ΕΠΙΤΡΟΠΗ ΚΕΦΑΛΑΙΑΓΟΡΑΣ ΚΥΠΡΟΥ
CYPRUS SECURITIES AND EXCHANGE COMMISSION

Practical guide for the new prudential framework for Investment Firms

The Cyprus Securities and Exchange Commission ('CySEC') has prepared this document with the aim to provide the industry with an outline of the new prudential framework for investment firms which will replace the existing prudential requirements of investment firms, currently set out in the Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment Firms (the "CRR")[1] and the European Directive 2013/36/EU (the "CRD IV")[2].

The new prudential framework comprises of:

i. REGULATION (EU) 2019/2033 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014 (the "IFR"), and

ii. DIRECTIVE (EU) 2019/2034 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU (the "IFD").

The IFR and IFD were published on the 5th of December 2019 in the Official Journal of the European Union and form part of the action plan for a Capital Markets Union.

The **IFR** becomes directly applicable in all EU Member States **on June 26, 2021.**

The **IFD** should be transposed into national legislation by June 26, 2021 and will be in force from **June 26, 2021**.

The European Commission will issue in the coming months a number of implementing technical standards that will be developed by the European Banking Authority (EBA).

---

[1] On 7th June 2019, the Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 ('CRR2') was published on the Official Journal of the European Union, amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012. CRR2 shall enter into force on 28th June 2021, with some exemptions.

[2] On 7th June 2019, the Directive (EU) 2019/878 of the European Parliament and of the Council of May 20, 2019 ('CRDV') was published on the Official Journal of the European Union, amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures. CRDV shall enter into force on 28th June 2021, with some exemptions.

Below, CIFs can find the rationale behind the new prudential framework and an outline of its main requirements.

A. Rationale behind the new prudential framework

1. The existing prudential regime of Investment Firms (CRR, CRDIV) is largely based on successive iterations of the international regulatory standards set for large banking groups by the Basel Committee on Banking Supervision and only partially address the specific risks inherent to the diverse activities of a large number of investment firms. It was therefore necessary to address the specific vulnerabilities and risks inherent to those investment firms by means of appropriate and proportionate prudential arrangements at European Union level.

2. Investment firms generally do not have large portfolios of retail and corporate loans and do not take deposits. The likelihood that their failure can have a detrimental impact on overall financial stability is lower than in the case of credit institutions. The risks faced and posed by most investment firms are thus substantially different to the risks faced and posed by credit institutions and such differences should be clearly reflected in the prudential framework of the European Union.

3. The new prudential framework for investment firms takes into account the particular business practises of different types of investment firms and especially their size and interconnectedness with other financial and economic actors. The new prudential requirements are calibrated in a manner proportionate to the type of investment firm, the best interests of the clients of that type of investment firm and the promotion of the smooth and orderly functioning of the markets in which that type of investment firm operates. They also mitigate identified areas of risk and help ensure that, if an investment firm fails, it can be wound down in an orderly manner with minimal disruption to the stability of financial markets.

B. Scope of Application

4. IFR and IFD apply to **ALL** investment firms authorised and supervised under the European Directive 2014/65/EU (MIFID II). In Cyprus, this Directive was transposed by the Investment Services and Activities and Regulated Markets Law of 2017 (the 'Law').

C. <u>New classification of Investment Firms</u>

5. IFR and IFD introduce a new classification system for investment firms, based on their activities, systemic importance, size and interconnectedness, as follows:

6. <u>Categorisation of investment firms</u>[3]

6.1. Class 1A

The firm that, carries out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU (points (3) and (6) of Part I, Annex I of the Law)[4], but is not a commodity and emission allowance dealer, a collective investment undertaking or an insurance undertaking and meets **any of** the conditions below shall be considered as systemically important firm and <u>will seek authorisation **as a credit institution**, supervised under CRR2/CRDV capital framework</u> (per Art. 62(3) of IFR that amends the definition of a credit institution in CRR):

a) the total value of the consolidated assets of the undertaking is equal to or **exceeds EUR 30 billion**;

b) the total value of the assets of the undertaking is less than EUR 30 billion, and the undertaking is part of a group in which the total value of the consolidated assets of all undertakings in that group that individually have total assets of less than EUR 30 billion and that carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU is equal to or exceeds EUR 30 billion;

c) the total value of the assets of the undertaking is less than EUR 30 billion, and the undertaking is part of a group in which the total value of the consolidated assets of all undertakings in the group that carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU is equal to or exceeds EUR 30 billion.

6.2. Class 1B

The Investment firm, that carries out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU (points (3) and (6) of Part I, Annex I of the Law)[4], but is not a commodity and emission allowance dealer, a collective investment undertaking or an insurance undertaking and meets **any of** the following

---

[3] Note that the IFR/IFD do not refer to "classes" of investment firms as such, but the European Commission at the time of the proposal for the IFR/IFD was referring to them, making IFR/IFD package easier to follow. Thus, CySEC is using this classification for a better understanding of the IFR/IFD regime.

[4] Investment Firms with €730.000 initial capital requirement;

conditions will remain as an Investment firm under CySEC's supervision but will be supervised under CRR2/CRDV for prudential requirements(article 1(2) of IFR).

a) total value of the consolidated assets of the investment firm is equal to or **exceeds EUR 15 billion**,

b) the total value of the consolidated assets of the investment firm is less than EUR 15 billion, and the investment firm is part of a group in which the total value of the consolidated assets of all undertakings in the group that individually have total assets of less than EUR 15 billion and that carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU is equal to or exceeds EUR 15 billion,

c) the investment firm is subject to a decision by the competent authority in accordance with Article 5 of IFD.

6.3. Class 2

An investment firm is categorized as Class 2 if it **no longer meets <u>any</u> of the conditions** mentioned in point 6.4 below.

Class 2 investment firms will be subject to the new IFR/IFD regime.

6.4. Class 3

An investment firm is categorized as Class 3 if it meets **<u>all of</u>** the criteria below and thus qualifies as a small and non-interconnected investment firm (Art. 12(1) of IFR):

(a) AUM (Assets Under Management) measured in accordance with Article 17 is less than EUR 1,2 billion;
(b) COH (Client Orders Handled) measured in accordance with Article 20 is less than either:
- EUR 100 million/day for cash trades; or
- EUR 1 billion/day for derivatives;
(c) ASA (Assets safeguarded and administered) measured in accordance with Article 19 is zero;
(d) CMH (Client Money Held) measured in accordance with Article 18 is zero;
(e) DTF (Daily Trading Flow) measured in accordance with Article 33 is zero;
(f) NPR (Net Position Risk) or CMG (Clearing Margin Given) measured in accordance with Articles 22 and 23 is zero;
(g) TCD (Trading Counterparty Default) measured in accordance with Article 26 is zero;
(h) The on- and off-balance-sheet total of the investment firm is less than EUR 100 million;

(i) The total annual gross revenue from investment services and activities of the investment firm is less than EUR 30 million, calculated as an average on the basis of the annual figures from the two-year period immediately preceding the given financial year.

Investment firms under class 3 will be subject to the new IFR/IFD regime but with certain exceptions.

D. Initial capital requirement

7. Article 9 of the IFD introduces new initial capital requirements for the authorization of all Investment Firms required pursuant to Art.15 of Directive 2014/65/EU (section 16 of the Law) to provide any of the investment services or perform any of the investment activities listed below:

	Activities per Part I, Annex A of the Law	**Initial capital**
(a)	- Dealing on own account - Underwriting and/or placing on a firm commitment basis	€750,000
(b)	- Reception and transmission of orders in relation to one or more financial instruments; - Execution of orders on behalf of clients, - Portfolio management; - Investment advice and - Placing of financial instruments without a firm commitment basis and is <u>not permitted</u> to hold client money or securities belonging to its clients	€75,000
(c)	Investment firms other than those referred in points (a), (b) and (d)	€150,000
(d)	Operation of an Organised Trading Facility (where the investment firm engages in dealing on own account or is permitted to do so)	€750,000

E. Initial capital composition

8. The initial capital of an Investment Firm shall consist of the Common Equity Tier 1 capital (‘CET1’), Additional Tier 1 capital (‘AT1’) and Tier 2 capital (subject to certain conditions – Art. 9 of IFR).

F. The K-factor requirement

9. K-factors are quantitative indicators that reflect the risk that the new prudential regime intends to address. They are divided into three groups and they aim to capture the risk the investment firm can pose to customers (‘RtC’), to market access (‘RtM’) or the investment firm itself (‘RtF’) (Art. 15 – IFR).

The K-factor requirement shall amount to at least the sum of the RtC, RtM and RtF, as follows:

Risk type	**K-factors**	**Coefficient**[5]
Risk to Client (**RtC**)	**K-AUM**: Assets under management – under both discretionary portfolio management and non-discretionary advisory arrangements of an ongoing basis (Art. 17 – IFR).	0,02%
	K-CMH: Client money held – captures the risk of potential for harm where an investment firm holds money for its customers taking into account the legal arrangements in relation to asset segregation and irrespective of the national accounting regime applicable to client money. Excludes client money that is deposited on a (custodian) bank account in the name of the client itself, where the investment firm has access to these client funds via a third-party mandate. (on segregated or non-segregated basis) (Art. 18 – IFR).	0,4% (on segregated accounts) 0,5% (on non-segregated accounts)

[5] The volume of each K-factor should be multiplied by the corresponding coefficient in order to determine the K-factor requirement.

	K-ASA: Assets safeguarded and administered – ensures that investment firms hold capital in proportion to such balances, regardless of whether they are on its own balance sheet or in third-party accounts (Art. 19 – IFR).	0,04%
	K-COH: Client orders handled – captures the potential risk to clients of an investment firm which executes its orders (in the name of the client, not in the name of the investment firm itself). (Art. 20 – IFR).	0,1%
Risk to Market (**RtM**)	**K-NPR**: Net position risk – based on the market risk framework (standardised approach, or if applicable, internal models) of the CRR (Art. 22 – IFR) **Or** **K-CMG**: Clearing member guarantee - Investment firm's clearing member – where permitted by a Member State competent authority for specific types of investment firms which deal on own account through clearing members, based on the total margins required by an investment firm's clearing member (Art. 23 – IFR)	
Risk to Firm (RtF)	**K-DTF**: Daily trading flow – based on transactions recorded in the trading book of the investment firm dealing on own account, whether for itself or on behalf of a client, and the transactions that an investment firm enters through the execution of orders on behalf of clients in its own name. (Art. 33 – IFR)	0,1% for cash trades 0,01% on derivatives

	K-TCD: Trading counterparty default – investment firm's exposure to the default of their trading counterparties in accordance with simplified provisions for counterparty credit risk based on the CRR (Art. 26 – IFR)	
	K-CON: Concentration – concentration risk in an investment firm's large exposures to specific counterparties based on the provisions of the CRR that apply to large exposures in the trading book. (Art. 39 – IFR).	

G. Own funds requirements and composition

10. Class 2 Investment firms shall at all times have own funds at least D, where D is defined as the highest of the following (Art.11 – IFR):

a) The fixed overheads requirement (Art.13 – IFR):

At least one quarter (¼) of the fixed overheads of the preceding year.

b) The permanent minimum requirement (Art. 14 – IFR)

The permanent minimum capital requirement of an investment firm is at least the initial capital requirement (see point 7 above).

c) The K-factor requirement (point 9 above)

The K-factor requirement shall amount to at least the sum of the RtC, RtM and RtF.

11. For **Class 3** investment firms (small and non-interconnected investment firms) D shall be defined as the highest of the following:

a) Fixed overheads requirement (point 10(a) above)
b) Permanent Minimum capital requirement (point 10(b) above)

12. Investment firms shall have own funds consisting of the sum of their Common Equity Tier 1 capital, Additional Tier 1 capital and Tier 2 capital, and shall meet all the following conditions at all times (Art. 9 of IFR):

a) $$\frac{\text{Common Equity Tier 1 capital}}{D} \geq 56\%$$

b) $$\frac{\text{Common Equity Tier 1 capital + Additional Tier 1 capital}}{D} \geq 75\%$$

c) $$\frac{\text{Common Equity Tier 1 capital + Additional Tier 1 capital + Tier 2 capital}}{D} \geq 100\%$$

Where D is own funds requirements as defined in Art. 11 of IFR (see point 10 above).

H. Concentration risk requirements

13. Investment firms under class 2 and class 3 (subject to exemptions) shall monitor and control their concentration risk so as not to exceed the following limits (per Art.37 of IFR):

a) An investment firm's limit with regard to the concentration risk of an exposure value with regard to an individual client or group of connected clients shall be 25% of its own funds.

b) Where that individual client is a credit institution or an investment firm, or where a group of connected clients includes one or more credit institutions or investment firms, the limit with regard to concentration risk shall be the higher of 25% of the investment firm's own funds or EUR 150 million provided that for the sum of exposure values with regard to all connected clients that are not credit institutions or investment firms, the limit with regard to concentration risk remains at 25% of the investment firms' own funds.

   Where the amount of EUR 150 million is higher than 25% of the investment firm's own funds, the limit with regard to concentration risk shall not exceed 100% of the investment firm's own funds.

I. Liquidity requirements

14. Investment firms under class 2 and class 3 (subject to exemptions) shall hold an amount of liquid assets equivalent to at least one third (1/3) of the Fixed overhead requirement, calculated in accordance with Art. 13(1) of IFR.

More information regarding liquid assets and other exemptions can be found in Art. 43 of IFR.

J. Disclosure requirements

15. The IFR/IFD prescribe a wide range of disclosure obligations for Class 2 investment firms (and, to an extent, any Class 3 firms that issue additional tier 1 capital instruments). Specifically, public disclosures are required in respect of:

a) risk management objectives and policies (Art. 47 – IFR)
b) internal governance arrangements (Art. 48 – IFR)
c) own funds requirements (Art. 49, 50 – IFR)
d) remuneration policy and practices (Art. 51 – IFR)
e) investment policy (Art. 52 – IFR)
f) environmental, social and governance risk (Art. 53 – IFR)

K. Reporting requirements

16. In terms of reporting, Article 54 of the IFR provides that on a quarterly basis Class 2 investment firms shall report to their Member State competent authority the following items:

a) Level and composition of own funds
b) Own funds requirements
c) Own funds requirement calculations
d) Where the firm is a Class 3 firm – the level of activity, including the balance sheet and revenue breakdown by investment service and applicable K-factor
e) Concentration risk
f) Liquidity requirements

Class 3 investment firms shall submit the above on an annual basis.

Other reporting requirements apply for certain investment firms, as mentioned in Art. 55 of IFR.

L. Other supervisory requirements

As per Art. 24 of IFD, investment firms under class 2 shall have in place sound, effective and comprehensive arrangements, strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital and liquid assets that they consider adequate to cover the nature and level of risks which they may pose to others and to which the investment firms themselves are or might be exposed (Internal capital adequacy process (ICAAPs).

The above process needs to be appropriate and proportionate to the nature, scale and complexity of its activities.

The competent authorities may also request Class 3 investment firms to comply with the ICAAP requirement to the extent they deem it to be appropriate.

Class 2 Investment firms will also have to establish internal governance processes on treatment of risks (Art. 29, IFD), country-by-country reporting (Art. 27, IFD) and specific remuneration rules which are largely based on the framework set out in CRR/CRD IV (Art. 32, IFD).

Class 3 Investment firms will also have to establish internal governance processes on treatment of risks (Art. 29, IFD).

M. Prudential consolidation

Investment firm groups should examine the criteria set in Art. 46 of IFD to determine whether they fall under consolidated supervision and if yes, their group supervisor. The prudential consolidation requirements are stated in Art.7 of IFR.

N. Transitional Provisions

Article 57 of the IFR sets out the transitional provisions regarding the own funds requirements of investment firms.