

# Remuneration regulation update

## Investment Firms Regime - new EBA consultations on MRTs and instruments

*Following the publication of the Investment Firms Regime in the European Journal in December 2019, on 4 June 2020 the EBA published a series of Consultation Papers setting out further detail as to how the new regime will be implemented. In particular Regulatory Technical Standards (RTS) on the identification of Material Risk Takers (MRTs) and the instruments that can be used to remunerate MRTs were published.*

### **At a glance**

#### **What is it?**

- The Investment Firms Regime, or IFR (comprised of the Investments Firms Directive and the Investment Firms Regulation) is a new prudential regime aimed specifically at investment firms. It contains a number of remuneration requirements.
- The Consultation Papers and draft RTS provide further clarity regarding how the EBA will expect firms to implement and comply with IFR in practice.
- 4 draft RTS and an implementation timeline were released, however the items most pertinent to remuneration were the consultations on the identification of MRTs and the use of instruments for awards of variable remuneration.

#### **Who is this relevant to?**

- Broadly any firms with MiFID permissions will be subject to IFR. The regime does allow disapplication of all or some of the requirements on the basis of proportionality, however the thresholds are much lower than those under the current regimes. Depending on a firm's organisational structure, the regime may apply on a consolidated as well as a solo entity basis.
- The FCA have confirmed they will bring in an equivalent regime to IFR regardless of the terms of the UK's exit from the EU. They may however deviate in their implementation from the EU regulation as the UK will not strictly be subject to EU law. Differences are likely to be in the detail of implementation rather than the key principles.

#### **Where can I find it?**

- The EBA press release which includes links to all Consultation Papers can be found [here](#).

#### **What is the timing?**

- The consultation runs until 4 September 2020 with finalised RTS set to be released October 2020.
- IFR will apply from 26 June 2021. Previously it was expected that the remuneration requirements would come into effect for the first full performance period beginning on or after this date (based on precedents such as CRD IV and UCITS V).

- The instruments RTS, however, states that the remuneration requirements will apply from 26 January 2021 and the '2021 performance year'. This suggests that the rules may come into force a year earlier for many firms. Although this would be out of line with historic precedents, it would address the timing issue of the 'gap' between CRD V and IFR coming into force.
- This provides a key area of uncertainty which we hope the consultation process will resolve for European IFR entities.
- Notwithstanding the approach for the rest of Europe, we understand, that as a non-EU member state at the point that IFR comes into force and historic precedent, it would seem unlikely for the FCA to implement the remuneration requirements before June 2021.
- We will provide updates as and when there is further clarity on this point for entities outside the UK, however firms should plan for all eventualities.

#### **What should I do next?**

- Consider whether to respond to the questions posted in the Consultation Papers in advance of 4 September 2020. The EBA are holding a public hearing on 30th June with dial in details to be published on the EBA website in due course.
- Carry out an initial impact assessment to determine what extent the proposed changes may have on your business. Although the Consultation Papers can be deemed near final, they may be subject to change, depending on the outcome of the consultation.
- Given the uncertainty around the timing of implementation and the possibility that the rules may apply sooner than originally thought, firms may wish to expedite their implementation planning.

#### **Who can I contact?**

- Further details and contact details are provided at the end of this document.



## In detail

### Context

In 2017 the European Commission proposed a review of the existing prudential regime for investment firms based on the premise that it was not appropriate to apply the same requirements to banks and investment firms given the fundamental differences between the sectors.

Following a long consultation process IFR was published in the European Journal in December 2019. As part of the publication the EBA were instructed to develop various RTS to provide detailed implementation guidance on specific technical points. A series of these draft RTS were published on 4 June 2020 as part of a set of Consultation Papers. In particular RTS on the identification of MRTs and the instruments that can be used to pay MRTs were published.

National regulators have until June 2021 to implement the requirements into national regulation. The majority of the requirements will come into force for performance periods starting on or after 26 June 2021. Firms will welcome the clarity provided by the RTS, particularly given the FCA's consultation paper on the implementation of IFR in the UK has been delayed due to more pressing concerns as a result of the COVID-19 crisis. That consultation is now expected between July and September.

### Who does this apply to?

IFR will apply to all MiFID entities, including those firms which are currently categorised as IFPRU or BIPRU. AIFMs and UCITS ManCos with MiFID 'top-up' permissions will also likely be captured.

As part of this consultation package, the EBA published further guidance on the scope of the Regime and in particular detail regarding the treatment of the largest organisations that could create systemic risk. The draft RTS on that topic specifies that any investment firm that exceeds any of the below thresholds will continue to be subject to the Capital Requirements Directive (CRD) rather than IFR:

- Total gross notional value of non-centrally cleared OTC derivatives of EUR 50 billion;
- Total value of financial instruments underwriting and/or placing of financial instruments on a firm commitment basis of EUR 5 billion;
- Total value of granted credits or loans to investors to allow them to carry out transactions of EUR 5 billion
- Total value of debt securities outstanding of EUR 5 billion; and

- Provide clearing services to FS firms who are not clearing members themselves (although this is subject to local regulator discretion).

Where the firm is not deemed to be able to create systemic risk, the remuneration requirements will apply to all firms who are not defined as 'small and non-interconnected'. A full list of the relevant thresholds under this definition are set out in the appendix.

### Material Risk Taker identification

Similar to the current regimes, IFR requires firms to identify MRTs. It is these individuals that the regulations apply to the greatest extent, including structural requirements for their pay such as deferral, payment in instruments, malus and clawback.

The draft [MRT RTS](#) outlines the criteria that firms are expected to interpret and apply to identify their MRT population. The format of the RTS is similar to that which applies under the CRD regime and includes prescriptive qualitative and quantitative criteria.

This provides for a less flexible approach to identification than the approach that many investment firms are familiar with under the BIPRU regime (or equally AIFMD or UCITS V).

The RTS applies on an individual entity and consolidated basis which means many firms will need to apply the criteria separately to each impacted entity as well as to the Group as a whole.

The RTS provides much needed clarity on the population to whom the IFR will apply. Although there is still some uncertainty regarding how the criteria will apply in practice, this will allow firms to start their implementation of IFR in earnest.

The full criteria are set out in the appendix however a summary is provided below.

#### Qualitative criteria

The 9 prescriptive, qualitative criteria are likely to broadly capture similar numbers of staff to under the CRD regime but are likely to capture more individuals than are currently captured under the BIPRU regime.

From a senior management perspective the criteria broadly capture

- I. The Board;
- II. The Executive Committee ('ExCo');
- III. Individuals who head a Material Business Unit ('MBU') or control function (Risk, Compliance, Internal Audit) and report to the Board or ExCo;
- IV. Individuals who head a subordinated business unit or control function and report to someone identified in III above; or
- V. SMF holders if not already captured under any other criteria.

A new definition of Material Business Unit has been provided as a 'business unit that contributes to more than [10% / 20%] of the investment firm's total own funds requirement at the end of the preceding financial year. Firms are requested to input into the final percentage as part of the consultation.

The criteria also captures individuals responsible for managing key risk areas, approving new products, or managing money laundering or terrorist financing risks.

Finally the criteria captures function heads, including those responsible for execution or the approval of processes or systems, economic analysis, or outsourcing critical functions. Individuals 'responsible for execution or approval of processes or systems' are also captured, although it is not clear how ranging the definition of processes or systems might be. Additionally, individuals responsible for IT or security, particularly management of client assets, safeguarding of client client money, and the execution of client orders or trading activity, are captured.

The criteria that has the greatest amount of uncertainty around it is the identification of those with responsibility for approval or execution of processes or systems. It is not clear how wide ranging this is or the nature of the processes and systems it is intended to capture. One way it could be interpreted could be the systems and processes specified in the Prescribed Responsibilities under the Senior Manager and Certification Regime. This interpretation appears to align with the EBA's commentary in the cost-benefit analysis section of the Consultation Paper, however it remains to be seen how the FCA expect firms to implement that particular requirement.

Firms will likely welcome that, at this stage it appears that the qualitative criteria do not capture portfolio managers, although they may be captured under the quantitative criteria or by virtue of senior management responsibilities or their membership of certain committees.

Although the criteria may seem comprehensive, firms are still expected to consider their own criteria based on their key risks including those that drive the K Factors for the capital requirements calculations.

#### Quantitative criteria

Previously, only the CRD regime has included a prescriptive quantitative threshold above which individuals are expected to be identified as MRTs. IFR takes the same approach and the criteria are broadly consistent with the CRD regime. This is likely to increase the number of MRTs identified for firms who have previously been part of the BIPRU regime, particularly where there are large numbers of high earners.



Individuals will now be provisionally identified if they earn:

- total remuneration which is equal to or greater than €500k and equal to or greater than the average of the remuneration of the management body and senior management;
- total remuneration which is equal to or greater than €750k;
- Remuneration putting them within the top 0.3% of high earners, where a firm has over 1,000 members of staff; or
- higher total remuneration than staff members identified under specific qualitative criteria.

It is slightly surprising that those earning more than individuals captured under certain qualitative criteria will be identified - this is a provision under CRD IV, however will be removed under CRD V based on the draft proposals published to date. This is likely to have been driven by the wording of the Directive itself.

#### Exclusions

Where an individual is only identified under the quantitative criteria and firms can demonstrate that the individual does not have a material impact on the risk profile of the firm, they can be excluded from the list of MRTs.

Where an individual earns in excess of €750k or is in the top 0.3% of high earners, firms must apply to their local regulator for such exclusions. Where individuals earn in excess of €1m the local regulator must notify the EBA and such exclusions would only be considered in 'exceptional circumstances', where 'exceptional' is defined as 'unusual, very infrequent or far beyond what is usual in magnitude or degree'.

This is consistent with CRD and it is likely that the FCA will operate the same exclusion process that they operate under that regime. Given the UK will have exited the EU by the time IFR comes into force, the FCA may take a more flexible approach to exclusions over €1m as strictly they will not be required to notify the EBA.

#### Consultation questions

The Consultation Papers asks for responses in respect of the following questions:

- 1) In reference to qualitative criteria 4, what would be the appropriate percentage of own funds to determine that a business unit has a material impact on the risk profile of the investment firm?
- 2) Are the qualitative and quantitative criteria appropriate and sufficiently clear?

#### Instruments

Firms subject to the regime that are classified as 'significant' will be required to award 50% of variable remuneration paid to MRTs in instruments. Firms are deemed "significant" where they have on and off balance sheet assets in excess of €100m (the FCA may increase this to €300m).

The draft [instruments RTS](#) provides further detail regarding the instruments that can be used to satisfy this requirement. The RTS focuses exclusively on equity-type instruments and does not cover funds which may also be used to meet this requirement. The RTS provides more detailed requirements for each type of instrument that can be used, however the key principles are:

- Instruments used must be linked to the credit quality of the firm as a going concern. Instruments could include those used as core Tier 1 and core Tier 2 capital, or other capital for the purposes of meeting the prudential requirements under the Directive.
- All instruments that can be utilised for capital purposes can be used for remuneration purposes.
- Firms are able to use synthetic equity.
- Firms can use parent equity provided that there is a clear link between the credit quality of the investment firm using these instruments for the purpose of variable remuneration and the credit quality of the issuer of the instrument. This is assumed to be the case in the case of parent and subsidiary.
- Dividends / distributions can't be paid during the deferral period or accumulated to the end of the period.
- Where firms don't issue instruments they can take a different approach with local regulator approval, to achieve the same objective (i.e. link to credit quality as going concern).

Firms will likely see the guidance on instruments in a relatively positive light, as it offers reasonable flexibility. This is particularly the case for firms who may not issue appropriate instruments at present (e.g. Partnerships). It is not yet clear, however, whether the FCA will take a similar approach under IFR to that they take under CRD, in terms of not allowing firms to use alternative instruments where listed equity is available (even where that equity is at parent company rather than regulated entity level).

#### Consultation questions

The Consultation Papers asks for responses in respect of the following questions:

- 1) Are the requirements appropriate and sufficiently clear?

#### Interaction with AIFMD and UCITS V

Where firms are subject to the remuneration requirements under UCITS V and AIFMD, these will continue to apply alongside the IFR. The EBA has considered both regulations in drafting these RTS.

Where firms are subject to UCITS V and AIFMD through delegation, it is likely that IFR will be considered an 'equivalent' regime.

#### Timeline of future releases

There are a number of further remuneration related releases expected from the EBA in the coming 24 months. A full timetable of future releases is detailed in the appendix.

#### Next steps

##### You should:

- Consider responding to the Consultations by the deadline of 4 September 2020.
- Assess whether or not IFR will apply to your firm based on the regulatory permissions held and the updated provision regarding the largest investment firms continuing to be subject to CRD.
- Determine which remuneration provisions your firm will be subject to based on whether the firm will be deemed "significant", "non-significant" or "small and non-interconnected", and plan for implementation.
- If applicable, conduct a gap analysis of the proposed MRT identification criteria against the current approach of your firm and the impact this may have on your MRT population. If you are a "significant firm", conduct analysis to understand the impact on this population's pay.
- If applicable, consider your firm's preferred approach to instruments for use as variable remuneration, in line with the guidance provided by the draft RTS
- We will provide updates as and when the EBA publish the new RTS and the FCA begin to consult on their implementation of the requirements.

## Appendix 1 - Article 12 proportionality thresholds

An investment firm shall be deemed a small and non-interconnected investment firm for the purposes of IFD and IFR where it meets all of the following conditions:

- Assets under managements is less than EUR 1.2 billion;
- Client orders handled is less than either:
  - EUR 100 million / day for cash trades or
  - EUR 1 billion / day for derivatives.
- Assets safeguarded and administered is zero;
- Daily trading flow is zero;
- Client money held is zero;
- Daily trading flow is zero;
- Net position risk or clearing margin given is zero;
- Trading counterparty default is zero;
- The on- and off-balance sheet total of the investment firm is less than EUR 100 million; and
- 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.

These thresholds are expected to apply on a consolidated basis.

## Appendix 2 - Qualitative criteria

- 1) A member of the management body in its management function.
- 2) A member of the management body in its supervisory function.
- 3) A member of the senior management.
- 4) Has managerial responsibility for a business unit that contributes to more than [10%/20%] of the investment firm's total own funds requirement at the end of the preceding financial year.
- 5) Has managerial responsibilities for the activities of a control function.
- 6) Has managerial responsibilities for the prevention of money laundering and terrorist financing.
- 7) Has managerial responsibilities for a material risk to which the investment firm is exposed or is a voting member of a committee responsible for managing, monitoring and mitigating a material risk to which the investment firm is exposed.
- 8) Has managerial responsibility for the execution or the approval of processes or systems, performing economic analysis, management of outsourcing arrangements of critical or important functions or providing information technology or security that are relevant for the investment firm's business activities with regard to one or more of the following:
  - a) The management or safeguarding of assets under both discretionary portfolio management and non discretionary advisory arrangements of an ongoing nature.

b) The administration or safeguarding of client money held both on segregated accounts and on non-segregated accounts.

c) The execution of client orders

d) The execution of trading activities.

9) Staff member meets either of the following criteria with regard to decisions for approving or vetoing the introduction of new products:

a) Has authority to take such decisions

b) Is a voting member of a committee which has authority to take such decisions.

## Appendix 3 - Quantitative criteria

Where any of the following criteria are met in or for the preceding financial year the staff member should be identified as a material risk taker:

a) Total remuneration which is equal to or greater than EUR 500,000 and equal to or greater than the average of the remuneration of members of the management body and senior management (on a Full Time Equivalent basis).

b) Total remuneration which is equal to or greater than 750 000 EUR or more.

c) Total remuneration within the top 0.3% of the firm where the firm has over 1,000 members of staff members.

d) Total remuneration equal to or greater than the lowest total remuneration awarded in that financial year to those identified under qualitative criteria 1,3,4,7,8 or 9 as detailed in the preceding section of this bulletin.

Publication	Legal deadline	EBA deliverables	Phase
Guidelines to specify the content of the application of governance arrangements	None	First quarter of 2021	Phase 2
Final RTS to specify appropriate criteria to identify the categories of staff whose professional activities have a material impact on the IF's risk profile	18 months after EIF	October 2020	Phase 1
Final RTS to specify instruments for variable remuneration	18 months after EIF	October 2020	Phase 1
Guidelines on benchmarking of remuneration practices and the gender pay gap	None	Last quarter of 2021	Phase 3
Guidelines on the application of sound remuneration policies	None	Last quarter of 2021	Phase 3
EBA to publish supervisory information on high earners (the EBA may issue Guidelines to facilitate data collection)	None	Last quarter of 2021	Phase 3

## For further information, help or support...

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