (**SRB**) at the head of the Single Resolution Mechanism (**SRM**) that may require those largest MiFID investments firms becoming regulated as or like banks, to comply with additional rules and/or supervisory expectations. It is conceivable that the United Kingdom may mirror some of the IFR/IFD framework into its own domestic regulatory regime.

Regardless of temporary reliefs, affected financial services firms will need to act now in order to be best placed for these changes to capital requirements, and have compliance systems to capture new metrics on an on-going basis including how these flow into the Internal Capital Adequacy Assessment Process (**ICAAP**), the Individual Liquidity Adequacy Assessment Process (**ILAAP**) and the Supervisory Review and Evaluation Process (**SREP**), new rules on remuneration and ultimately a more regulatory invasive, possibly more centralized style of supervision for certain larger firms. The issues raised herein are likely to be relevant to all business and control functions (legal, risk, compliance, governance and audit) in optimizing both the regulatory capital requirement impact, the on-going cost of compliance but will likely also influence how some firms structure, execute, book and custody various transactions.

Classes of investment firms

In summary, the IFR/IFD framework's aim is to create a new, simpler and more risk-sensitive prudential capital regime for investment firms, by cross reference to such term in MiFID II,[8] built around an assessment of the type, size and complexity of the

7 The transitional provisions permit for firms to hold a multiplier of certain parts of their regulatory capital requirements for such five-year period. A number of considerations will depend largely on their existing business model and how that might change under the IFR/IFD framework as well as the wider regulatory reforms. Please speak to you Eurozone Hub contacts to discuss how the IFR/IFD framework and/or the temporary transition provisions

8 The IFR/IFD framework does not apply to a firm, which is exempted due to a:
- derogation in Article 2 MiFID II; or
- national options and/or discretion exercised by a Member State in accordance with Article 3 MiFID II.

firm's business and its wider group including by reference to quantitative metrics, called "**K-Factors**". These K-Factors are supposed to help define regulatory capital levels in a more proportionate manner than the existing prudential regulatory regime that applies to MiFID investment firms (i.e., CRR/CRD IV, as amended by **CRR 2/CRD V**).

The IFR/IFD also introduces changes to the prudential requirements that are required to be met by insurers, non-MiFID financial service providers, UCITS Management Companies and Alternative Investment Fund Managers in the event that these have made use of "MiFID Top-Up" permissions i.e., where in addition to being authorized under AIFMD, such firms have "topped-up" their permissions allowing these to carry out MiFID activity and services. In such a case such firms will have to apply IFR/IFD in parallel to their existing prudential requirements.

The IFR/IFD framework requires that in-scope firms fall within a specific class. The allocation to a specific class is driven by both the type of MiFID investment activity being undertaken pursuant to MiFID II/MiFIR (i.e., qualitative consideration) and the K-Factor values (i.e., quantitative considerations). Anti-avoidance provisions for groups are set out in the IFR/IFD framework. The four classes of firms for IFR/IFD purposes are namely:

- **Class 1:** systemic firms undertaking "bank-like" activities that are reclassified as "credit institutions" under the amendments to the CRR made by Art. 62(3) IFR and will then forthwith be subject to the prudential, risk and remuneration requirements of CRR 2/CRD V, as will be further amended through the future implementation in the EU of the Basel III package. For those in the Eurozone these would then become subject to Banking Union lead supervision and perhaps a very different supervisory tone then what they may be used to. Crucially, absent any communication from the EBA and/or ECB-SSM, any firm that would count as a Class 1 firm on December 24, 2019 is required to apply for re-authorization as a credit institution by December 27, 2020 as re-authorization is **not** automatic. Any firms that qualify as a Class 1 firm following June 26, 2021 must also promptly apply for re-authorization but may continue their activity pending a decision on their application. There is no clarification currently as to how re-authorization treats existing cross-border or branch activities under MiFID passporting rights, which would be extended under a CRR 2/CRD V passporting rights adding foreign exchange, lending and other services.
- **Class 1 minus:** Class 1 firms that are not reclassified as credit institutions and are thus not transferred to the CRR 2/CRD V regime.
- **Class 2:** non-systemic investment firms falling between classes 1 and 3 but who exceed one or more of the thresholds applicable to a Class 3 firm.
- **Class 3:** small and non-interconnected firms that do not undertake "higher risk activities" and are below certain thresholds of the K-Factors and who may benefit from certain proportionate application of the IFR/IFD framework

If a firm, which is conducting high-risk activities, has consolidated assets of more than €30bn, the firm will be reclassified as a credit institution; this is the "Class 1" type. Alternatively, if the firm's consolidated assets are between €15bn and €30bn, then the firm will be required to comply with the CRR 2/CRD V framework for prudential purposes rather than the IFR/IFD but still be treated as an investment firm and not a credit institution. If the assets are over €5bn and the firm satisfies a test as to its systemic significance, then supervisors have a discretion to require the firm to comply with CRR 2/CRD V framework for prudential purposes rather than IFR/IFD. Certain carve-outs exist for commodity and emission allowance dealers as well as for AIFs, UCITS and insurance undertakings.

The classification of Class 2 and Class 3 firms on the other hand depends on the activities they carry out. Class 2 firms are non-systemic investment firms who exceed one or more of the Class 3 thresholds described. This means that they will still need to comply with the full IFR and IFD requirements, including in respect of own funds, concentration risk, liquidity, reporting and public disclosure requirements. "K-Factors" are also used to calculate capital requirements for Class 2 firms. A Class 2 firm can become a Class 3 firm and conversely a Class 3 firm can be re-categorized as Class 2 if it no longer satisfies the thresholds – either immediately or after three months depending on the relevant threshold.

A firm exceeding the following thresholds will be categorized as a Class 2 firm for IFR/IFD purposes:

- **Assets under management** (**AUM**) calculated on a consolidated basis for a group – over EUR 1.2 billion in value of assets managed under

discretionary portfolio management and non-discretionary investment advice of an on-going nature. Asset whose management is formally delegated to another firm are included but assets that are delegated to it are excluded from that calculation.

- **Client orders handled (COH)** calculated on a consolidated basis for a group and may include transactions entered into by the firm in its own name – EUR 100 million (cash trades) or EUR 1 billion derivatives in notional amounts (OTC/ETD) each day with reference to the value of client orders arising out of the receipt and transmission or the execution of such client orders. The COH calculation covers transactions that result from investment advice which are not factored in the AUM calculation. Moreover, the COH calculation includes those set of transactions resulting from portfolio management arrangements on behalf of investment funds that are not otherwise factored into account under the AUM metric.
- **Assets safeguarded and administered (ASA)** calculated on an individual firm basis – over EUR 0 value of assets safeguarded and administered for clients regardless of where these are recorded for accounts and balance sheet purposes and regardless of whether these are segregated by other firms i.e., with a custodian/depositary.
- **Client money held (CMH)** calculated on an individual firm basis – over EUR 0 value of client money held.
- **Daily trading flow (DTF)** calculated on an individual firm basis – over EUR 0 value of transactions entered into by the firm dealing on own account or executing client orders but in its own name. This metric excludes transactions that have been included in the COH metric or those arising out of portfolio management services on behalf of investment funds.
- **Net position risk (NPR)** calculated on an individual firm basis – over EUR 0 value of transactions recorded in a firm's trading book that give rise to foreign exchange and/or commodities risk.
- **Clearing margin given (CMG)** calculated on an individual firm basis – over EUR 0 value of the third highest amount of total margin related to transactions required daily over the preceding three months multiplied by a factor of 1.3. CMG will apply to transactions, whether in the firm's trading book or which give rise to foreign exchange and/or commodities risk, are centrally cleared through a CCP that is authorized or recognized pursuant to EMIR.
- **Trading counterparty default (TCD)** calculated on an individual firm basis – over EUR 0 value of derivatives (OTC and ETD), securities financing transactions (**SFT**s as defined under the EU's SFTR) and related transactions in a firm's trading book that give rise to a risk of counterparty default. Arts. 26 to and including 32 set out specific rules, which may be supplemented by rulemaking from the EBA and the ECB-SSM, see our coverage from our Eurozone Hub, relating to the calculation of the following for the purposes of

TCD: exposure value, replacement costs, potential future exposure, collateral (as amended by way of a volatility adjustment), netting and credit valuation adjustment.

- **Balance sheet total** calculated on a consolidated basis for a group and which includes off-balance sheet items – over EUR 100 million.
- **Annual gross revenue from investment services** calculated on a consolidated basis for a group – over EUR 30 million in value.

Class 3 firms' specific prudential requirements do not relate to the K-Factors, but Class 3 firms still need to calculate their K-Factor scope for categorization purposes. Class 3 investment firms are not subject to the remuneration requirements under IFR/IFD, except if they are included in a group subject to consolidated supervision under the new regime.

Given that the large majority of MiFID investment firms were only subject to a EUR 50,000 initial capital requirement, they will likely become subject to significantly higher capital requirements as a result of changes to the methodology and the K-Factors. In short, K-Factors are clearly costly in terms of increased own fund requirements but will also likely be costly in terms of investment in systems and resources needed to identify, mitigate and manage risks generally as well as those specifically relevant to the K-Factors. A number of affected firms will most likely look to recoup the costs elsewhere.

Classes and prudential requirements

The IFR/IFD Framework operates, like in CRR 2/CRD V on a three pillar structure. Pillar 1 corresponds to the initial capital requirement (**ICR**), Pillar 2 is calculated following an ICAAP and SREP process with the possibility of capital add-ons and Pillar 3 imposes a compulsory disclosure regime. The new IFR/IFD Pillar 1 requirement is the greater of:

A. a permanent ICR of between EUR 75,000 and 750,000;

B. a fixed overhead requirement (**FOR**) equal to 25% of the previous year's fixed overheads; and

C. the relevant K-Factor coefficient(s) which acts as a multiplier and which applies to all Class 1 minus and Class 2 firms but not Class 3 firms.

Once a value is established for a firm, the make-up of regulatory capital must follow the three types of permitted capital i.e., Common Equity Tier 1 (CET1) i.e. common equity, Additional Tier 1 (AT1), form of convertible bonds, and Tier 2 instruments (T2) usually made up of subordinated debt. IFR/IFD firms (in keeping with the CRR2/CRD V framework) must have and maintain CET 1 of at least 56% of its regulatory capital base, and AT1 cannot exceed 44% whereas T2 may not exceed 25%. This means that for a firm's own funds requirements CET1 + AT 1 must be greater than 75% and CET 1 + AT 1 + T2 capital must be greater than 100% at all times.

The IFR/IFD framework sets the new ICR levels according to their authorized activities:

- EUR 750,000: for firms undertaking any of: "dealing on own account"[9], "underwriting", or "placing on a firm commitment basis", which also includes operators of organized trading facilities (**OTF**) with permission to deal on own account;
- EUR 150,000; operation of a multilateral trading facility (**MTF**) or an OTF.
- EUR 75,000: for firms undertaking any of "reception and transmission of order", "execution of orders on behalf of clients", "portfolio management", "investment advice", "placing not on a firm commitment basis";

In terms of what this costs for firms, while calculations are likely to be different depending on firm type and activity[10], the increase of the starting point for ICR from EUR 50,000 to 75,000 is a noticeable increase.[11] Overall, we expect that investment firms that are caught within the scope of the IFR/IFD framework will see their Pillar 1 requirements increase. The Class 1 minus firms may see their Pillar 2 requirements increase and those Class 1 firms that are recategorized as credit institutions will ultimately see a stark increase in overall regulatory capital requirements. In contrast, the regulatory capital requirements for firms that operate a MTF or an OTF but do not deal on own account has been lowered from EUR 730,000 to 150,000 to lower barriers to entry. A lot of the firm specifics will depend on which metrics flow into the K-Factors. Consequently, we expect that this might lead to a further need for engagement with supervisors on those metrics as well as a close look at the role and breadth of waivers that instead of subjecting investment firms to individual requirements might permit them to be part of consolidated supervision.

For example, a firm's K-Factor requirement equals the aggregate of values in Risk-to-Consumer K-Factors plus the Risk-to-Markets K-Factors plus the Risk-to-Firm K-Factors. The Risk-to-Consumer K-Factors are the K-Factors for Assets Under Management (**K-AUM**), Client Money Held (**K-CMH**), Assets Safeguarded and Administered (**K-ASA**) and Client Orders Handled (**K-COH**). Thus the sum of these four K-Factors gives the total Risk-to-Consumer K-Factor component. The Risk-to-Market K-Factor on the other hand, is either the K-Factor for Net Position Risk (**K-NPR**) or the K-Factor for Clearing Margin Given (**K-CMG**) or a combination of the two. The Risk-to-Firm K-factors are the K-Factors for Trading Counterparty Default (**K-TCD**), Daily Trading Flow (**K-DTF**) and Concentration Risk (**K-CON**), with the sum of the three giving the total risk-to-firm K-factor component.

9 Crucially, the new framework does not grandfather or replicate the provisions in CRD IV that exempt certain investment firms dealing on their own account from the ICR requirement of EUR 730,000 where their positions in financial instruments result from a failure to match investors' orders or they only deal on own account to invest own funds.

10 Those dealing on own account and (and the key word is "and") underwriting of financial instruments will have initial capital set at EUR 750,000.

11 We note that for so called "exempt CAD" advisory firms such as those relocating from the UK, the initial capital requirements could go from EUR 5,000 to 75,000 as they become Class 2 firms.

The need to monitor the K-Factors may place some smaller firms, including Class 2 and Class 3 firms under additional compliance burden as they also transition to a more bank-like supervisory environment with a greater focus on the ICAAP/ILAAP as well as a SREP process. This also matters as the IFR/IFD framework's classes of firms means that:

- Third-country entities may suddenly have to introduce a single EU intermediate parent undertaking (**EU IPU**) pursuant to changes in CRD V[12], where the EU IPU may itself require a license from supervisors. The changes in CRD V require third-country entities who hold two or more institutions subject to CRR (i.e. Class 1 and Class 1 minus firms for IFR/IFD purposes) to set up an EU IPU or, if certain thresholds are met, two EU IPUs. The changes in IFD however go a step forward to cover all investment firms authorized in the EU under MiFID to treat these as institutions. As a result third-country entities may be faced with a need to reassess how they hold their EU operations; and
- All EU MiFID investments firms that were previously not in the scope of the EU's Credit Institutions Winding-up Directive or the Bank Recovery and Resolution Directive, may, given the changes to the classes i.e., those needing to meet ICR of EUR 750,000 into the scope of these rules, while those that fall outside of them, including certain MTFs and OTFs may, unless Member States but ultimately the EBA and/or SRB provides clarity, cease to have this compliance obligation.

Liquidity

All investment firms are required to have internal procedures to monitor and manage their liquidity requirements and to hold a minimum of one third of their FOR requirement in liquid assets at all times. Thus the liquidity requirement is equal to the sum of:

- A minimum one third of the firm's FOR (so a twelfth of the firm's fixed overheads in the preceding year); and
- 1.6% of the value of any customer guarantees given by the firm.

As part of the Pillar 2 process, supervisors can require investment firms to hold more liquid assets. There is a derogation from this available for Class 3 firms.

In order to meet the liquidity requirements IFR/IFD firms must maintain holdings in any of the following:

- Assets that meet the definition of high quality liquid assets (**HQLA**) in the LCR Commission Delegated Regulation[13], including what that law states as "Level 1 Assets", "Level 2A assets, "Level 2B assets", "Level 2B securitizations" and/or shares or units in collective investment schemes. With respect to shares or units in collective investment schemes the threshold is reduced to EUR 50 million from 500 million.);
- Financial instruments trading on a liquid market, which will be subject to a valuation haircut of 55%);
- Unencumbered short-term deposits at credit institutions; and
- For Class 3 firms and other firms that do not undertake the MiFID activity of dealing on own account, underwriting or placing on a firm commitment basis, they may, subject to certain conditions, treat receivables of trade debtors and fees or commissions payable within 30 days as an eligible liquid asset.

Concentration risk limits

In a similar fashion to the "large exposure regime" under the CRR 2/CRD V regime, the IFR/IFD imposes limits on exposures that stem from net positions in the trading book, or derivatives, securities financing transactions and other related transactions. Where such exposures are to a single client or a group of connected clients (including parent/subsidiary undertaking relationships) then these may not exceed:

- 25% of the firm's regulatory capital levels, unless the excess is capitalized through K-CON and the relevant supervisor has been notified. Certain modifications exist for exposures to credit institutions or other investment firms;
- 500% of the firm's regulatory capital levels for a period totaling up to 10 days following the breach of the 25% threshold; and

12 Available here.
13 Available here.

- an aggregate threshold of 600% of the firm's regulatory capital levels where an excess over the 25% threshold has continued for more than 10 days since the breach.

As under the large exposure regime a firm that breaches the limit must promptly notify the competent authorities of the amount of the excess, the name of the individual client concerned and where applicable the name if the group of connected clients concerned.

Reporting requirements

Reporting requirements for investment firms concern their own funds requirements, the basis for the calculation of their own funds requirements, the composition of their own funds, their profile and size in relation to the parameters for small and non-interconnected investment firms, their liquidity requirements. Firms, except Class 3 firms, will be subject to country-by country reporting obligations under either Art. 80 for Class 1 and Class 1 minus firms and Art. 27 IFD for Class 2 firms.

Disclosure requirements

Investment firms which are not classified as small and non-interconnected should disclose their levels of own funds, own funds requirements, governance arrangements, and remuneration policies and practices. The IFR thus imposes disclosure requirements on:

- Class 2 firms; and
- Class 3 firms which issue AT1 capital instruments.

The disclosure requirements for Class 2 firms cover its risk management objectives and policies, corporate governance, own funds, capital requirements, the firm's remuneration and investment policies, and environmental, social and governance risks (**ESG factors**). In relation to the remuneration aspect, investment firms should disclose aspects related to gender neutrality and the gender pay gap, for those categories of staff whose professional activities have a material impact on investment firm's risk profile. There are also separate requirements related to guaranteed bonuses, ratio of fixed to variable remuneration, pay out, deferral, discretionary pension benefits and proportionality.

Investment policy

Member States are to ensure that investment firms disclose:

- the complete description of voting behaviour in the general meetings of companies the shares of which are held; and
- the proportion of voting rights attached to the shares held directly or indirectly by the investment firm, broken down by Member State and sector.

Firms that do not meet certain criteria, will also be required, from December 26, 2022, to disclose information on environmental, social and governance risks including physical and transition risks.

Netting and collateral volatility

Art. 31 IFR sets out rules that an investment firm may:

- first, treat perfectly matching contracts included in a netting agreement as if they were a single contract with a notional principal equivalent to the net receipts;
- second, net other transactions subject to novation under which all obligations between the investment firm and its counterparty are automatically amalgamated in such a way that the novation legally substitutes one single net amount for the previous gross obligations; and
- third, net other transactions where the firm ensures that the following conditions have been met:

Ongoing review of the permission to use internal models

The IFD introduces prescriptive rules in Article 37 that require ESFS authorities to review on a regular basis, and at the very least every three years, investment firms' compliance with the permissions to use internal models. This will most likely require a number of IFR/IFD firms to improve their model risk and governance policies and adopt periodic internal reporting that may have to be presented to or which may be shared amongst supervisors across various ESFS authorities.[14]

14 For some details on model risk and governance, including the ECB-SSM's rules on this please see the Dentons Eurozone Hub Thought Leadership selection available here.

Supervisors are required to particularly focus on how internal models are applied to new products and how these are reviewed by the firm and its assessment of how its models are fit for purpose i.e., use well-developed and up-to-date techniques and practices. Supervisors are also empowered to direct firms to correct or take other mitigating steps to rectify material deficiencies. Equally, supervisors may impose capital add-ons or higher multiplication factors to K-Factor coefficients.

Internal governance, risk management and country by country reporting

The IFD requires that Member States ensure that, in addition to the requirements in the MiFIR/MiFID II regime[15], have "robust governance arrangements" in place as set out in Article 26 IFD. Firms are required to have:

a. a clear organisational structure with well-defined, transparent and consistent lines of responsibility;

b. effective processes to identify, manage, monitor and report the risks that investment firms are or might be exposed to, or the risks that they pose or might pose to others;

c. adequate internal control mechanisms, including sound administration and accounting procedures;

d. remuneration policies and practices that are consistent with and promote sound and effective risk management. The remuneration policies and practices referred to shall be gender neutral.

Borrowing from the EU banking sector regulatory principles, firms must approve and periodically review the strategies and policies of the firm on its risk appetite as well as how such Risk Appetite Framework (**RAF**) is monitored and managed and devotes sufficient time of the management body, including by way of a risk committee where one is established, to properly consider the risks in the RAF and adequate resources to manage these. Firms are required to establish reporting lines to the management body for all material risks and risk management policies.

Consequently, firms are required in Art. 29 IFD to have robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of material sources and effects of risk to clients, market, the investment firm or liquidity risk and any material impact on own funds. These strategies, policies, processes and systems shall be proportionate to the complexity, risk profile and business i.e. scope of operation of the firm and the risk tolerance set in the RAF. Importantly, the IFD specifically states that this should also be reflective of the investment firm's importance in each Member States in which it carries out business. This may require firms to also introspectively assess this factor.

Firms are also required to observe country-by-country reporting arrangements in relation to their branches and subsidiaries in an EU or third-country jurisdiction other than in which the firm is authorized. Firms must disclose on a jurisdiction by jurisdiction basis and annexed to the annual financial statements or consolidated financial statements:

i. the name, nature of activities and location of any subsidiaries and branches;

ii. turnover;

iii. the number of employees on a full time equivalent basis;

iv. profit or loss before tax;

v. tax on profit or loss;

vi. the public subsidies received.

Equally, the IFD reinforces the regulatory principles that apply to situations where an investment firm needs to wind down or cease its activities. ESFS authorities are empowered to require investment firms to, by taking into account the viability and sustainability of their business models and strategies, give due consideration to requirements and necessary resources that are realistic in terms of timescale and maintenance of own funds and liquidity throughout their process of exiting the market. This may require firms to maintain or have a readily accessible and periodically updated "exit plan" on file.

15 Notably Articles 9 (Management Body), 16 (Organizational requirements) and Article 17 (Algorithmic trading) of MiFID II, as supplemented at the EU level (including by way of the Commission Delegated Regulation and Directives) as well as national law measures.

Reinforcing the EU's third-country equivalence regime

The IFR/IFD regime strengthens the equivalence regime that would apply to third country investment firms. The MiFIR/MiFID II regime permits third-country firms registered with ESMA to provide securities and derivatives services to professional clients and eligible counterparties in the EU provided that the European Commission has adopted an "equivalence decision" regarding that third-country. The IFR requires that the Commission now assess such third-country provisions with that of the IFR/IFD framework and conduct a "detailed and granular assessment" of the third-country's rules if and where the activities relevant to the EU are likely to be of systemic importance to the EU.

The IFR also requires third-country firms registered with ESMA to provide it with annual reports on the firm's activities, hold records and provide information to ESMA on request as well as to cooperate in on-site inspections. ESMA may also temporarily prohibit or restrict a third-country firm from providing investment services or performing investment activities with or without any ancillary services. This would happen where the third country firm has failed to comply with any prohibition or restriction imposed by ESMA, the EBA, or a competent authority. Similar fate awaits those who have not complied with a request from ESMA in due time and manner, or where the third country firm does not cooperate with an investigation or an on-site inspection carried.

Rolling-out new remuneration rules

The IFR/IFD's remuneration rules, which affect both variable and fixed remuneration, will apply from January 2022 and likely only to Class 2 investment firms on an individual and consolidated basis unless waived by a national competent authority. Class 3 firms are generally not subject to the IFR/IFD remuneration rules unless they are included in a group subject to consolidated supervision or the national competent authority has made a supervisory direction.

For affected firms in the EU (and subsidiaries in non-EEA countries) this means:

1. **assessing the persons in scope** i.e., all staff whose professional activities have a material impact on the investment firm's risk profile, senior management, risk takers, control functions and all employees receiving overall remuneration to at least the lowest remuneration of any risk taker or senior management. The EBA is tasked with providing additional guidelines;

2. **Taking the following general measures:**
    a. structuring **discretionary pension benefits** in a manner that if an employee leaves the investment firm prior to retirement that the discretionary pension benefits are held by the firm for five years in the form of instruments.
    b. ensuring **termination payments** do not compensate or otherwise reward failure or misconduct.
    c. setting up a **Gender-Balanced Remuneration Committee**. Firms with recorded assets (including off-balance sheet) over EUR 100 million must establish a gender-balanced committee. This committee may be established at group level and must be made-up of individual members who do not perform an executive role in the investment firm. The committee must also directly oversee the remuneration of senior officers in risk management and compliance functions.
    d. in respect of **control function staff**, remunerating these in accordance with the achievement of the objectives linked to the performance of their functions regardless of the performance of the business areas the control function relates to.
    e. increasing **regulatory and public disclosure on remuneration policies** and practices as well as in respect of gender neutrality and gender pay gaps. Importantly, firms will have to disclose to the relevant regulator information on staff that receive more than EUR 1 million or more in a financial year and their job responsibilities, the business area involved and the main elements of the remuneration package and pension contributions.
3. Taking the following specific measures to variable remuneration:
    a. **Guaranteed bonuses**: may only be awarded to new staff and in their first year and only if the investment firm has a strong capital base.
    b. **Fixed to variable remuneration ratio**: a firm's remuneration policy must set appropriate ratios between fixed and variable components of total remuneration and may suspend variable components. Member States may in addition to the IFR/IFD framework set bonus caps.
    c. **Pay-out plans**: require that at least 50% of any variable remuneration must be paid in one or more of the following instruments:
        i. Shares or equivalent ownership interests;
        ii. Share-linked or equivalent non-cash instruments;
        iii. AT 1 and T2 instruments such as long-term subordinated debt instruments;
        iv. Other instruments that may be fully converted to CET 1 instruments
        v. Non-cash instruments that reflect the instruments of portfolios managed.

        Equally, at least 40% of any variable remuneration has to be deferred over a three to five year period and must vest on a pro-rata basis.
    d. **Proportionate application**: the IFR/IFD remuneration rules on pay-outs and deferrals may be disapplied if the value of the firm's assets on and off balance sheet account for an average that is less than or equal to EUR 100 million for the preceding four-year period to the given financial year in which the pay-out is to occur and the individual's annual variable remuneration does not exceed EUR 50,000 and that figured does not account for more than 25% of the individual's total annual remuneration.
    d. Putting in place plans to block variable remuneration for senior management in all circumstances and limit it to a certain portion of net revenue for other staff where it would be "inconsistent with the maintenance of a sound capital base" where firms "**benefit from extraordinary public financial support**".

While some of these reforms borrow from principles that have been put in place for the EU's banking sector, some questions arise for firms where staff (howsoever employed or with ownership rights) receive partnership drawings or benefit from carry arrangements. Equally, until further guidance is published at the EBA and/or ECB-SSM level, there are some issues that arise whether these remuneration rules apply to a group on a consolidated basis and/or how to apply to firms' operations in non-EEA countries where the application of such rules would be unlawful. Equally, firms may wish to seek advice on the scope, role and composition or remuneration committees as well as when, how and with what frequency any use of clawback arrangements should be employed.

Outlook and next steps

The IFR/IFD framework's aims, according to the EU co-legislator bodies, promised to simplify and streamline rules in a proportionate manner to those firms those engaging in MiFID activity. It may well however be that the compliance burden is disproportionate. As a result, it may well be that many firms (both EU and non-EEA based), in addition to the points raised above, may wish to, working with external counsel:

- assess the scope of regulated entities that fall under the IFR/IFD framework and their appropriate classification;
- identify the group structure of these firms and their members and possibly re-allocate business and control functions;
- establish which staff members are likely to be subject to the new remuneration rules and engage in earlier discussion with them, including how remuneration is structured;
- reassess policies and procedures as well as governance arrangements applicable to business units but also the functioning of control functions and whether they meet the requirements set out in the IFR/IFD framework.
- assess their breadth of supervisory engagement touchpoints with authorities within Member States but as well as across the entire EU-27 and the IFR/IFD framework sets close cooperation mechanisms across the entire European System of Financial Supervision (**ESFS**) and require that such authorities consider the potential impact of their decisions on the stability of the financial system in other Member States as well as the EU as a whole.

In terms of increased scrutiny and coordinated supervisory coordination, this applies to cooperation and assistance amongst supervisory, including EBA and ESMA facilitating greater use of common forms but also greater ability to carry-out cross-border on-spot checks.[16] This focus on a considerate coordinated supervision is relatively new in how it is set out in Articles 6 to and including 8 coordination generally as well as to supervisory powers set out in Articles 12 to and including 16 IFD along with Articles 18 to and including 23 IFD. Articles 39 to and including 57 set out additional supervision and sanctioning powers that go beyond those in the MiFIR/MiFID II framework and which will be supplemented by delegated acts and supervisory expectations. In addition to increased coordination, Article 38 IFD permits supervisors to direct firms to take early intervention measures if it becomes likely that it will not meet the requirements (not just its threshold conditions) of the IFR/IFD framework and national transposing provisions over a horizon of 12 months.

Firms will also want to engage with external counsel from early on and certainly before the June 2021 deadline to plan and then discuss with supervisors the applicability of the transitional provisions but also the availability waivers on individual or consolidated compliance requirements. The same applies to changes to compensation and remuneration rules, as this will also possibly require employment and tax counsel coordination across a breadth of jurisdictions.

If you would like to discuss any of the items mentioned above, in particular how to forward-plan compliance with the IFR/IFD framework including how it fits into the wider supervisory priorities of the ECB-SSM, EBA and other ESAs or how they may affect your business more generally, please contact our Eurozone Hub key contacts.

16 See also our coverage on the ECB-SSM's own rules on on-site inspections available here as well as ESMA's approach to Common Supervisory Actions available here.

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