

Practical Guide for the implementation of IFR/IFD

The Cyprus Securities and Exchange Commission ('CySEC') wishes through this practical guide to provide Cyprus Investment Firms ('CIFs') with important information in regards to the implementation of the new prudential framework for investment firms which came into force on 26th June 2021.

A. Relevant Legislation

1. 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** became directly applicable in all EU Member States **on June 26, 2021**. The **IFD** will be transposed into national legislation.

This guide should be read in conjunction with the Regulatory Technical Standards ('RTS') and Implementing Technical Standards ('ITS') issued by the European Commission ('EC') and developed by the European Banking Authority ('EBA') in regards to the new prudential framework. Note that further RTS and ITS will be issued in the coming months by the EC. **Thus, all CIFs are urged to search through the EBA's [website](#) on a continuous basis so as to be fully updated with the new developments.**

B. Rationale behind the new prudential framework

2. The previous prudential regime of Investment Firms (CRR, CRDIV) was 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 addressed 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.
3. 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.
4. 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.

C. Scope of Application

5. 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, as amended](#) (the 'Law').

D. New classification of Investment Firms

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

Categorisation of investment firms¹

6.1. Class 1

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), 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 will seek authorisation as a credit institution, supervised under CRR2/CRDV capital framework (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 1 minus

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), but is not a commodity and emission allowance dealer, a collective investment undertaking or an insurance undertaking and meets **any of** the following 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).

¹ 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.

- 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 any 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 **all of** 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.

E. 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 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 as amended	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

F. 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).

G. 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 ²
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)
	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%

² The volume of each K-factor should be multiplied by the corresponding coefficient in order to determine the K-factor requirement.

	<p>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).</p>	0,1%
Risk to Market (RtM)	<p>K-NPR: Net position risk – based on the market risk framework (standardised approach, or if applicable, internal models) of the CRR (Art. 22 – IFR)</p> <p>Or</p> <p>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)</p>	
Risk to Firm (RtF)	<p>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)</p>	<p>0,1% for cash trades</p> <p>0,01% on derivatives</p>
	<p>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)</p>	

	<p>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).</p>	
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10. Where an Investment Firm does not have available information to calculate the K-factors for the required period, it shall use historical data as soon as such data becomes available.

CySEC may replace missing historical data points by regulatory determinations based on the business projections that the investment firm submitted in accordance with section 7 of the Law (that transposes Article 7 of Directive 2014/65/EU).

H. Own funds requirements and composition

11. 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 ($\frac{1}{4}$) 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.

12. 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)

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

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

Where D is own funds requirements as defined in Art. 11 of IFR.

I. Concentration risk requirements

14. Trading book exposures

The CIFs, that will be categorized as Class 2 IF should continue to monitor and control their concentration risk in regards to their **trading book** exposures to a client or a group of connected clients in accordance with Part four of IFR.

In particular, 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.

Where the concentration exposure limits mentioned in Art. 37 of IFR are exceeded, a CIF **shall notify CySEC** without delay and CySEC **may grant the CIF a limited period to comply with the limits of Art. 37 of IFR.**

15. Directors' and Shareholders' exposures limits

The Directive of the Cyprus Securities and Exchange Commission for the prudential supervision of investment firms (DI144-2014-14) has been repealed and thus the limits on exposures with the CIFs' shareholders and/or its Board of Directors (per par. 61 of the repealed DI144-2014-14) will **no longer be applicable**.

Trading book exposures with a CIF's shareholders and/or its Board of Directors will be subject to the limits requirements of Art. 37 of IFD and notification requirements of Art. 38 of IFD (see above).

Nevertheless, during the assessment of the amount, type and distribution of internal capital and liquid assets that the CIFs consider adequate to cover the nature and level of risks which they may pose to others and to which the CIFs themselves are or might be exposed, they should take into account the level of banking book concentration risk they are exposed to.

Where CySEC, on the basis of the reviews carried out in accordance with Articles 36 and 37 of IFD, ascertains that the CIF is exposed to risks or elements of risks, including banking book concentration risk, or poses risks to others that are material and are not covered or not sufficiently covered by the own funds requirement, and especially K-factor requirements, set out in Part Three or Four of IFR, then it shall impose, as per article 40 of IFD, the additional own funds requirement referred to in point (a) of Article 39(2) of IFD.

16. Banking book exposures

According to IFD/IFR there are **no limits** on the banking book exposures of an Investment Firm.

Nevertheless, as per article 54 of IFR, the CIFs should report to CySEC the following information in regards to their banking book exposures:

- a) the level of concentration risk associated with the default of counterparties and with trading book positions, both on an individual counterparty and aggregate basis;

- b) the level of concentration risk with respect to the credit institutions, investment firms and other entities where client money is held;
- c) the level of concentration risk with respect to the credit institutions, investment firms and other entities where client securities are deposited;
- d) the level of concentration risk with respect to the credit institutions where the investment firm's own cash is deposited;
- e) the level of concentration risk from earnings;
- f) the level of concentration risk as described in points (a) to (e) calculated taking into account assets and off-balance-sheet items not recorded in the trading book in addition to exposures arising from trading book positions.

In addition to the above, during the assessment of the amount, type and distribution of internal capital and liquid assets that the CIFs consider adequate to cover the nature and level of risks which they may pose to others and to which the CIFs themselves are or might be exposed, they should take into account the level of banking book concentration risk they are exposed to.

Where CySEC, on the basis of the reviews carried out in accordance with Articles 36 and 37, ascertains that the CIF is exposed to risks or elements of risks, including banking book concentration risk, or poses risks to others that are material and are not covered or not sufficiently covered by the own funds requirement, and especially K-factor requirements, set out in Part Three or Four of IFR, then it shall impose, as per article 40 of IFD, the additional own funds requirement referred to in point (a) of Article 39(2) of IFD.

J. Liquidity requirements

- 17.** Investment firms under class 2 **and** class 3 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.

As per article 44 of the IFR, investment firms **may, in exceptional circumstances, and after an approval of CySEC** reduce the amount of liquid assets held.

Note that CySEC's approval for reduction of liquidity requirements shall apply only for a **period of thirty (30) days only** per Art. 44(2) of IFR.

K. Supervisory measures and powers

18. As per article 38 of IFD, CySEC requires CIFs to take at **an early stage** the measures necessary to address the problems arising from not meeting the requirements of IFD or IFR, or where CySEC has evidence that the CIF is likely to breach its regulatory requirements within the next 12 months.

In case a CIF has not taken the necessary early measures to restore compliance with the requirements of IFD or IFR, then CySEC has the supervisory powers mentioned in Article 39 of IFD.

L. Reporting and disclosure requirements

19. Reporting requirements

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.

The above information shall be reported using the final set of Reporting Templates ('Templates') issued by the EBA, which can be found [here](#).

The corresponding **CySEC's Forms** can be found [here](#) and also under the section of Prudential Supervision Forms in CySEC's website.

CIFs that are under consolidated supervision by CySEC should submit both solo and consolidated information, using the same set of Forms.

20. Consolidation reporting requirements

In addition to the reporting information mentioned in point 19 above, the CIFs that are under consolidated supervision by CySEC should complete **'GS' tab**, found in the abovementioned Forms, in regards to the own funds requirements of the affiliate entities, including the CIF, that are subject to consolidated supervision by CySEC.

According to Article 4(1)(11) of IFR consolidated situation means the situation that results from applying the requirements of IFR, in accordance with Article 7 of IFR, to a Union parent investment firm, Union parent investment holding company or Union parent mixed financial holding company as if that undertaking formed, together with all the investment firms, financial institutions, ancillary services undertakings and tied agents in the investment firm group, a single investment firm.

For the purpose of this definition, the terms 'investment firm', 'financial institution', 'ancillary services undertaking' and 'tied agent' shall also apply to undertakings established in third countries, which, were they established in the Union, would fulfil the definitions of those terms.

21. Disclosure requirements

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).

We note that as per article 53 of IFR, from 26 December 2022, investment firms which do not meet the criteria referred to in Article 32(4) of IFD shall disclose information on environmental, social and governance risks, including physical risks and transition risks, as defined in the report referred to in Article 35 of IFD.

22. Reporting reference dates

CIFs shall submit their reporting requirements to CySEC on the following reference dates:

(a) Quarterly reporting (for Class 2 CIFs): 31 March, 30 June, 30 September and 31 December;

(b) Annual reporting (for Class 3 CIFs): 31 December.

The first official reporting reference date for **Class 2 CIFs**, under IFR/IFD, shall be for **30th September 2021**, due to be submitted to CySEC by 11th November 2021.

The first official reporting reference date for **Class 3 CIFs**, under IFR/IFD, shall be for **31st December 2021**, due to be submitted to CySEC on 11th February 2022.

As mentioned in article 1 of the relevant [ITS](#), where the CIFs' accounting year-end deviates from the calendar year, reporting reference dates may be adjusted accordingly, so that the quarterly reporting of information is done every three months of the respective accounting year and the annual reporting at the accounting year-end. For example, if the accounting year-end of a CIF is 30th September, then the CIF may choose to have its quarterly reporting reference dates as follows: 31st December, 31st March, 30th June, 30th September.

CIFs that are under consolidated supervision by CySEC should submit both solo and consolidated information, within the deadlines mentioned above and using the same set of reporting templates.

M. Internal capital adequacy assessment process and internal risk-assessment process

23. 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 (ICAAP and ILAAP).

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

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).

CySEC may also request Class 3 investment firms to comply with the ICAAP and ILAAP requirement to the extent they deem it to be appropriate.

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

24. Transitional provisions

Article 57 of Part Nine of IFR sets the transitional provisions that the CIFs may apply regarding the own funds requirements of investment firms.

N. Other important information

CySEC could like to draw CIFs' attention to the following important information/requirements following the implementation of IFR/IFD.

25. Macroprudential Oversight of Institutions Law

Class 1 minus CIFs will continue to be subject to the requirements of the Macroprudential Oversight of Institutions Law of 2015, as amended.

Class 2 CIFs, that are authorised to provide the investment services listed in points 3 (dealing on own account) and/or 6 (underwriting with firm commitment) of the Third Appendix, Part I of the Law, will **no longer** be subject to the requirements of the Macroprudential Oversight of Institutions Law of 2015, as amended.

26. Prudential treatment of Investors Compensation Fund ('ICF') contribution

As per CySEC's Circulars [C334](#) and [C162](#) in regards to the prudential treatment of the ICF contribution, CIFs should continue to deduct both the ICF contribution and the additional cash buffer of 3 per thousand of the eligible funds and financial instruments of their clients from their Common Equity Tier 1 capital.

27. Inclusion of interim profits in Common Equity Tier 1 Capital ('CET1')

As per CySEC's Circular [C305](#), in regards to the inclusion of interim profits in CET1, CIFs that wish to include interim profits in CET1 they should apply for a permission from CySEC per the instructions given in the said Circular.

28. Prudential treatment of Cryptocurrencies

All CIFs should follow CySEC's Circular [C462](#) in regards to the prudential treatment of crypto assets and enhancement of risk management procedures associated with crypto assets.

29. Prudential consolidation

CIFs under consolidated supervision by CySEC should continue following CySEC's Circular [C350](#), in regards to preparation and submission of consolidated audited financial statements and consolidated prudential forms to CySEC.

30. Prudential supervision information per Form 144-14-11

All CIFs should continue to submit **Form 144-14-11** ('Form') per CySEC's Circular [C326](#). The Form should be submitted once a year via Transaction Reporting System ('TRS') from 1st to 30th June each year. The deadline to submit the Form is the 30th of June each year.