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"Winter is coming" – DP20/2 augurs prudential feats for investment firms

A recent discussion paper sets out to replace the patchwork of prudential requirements that currently govern investment firms with something more fit for purpose. But DP20/2 – and its forerunner FG20/1 – portend far-reaching implications for all firms, as **Julian Sampson** relates.

You all know the scene.

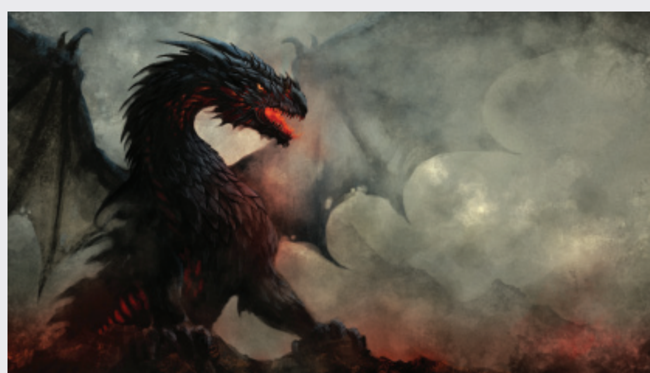
The king and his courtiers are feasting in the Great Hall, celebrating the defeat of the latest incursion into their territory by their enemies from Essos. Everyone is talking, the mead is flowing.

Unnoticed, the heavy doors at the end of the hall open a fraction and in staggers a messenger. He bears all the signs of having had to fight his way in. Let's call him FG20/1. But he is unnoticed by most of the assembly, who continue feasting until FG20/1 stands on a table and screams, "Winter is coming!" He then collapses in a heap on the floor, bruised and bloodied.

Everything stops. In the silence that follows, a few minor courtiers inspect the prone figure of FG20/1 and pronounce him dead. Nobody pays him any more attention and the company resume their revels.

But then, just as the assembly is getting back its appetite, the heavy doors burst open and in storms an immense dragon. Let's call it DP20/2. The dragon has thick protective scales and breathes fire. The king and his senior knights immediately leap into action, arming themselves with shield and sword, dodging the fiery breath and looking for the dragon's weak points. While they do battle, some sorcerers pull off a magic trick of their own and vanish in a puff of smoke. And the less warlike are ushered out to a place of safety, to the kingdom of the SNI where they will, after a few added defensive measures, be safe.

But what's this? What has happened? The crumpled form of FG20/1 has risen from the floor! It has joined the ranks of the undead! Brandishing unknown weapons, it pursues the smaller courtiers to SNI land and lays siege to them in their castles.



Now – I'm no George R R Martin, but this does illustrate a few points: DP20/2 ('A new UK prudential regime for MiFID investment firms'), published in June, is a beast of a discussion paper. It has far-reaching implications for all firms, some of which cannot be accurately foreseen at this stage. Many firms will be able to take advantage of the lighter-touch regime offered by the European Union's Investment Firms Directive and Regulation (IRD/R), on which this DP is based, as long as they meet the criteria of a Small and Non-Interconnected (SNI) firm. But for those firms, the lighter touch offered through this route is qualified by the requirements of FG20/1 ('Our framework: assessing adequate financial resources').

The driving ambition of DP20/2 is to replace the patchwork of prudential requirements that currently govern investment firms with something more fit for purpose. Investment firms are at present prudentially regulated by rules primarily designed to regulate banks and other credit institutions, so that must be welcome.

There are a number of new requirements. For smaller firms who only receive and transmit orders, manage, advise and execute, the most obvious is the hike in minimum initial capital to €75,000. For firms who also underwrite and deal on their own account, the new minimum initial capital will be €750,000. There will be a five-year transitional period during which firms can

get to this level, but it's not immediately obvious that the transitional period is available to firms currently categorised as Exempt-CAD firms. The Financial Conduct Authority is currently thinking about this – we'll have to wait to see how that battle goes.

All firms will have to calculate a Fixed Overhead Requirement (FOR). Under current rules, this is only required by larger firms. Exact details of how this is to be calculated are not yet available – but it's likely to look pretty much like the existing requirement. For planning purposes, think of 25 per cent of annual running costs – three months' burn. Similarly, all firms will be subject to a liquidity requirement of one third of the FOR.

And the actual capital that will need to be held will be the higher of three figures – the newly increased minimum initial capital, the FOR and a new 'K-factor requirement'. The K-factors are the way in which the firm's capital requirement is more closely tied to the activities of the firm. These include requirements that apply to all firms, as well as those which apply only to certain activities. K-factors applicable to all firms require additional capital to be set aside for the risk of the following activities:

- assets under management,
- client money held,
- assets safeguarded, and
- client orders handled.

Firms that underwrite and deal – whether for themselves or clients – will have to put aside additional capital for the risk arising from the following:

- trading flow,
- position risk,
- margin,
- counterparty default, and
- concentration risk.

On concentration risk, all firms, irrespective of size, will need to "monitor and control" their risks. Exactly how this risk is to be monitored and controlled is to be the subject of a later Regulatory Technical Standard, but firms who previously never had to calculate this will have to do something that looks pretty much like what the large firms are doing if they're to convince the FCA that they are indeed performing the monitoring and controlling. At least the SNI firms won't have to report to the FCA on this risk.

Now this isn't the place to look at the detail of how these are calculated, but one important point to note is that assets under management will include not only those under discretionary fund management arrangements, but also those in what the FCA calls "ongoing non-discretionary advisory arrangements". The FCA considers these to be subject to the same risks as those under full discretion. That will come as a shock to advisory firms who don't have a managing permission.

Clearly firms will want to start modelling the likely impacts on their balance sheet of each of these factors. Any such exercise is hampered by the fact that definitive details of how these factors are calculated are as yet unavailable and are subject to the consultation. The lesson here is that if you have a view on how best these factors are calculated, you should contribute to the consultation.

So, to return to the metaphor, the dragon sweeps the hall with fiery K-factors. The stronger knights are able to prepare, put up shields and deflect the scorching blast. But some smaller knights are not so lucky – they are sought out by the dragon and incinerated in the flames.

This is what happens to firms currently categorised as Exempt CAD firms, and to firms who currently benefit from the matched principal exemption. These exemptions will not exist under the new regime, and firms currently benefitting from them will be categorised and treated in the same way as other larger firms as well as other principal dealers. And that includes the minimum initial capital requirement of €750,000, along with the requirement to calculate capital based on K-factors. For these firms, things are going to get seriously hot.

But is that all? Is there no other protection? Well, you'll recall from our opening scene that some of those present at the feast were able to disappear. And some firms may be able to effectively do that as well. This DP – and the IFD/R on which it is based – applies to MiFID firms. Firms not carrying out MiFID activities are outside the scope of these proposals. Firms who are only regulated at the fringes of MiFID should consider whether, as a result of these proposals, the benefits of being a MiFID firm continue to outweigh the costs.

For many firms, that's not a practical option. Firms for whom MiFID activity is core to their business will have to seek out another route. But for those outfits whose only activity is advice and/or the reception and transmission of orders but who previously chose to opt into MiFID, perhaps to benefit from passporting arrangements, now is the time to consider whether they should be adjusting their permissions to allow them to opt out of MiFID.

And then there's the sanctuary of SNI land. This is the haven to which smaller firms may be able to escape, free from the worst ravages of the new regime. And if you can get there, it's worth the trip – firms categorised as SNIs benefit from the reduced IFR/D regime, the most significant advantage of which is not needing to calculate K-factors. In SNI land, the minimum capital requirement will be the greater of just the two components, initial capital and FOR. No K-factors need apply. And there's more – in SNI land, there are no new requirements for remuneration, governance and concentration risk. And easier FCA reporting!

But you've got to get through the gates. The DP sets out the IFD/R criteria for categorisation as an SNI. Most of the volume criteria (AUM under €1.2 billion,

Client Orders Handled of less than €100 million/day, annual gross revenue less than €30m) are set at a relatively high level, which will allow the majority of smaller firms to meet these categorisation requirements. Yet that's not the case with some other activities. For example, if you hold any amount of client money, any amount of client assets or have any principal positions, you'll find the gates of the kingdom of SNI land firmly barred against you.

This might seem harsh – firms that otherwise might be small enough to qualify as an SNI on a volume basis and who choose to hold relatively small client money or client asset amounts in order to provide clients with an integrated, in-house service will find themselves treated like all of the big players.

But, let's assume that you do qualify and you do make it through the gates of SNI land. Can the feasting re-commence?

No. You'll recall from the introduction that the earlier messenger, FG20/1, rose from the dead and pursued the SNIs. That's what's going to happen.

Regular subscribers to *Compliance Monitor* will recall that back in October 2019 we wrote about FG20/1 when it was merely consultation paper 19/20. We said then that the CP indicated what risks a firm's "adequate resources" might cover but made no suggestions as to the level and nature of the financial resources that would be required to do so. Thus the FCA suggested that, for example, firms should set aside capital to take account of the risks that discretionary portfolio managers may breach their mandate, that financial advisers might provide unsuitable advice, or that firms advising on corporate finance deals may fail to apply appropriate due diligence. For all these, and other potential harms, the FCA's expectation is that firms should consider the likelihood and impact of such things going wrong, and have in place adequate financial resources to ensure that they can put the wrong right. And this was expected to lead to higher levels of capital being held – as the regulator said then: "to achieve our objectives, in some instances and by applying a targeted approach to individual firms, it may be necessary to set a level of financial resources beyond the minimum required by prudential regimes for those firms."

So, while the walls of the kingdom of the SNI may be strong, they are not impenetrable. And remember that, like the undead, the FCA has powers of which we mere mortals could not dream. They have the capacity to ghost straight through the walls and end up sitting down at your council table.

Therefore, SNI firms need to get ready. They need to prepare (on a proportionate basis) a capital plan that looks like one FG20/1 talks about, considering the operational risks they're subject to. And one risk the FCA wants to see costed out is the cost of the walls tumbling down – when the firm fails. So, the regulator can ask to see your capital planning and risk assessment, even though the rules foreseen in DP20/2 don't require you to prepare one. And if you have prepared one but they don't like it, they can still subject an SNI firm to a torturous ICARA process (think ICAAP with spikes), the result of which may be to require you to hold adequate capital at a level they think appropriate.

Like all good serials, this is being well trailed. The consultation period closes on 25 September, with a feedback and consultation paper promised "later in 2020". Then the battle will be well and truly joined.

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