Financial Regulatory Alert

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Reminder to Investment Managers and Advisers of New UK Prudential Regime: Three-Month Countdown

October 06, 2021

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Key Points

- From 1 January 2022, a new prudential regime, intended to simplify the prudential requirements, will apply for UK MiFID investment firms regulated by the FCA. The new rules will also apply to certain firms with more limited activities.[1]
- The new regime will also apply to FCA-authorised AIFMs and UCITS management companies in relation to their "MiFID top-up" activities (including managing investments and advising on investments).
- Firms must assess what changes they need to make to comply with the new regime.

Summary

The new rules are mostly set out in a new FCA Handbook Sourcebook, "MIFIDPRU Sourcebook".

This alert sets out some of the most significant changes and points for consideration by affected firms. However, firms should seek legal advice to assess their individual circumstances as the application of the rules is specific to the activities and structure of the firm.

Categorisation

The impact of the new rules on the regulatory capital requirements of an affected firm will depend in part on the firm's categorisation as either a "small and non-interconnected investment firm" (SNI) or a "non-SNI" firm. Additional rules will apply to the "Largest Non-SNI" firms.

SNIs

A firm will constitute an SNI if it (a) does not have permission to deal on own account, and (b) falls below the specified thresholds.[2]

These thresholds require careful consideration, as whilst many of the concepts may appear familiar—for example, “average assets under management” (AUM) and “client orders handled”—they have special definitions for this purpose. For example, to determine “average AUM”, it is also necessary in some circumstances to consider AUM on a group basis.

Non-SNI and Largest Non-SNI firms

As the name suggests, firms which are not SNIs will constitute non-SNI firms. Additional requirements will apply to the largest non-SNIs.[3]

Consolidation

The MIFIDPRU regime introduces new requirements on prudential consolidation. At a high level, consolidation will be required to the level of the highest UK parent undertaking. Given some ambiguity in the drafting (in particular with respect to the concept of “connected undertaking”), careful analysis is to determine whether consolidation is necessary or not.

Own Funds – Definition

The new rules set out what will constitute “own funds”, particularly the following three classes of capital which are familiar from the UK Capital Requirements Regulation, namely: Common Equity Tier 1 (CET1); Additional Tier 1 (AT1); and Tier 2 (T2). The new rules also provide details on what deductions will need to be made when calculating a firm’s own funds. The FCA is continuing to consult on certain aspects, including as to how excess drawings by members in limited liability partnerships should be accounted for.

Own Funds – Requirements

The quantum of own funds which firms will need to hold will depend in depart on the firm categorisation. In summary:

- SNI firms will have to hold the greater of their respective “permanent minimum capital requirement” (PMR) and “fixed overhead requirement” (FOH) (both defined below).
- Non-SNI firms will have to hold the greater of their respective PMR, FOH and K-factor requirements (as defined below).

   a. PMR

The PMR relevant to a firm depends on the MiFID investment services and activities which it carries out, namely:

- £750,000 if the firm is engaged in one or more of: dealing on own account; underwriting and/or placing on a firm commitment basis; or operating an organised trading facility (OTF) without a limitation that prevents both matched principal trading and dealing on own account.
- £75,000 if (a) the firm does not have permission to hold client money or securities in the course of MiFID activities and (b) the firm only engages in one or more of the following activities: reception and transmission of orders; execution of orders on behalf of clients; portfolio management; investment advice; placing without a firm commitment basis.[4]

- £150,000 for all other in-scope firms.

b. FOH

FOH is intended to reflect "a minimum amount of capital that an FCA investment firm would need available to absorb losses if it has cause to wind-down or exit the market".[5] In MIFIDPRU 4.5.1 R, this figure is defined as "an amount equal to one quarter of the firm's relevant expenditure during the preceding year". MIFIDPRU 4.5.3 R then sets out the required methodology for calculating "relevant expenditure". In summary, the firm must first determine its total expenditure before distribution of profits,[6] and where available, this should be based on the figures in its most recent audited annual financial statements, or alternatively unaudited annual financial statements.[7] The firm may then deducted certain specified expenses from this figure, including (for example) fully discretionary staff bonuses, certain fees and charges paid to central counterparties/brokers, and taxes due on the profits.[8]

c. K-factor capital requirements

The K-factor capital requirements "represent a mixture of activity- and exposure-based requirements". Each K-factor has its own calculation methodology, and associated coefficients. The K-factors include: net position risk (K-NPR); daily trading flow (K-DTF); trading counterparty default (K-TCD); assets under management (whether on a discretionary portfolio management basis or under non-discretionary advisory arrangements of an ongoing nature) (K-AUM); handling client orders (K-COH); and client money held (K-CMH). For many managers, the K-AUM and K-COH factors in particular create a risk of significantly increased regulatory capital requirements compared to the requirements applicable under the current rules.

Risk Management and the Internal Capital Adequacy and Risk Assessment ICARA

The new rules have specific requirements in relation to risk management. Two are worth particular mention here: the Internal Capital Adequacy and Risk Assessment (ICARA) and the Overall Financial Adequacy Rule (OFAR).

Firms will be establish an "ICARA" process, which will be the "centrepiece of firms' risk management processes" (and will replace Internal Capital Adequacy Assessment Process (ICAAP) requirements for firms currently subject to them).[9] The ICARA assessment will need to: identify and monitor harms; undertake harm mitigation; engage in business model assessment, planning and forecasting; undertake action planning; plan for potential wind-downs; and assess the adequacy of their own funds and liquidity requirements. Firms will have to submit their ICARA document annually to the FCA, unless they change their business model in such a way that they should do so sooner.

As just stated, as part of the ICARA process, firms will be required to determine the level of own funds and liquid assets it must hold "to ensure that it can remain viable throughout the economic cycle, with the ability to address any potential harm from its ongoing activities; and to allow its business to wind-down in an orderly way".[10] These calculations will form the basis of the Overall Financial Adequacy Rule, under which a firm must hold at least this level of own funds and liquid assets **at all times**.

It should be noted that the requirement to assess the adequacy of a firm's own funds and liquidity requirements as mandated under the ICARA process and the OFAR is in addition to the "own funds" requirements which apply to firms and which are discussed in the previous section.

Concentration Risk and Liquidity

In relation to concentration risk, firms will be under specific obligations to monitor and control the risk. This will include considering the potential risks and harm that could be caused by concentration to a single client or a group of connected clients.[11] Further, non-SNI firms will have to report to the FCA on specific sources of concentration risk, and there will be additional requirements placed on firms which deal on their own account.

Regarding liquidity, there will be a "basic liquid assets requirement" which (in summary) would require firms to hold an amount of liquid assets equal to at least the sum of: one third of the FOH and 1.6 per cent of the total amount of any guarantees provided to clients.

Reporting and Disclosure

All firms subject to the new regime will have to report to the FCA quarterly with reference dates of the last business day in March, June, September and December. This reporting will have to be completed using the FCA's new set of forms.

The FCA is still consulting on the public disclosure requirements for firms, though it is expected that this will include (amongst others) required disclosures on the breakdown and composition of the firm's own funds, details about their risk management objectives and policies and (for non-SNI firms) details about separate directorships held by members of the management body.

The FCA has also said that it intends in the future to consult on integrating the new prudential regime (including the disclosure requirements) with environmental, social and governance (ESG) issues.

Remuneration Code Requirements

From 1 January 2022, a new Remuneration Code will apply to firms subject to the new prudential regime. These new rules will be inserted as a new chapter in the Systems and Controls Sourcebook of the FCA Handbook, SYSC 19G. The application of the new requirements will once again depend on the firm's category as an SNI, non-SNI or larges non-SNI firm. We will be providing a further alert with details of the upcoming changes in due course.

The contribution of Phil Davies is gratefully acknowledged.

[1] The new rules will also apply to Exempt CAD firms, subject to limited circumstances in which a MiFID Article 3 exemption may be available upon application to the FCA for a Variation of Permission.

[2] Each of the following specified thresholds must be satisfied for a firm to constitute an SNI: (i) their average assets under management are less than £1.2 billion; (ii) their average client orders handled: (a) cash trades are less than £100 million per day; and (b) derivative trades are less than £1 billion per day; (iii) their average assets safeguarded and administered is zero; (iv) their average client money held is zero; (v) their average daily trading flow is zero; (vi) their on- and off-balance sheet total is less than £100 million; and (vii) their average total annual gross revenue from investment services and/or activities is less than £30 million.

[3] A firm whose value of on- and off-balance sheet assets over the preceding four-year period is a rolling average of more than £300 million; or of more than £100 million and it has trading book business of over £150 million or derivatives business of over £100 million (MIFIDPRU 7.1.4 R.).

[4] We note that for firms in this category, this is likely to be an increase from the current €50,000 requirement. The FCA is proposing to phase in the new £75,000 gradually over the course of six years.

[5] Consultation Paper 21/7, here, paragraph 4.5.

[6] MIFIDPRU 4.5.3 R (1)(a).

[7] MIFIDPRU 4.5.2 R (1).

[8] See MIFIDPRU 4.5.3 R (2) for the full list.

[9] Policy Statement 21/9, here, paragraph 6.2.

[10] Consultation Paper 21/7, here, paragraph 7.9.

[11] Policy Statement 21/6, here, paragraph 7.3.

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