An Roinn Airgeadais
Department of Finance

Public Consultation on the exercise of national discretions in Directive (EU) 2019/2034

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Prepared by the Funds, Insurance, Markets & Pensions Division,
Department of Finance
finance.gov.ie

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1 The Consultation Process

The Department of Finance invites interested parties to make submissions in relation to the exercise of national discretions in the Investment Firm Directive (IFD) – Directive (EU) 2019/2034 and the Investment Firm Regulation (IFR) – Regulation (EU) 2019/2033.

While the majority of the provisions of the IFD will be transposed on a fully harmonised basis and the IFR applies directly without requiring transposition, there are a number of provisions in the Directive to which full harmonisation does not apply and Member States are given discretion as to the application of these provisions.

The consultation period will run to **5pm, 06 July 2020**. Submissions received after this deadline will not be considered.

In responding to this consultation you are invited to:

- Give your views on the specific questions set out below. You do not have to answer every question – you may choose to answer all of the questions or only those which are relevant to you.
- Provide details of any issues or concerns you feel should be considered in dealing with the particular topic being addressed in your response.
- Where appropriate, provide some analysis or views on the regulatory and/or financial impact of the proposed approach.

The comments received will be taken into consideration when deciding how best to transpose the IFD into Irish law.

How to Respond

The preferred means of response is by email to: *ifd@finance.gov.ie*.

Alternatively, you may respond by post to:

IFD Public Consultation
Funds, Insurance, Markets & Pensions Division
Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2, D02 R583

Please include contact details if you are responding by post. When responding, please indicate whether you are a professional adviser, representative body, corporate body or member of the public.

Freedom of Information
Responses to this consultation are subject to the provisions of the Freedom of Information Acts. Parties should also note that responses to the consultation may be published on the Department's website.

Meetings with Stakeholders
The Department of Finance may also invite key stakeholders to meet with them, including representative bodies and other interested groups or individuals.

After the Consultation
The submissions received in response to this consultation will be taken into consideration when transposing into Irish law the national discretions contained in the IFD.

Disclaimer
Nothing in this document constitutes legal advice or any other form of advice, nor should it be construed as such.

Please note that neither the Department of Finance nor the Minister for Finance assume any liability for the accuracy or completeness of the information contained in this consultation document.

2 General Background

Introduction

The IFD and IFR were adopted as legislative proposals on 05 December 2019 and entered into force on 25 December 2019. They are scheduled to be transposed into Irish law by 26 June 2021.

The IFD and IFR will be supplemented by way of delegated acts, where policymakers have delegated powers to the European Commission and/or the European Supervisory Authorities to draft delegated acts, regulatory technical standards and implementing technical standards.

Scope of the IFD/IFR

The IFD and IFR apply to investment firms authorised under the Markets in Financial Instruments Directive II (MiFID II).[1]

Objectives of the IFD/IFR

The prudential requirements applicable to credit institutions currently apply to investment firms with certain exemptions and derogations. The objective of the IFD and IFR is to provide for capital, liquidity and other prudential requirements for investment firms in the Union that reflect the business models of those firms and proportionately capture the risks posed and faced by these firms.

Equivalence requirements for the provision of investment services by third country firms have also been amended.

[1] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU. Transposed into Irish law by S.I. No. 375/2017 - European Union (Markets in Financial Instruments) Regulations 2017.

3 Key Elements of the IFD/IFR

Revised classification:

Class 1 - Investment firms authorised to deal on own account and/or to provide underwriting/placing of financial instruments on a firm commitment basis and that have consolidated assets equal to or above €30 billion (individually or on a group basis) are colloquially referred to as Class 1 firms.[2] A Class 1 firm will be required to submit an application for authorisation as a credit institution under CRD 4 and will fall under the Single Supervisory Mechanism (SSM) if located in the Eurozone.

Class 1 minus – Investment firms authorised to deal on own account and/or provide underwriting/placing of financial instruments on a firm commitment basis that do not meet the €30 billion threshold for Class 1 may still be subject to the same prudential requirements as Class 1 firms. These firms are colloquially referred to as Class 1 minus firms. The threshold for a firm to automatically fall into the Class 1 minus category is consolidated assets equal to or above €15bn, however there is also a national competent authority discretion to categorise certain smaller firms as Class 1 minus provided their consolidated assets equal or exceed €5bn and certain other criteria are met. Class 1 minus firms remain authorised as investment firms, however they are treated as 'institutions' under the CRR/CRD IV.

Class 2 – Firms that do meet the requirements of the other classes are colloquially referred to as Class 2, this is the default category for all investment firms unless they meet the criteria to be Class 1, Class 1 minus or Class 3. For this class of investment firms, the IFD/IFR requirements apply.

Class 3 – "Small and non-interconnected investment firms" are colloquially referred to as Class 3 firms and are those that comply with the criteria set out in Article 12 IFR, including the following thresholds set out in paragraph 1 of that Article as follows:

a) AUM (Assets Under Management)[3] measured in accordance with Article 17 IFR on a combined basis for all the investment firms in the group is less then EUR 1.2 billion;
b) COH (Client Orders Handled) measured in accordance with Article 20 IFR on a combined basis for all the investment firms in the group is less than either EUR 100 million per day for cash trades or EUR 1 billion per day for derivatives;
c) ASA (Assets Safeguarded and Administered) measured in accordance with Article 19 IFR is zero;
d) CMH (Client Money Held measured in accordance with Article 18 IFR is zero;
e) DTF (Daily Trading Flow) measured in accordance with Article 33 IFR is zero;
f) NPR (Net Position Risk) or CMG measured in accordance with Articles 22 IFR and Article 23 IFR is zero;

[2] Article 62(3) IFR which amends Article 4(1) (b) of the Regulation (EU) No 575/2013
[3] Recitals 20 – 24 of Regulation (EU) 2019/2033 explain what the terms AUM, COH, ASA, CMH, DTF, NPR and TCD are and a short description of each is included in Annex II of this document.

g) TCD (Trading Counterparty Default) measured in accordance with Article 26 IFR is zero;
h) The combined on and off balance sheet total of all the investment firms in the group is less than EUR 100 million; and,
i) The combined total annual gross revenue from investment services and activities of all the investment firms in the group 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.

Class 3 firms are subject to IFD and IFR, however have more limited capital, liquidity, reporting, disclosure, governance and remuneration requirements than Class 2 firms.

Own funds and capital requirements:

Class 2 firms will be required to hold own funds based on the higher of their Permanent Minimum Capital Requirement (PMR), Fixed Overhead Requirement (FOR), or K-factor requirement. The K-factor requirement is a new concept introduced by the IFR and is set out in Article 15 IFR. It requires firms to calculate capital requirements for three categories: Risk-to-Client, Risk-to-Market and Risk-to-Firm. These are then summed together to give the overall K-factor requirement.

Class 2 firms will also be required to conduct an internal capital adequacy and risk assessment process which will also consider risks to client, risks to market and risks to firm, in line with the K-factor approach.

Class 3 firms will be required to hold own funds based on the higher of their PMR or FOR.

Liquidity:

In addition to the above own funds requirements, investment firms will be required to hold an amount of liquid assets equal to at least one third of their FOR.
In the case of Class 3 firms, Member State competent authorities may exempt Class 3 firms from the liquidity requirement completely. If a Member State competent authority grants such an exemption, it must notify the EBA.

The assets that can be used to comprise the liquid asset component are set out in Article 43 of the IFR. Class 3 firms and Class 2 firms that do not carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU are allowed to use a wider definition of liquid assets. Specifically, these firms may include receivables from trade debtors as well as fees or commissions receivable within 30 days in their liquid assets subject to the following conditions:

a) They account for a maximum of one third of the minimum liquidity requirements;
b) They are not to be counted towards any additional liquidity requirements required by the competent authority for firm specific risks; and
c) They are subject to a 50% haircut.

Governance and Remuneration:

The provisions on internal governance, treatment of risks and remuneration are contained in Articles 25 to 34 of the IFD. Only Class 2 firms are in scope of this section. The remuneration requirements include a requirement for firms to set an "appropriate" ratio of fixed to variable remuneration. In terms of remuneration requirements, Class 3 firms will be subject solely to the existing MiFID II remuneration framework.

Reporting:

Article 54 of the IFR provides that Class 2 firms shall, on a quarterly basis, report to their Member State competent authority:

- Level and composition of own funds;
- Own funds requirements;
- Own funds requirement calculations;
- The level of activity in relation to the thresholds set out in IFR Article 12(1), including the balance sheet and revenue breakdown by investment service and applicable K-factor;
- Concentration risk; and,
- Liquidity requirements.

Under Article 54 IFR Class 3 firms are required to report to their Member State competent authority on an annual basis. They report the same information as Class 2 firms, with the exception that the concentration risk reporting requirements do not apply and the liquidity reporting requirements do not apply if an exemption has been granted by the Member State competent authority from the Article 43 IFR liquidity requirements.

Equivalence

In relation to the supervision of investment firm groups, Article 55 IFD deals with the supervision of investment firms with parent undertakings in third countries. It provides that where two or more EU investment firms are subsidiaries of a third country parent undertaking, the Member State competent authority shall assess whether the investment firms are subject to supervision by the parent's supervisory authority equivalent to the supervision set out in the IFD and the IFR.

Where this is not the case, the Member State competent authority which would be the group supervisor had the parent undertaking been established in the EU, may, after consulting other relevant Member State competent authorities, apply certain supervisory techniques. This can include the requirement to establish an investment holding company or a mixed financial holding company within the EU.

In the IFR, Article 63 amends Article 47 of the Markets in Financial Instruments Regulation (MiFIR) which relates to equivalence decisions taken by the Commission concerning third country jurisdictions.

Article 63 introduces a number of important amendments to the equivalence framework set out in MiFIR:

- A “detailed and granular assessment” of the legally binding prudential, organisational and business conduct requirements the third country firm is subject to where the scale and scope of the services to be provided by the firm is likely to be of systemic importance for the EU;
- Further detail on how systemic importance is assessed will be set out in a Delegated Act;
- The Commission must also assess and take into account the supervisory convergence between the third country concerned and the EU; and,
- Where the scale and scope of the services provided by the third country investment firm is likely to be of systemic importance for the EU, the Commission may attach specific operational conditions to the equivalence decision.

The IFR also contains monitoring and reporting requirements in relation to equivalence decisions, as well as provisions on how a third country firm’s registration with ESMA may be restricted or withdrawn.

4 National Discretions

Discretion 1 – IFD Article 4(1)

Having regard to the supervisory role exercised by the Central Bank of Ireland ('the Central Bank') in relation to MiFID II and financial services legislation more generally it is intended to designate the Central Bank as the single National Competent Authority for IFD.

Public Consultation Questions

1. Do you agree with the designation of the Central Bank of Ireland as the single National Competent Authority for IFD?

Discretion 2 & 3 – IFD Article 32(3), (5) & (6)

Article 32(1) sets out the requirements for investment firms in relation to variable remuneration. Specifically, Article 32(1)(j) & (l) set out the requirements for pay out of variable remuneration in instruments and deferral of payment of variable remuneration respectively.

Article 32(3) allows a Member State or the Competent Authority the discretion to place restrictions on the types and designs of instruments or prohibit the use of certain instruments for the purposes of variable remuneration.

Article 32(4) exempts investment firms and individuals from Article 32(1)(j) & (l) where respectively:

(a) an investment firm has on and off-balance sheet assets equal to or less than €100 million;
(b) an individual receives less than €50,000 annual variable remuneration and this does not represent more than one fourth of the individual's total annual remuneration.

Article 32(5) provides for a Member State discretion whereby the threshold (€100 million on and off-balance sheet assets) in Article 32(4)(a), below which the requirements of Articles 32(1)(j) & (l) would not apply, can be increased to a maximum of €300 million provided the following criteria are met:

(a) the investment firm is not, in the Member State in which it is established, one of the three largest investment firms in terms of total value of assets;

(b) the investment firm is not subject to obligations or is subject to simplified obligations in relation to recovery and resolution planning in accordance with Article 4 of Directive 2014/59/EU;

(c) the size of the investment firm's on and off-balance sheet trading-book business is equal to or less than EUR 150 million;

(d) the size of the investment firm's on and off-balance sheet derivative business is equal to or less than EUR 100 million;

(e) the threshold does not exceed EUR 300 million; and

(f) it is appropriate to increase the threshold, taking into account the nature and scope of the investment firm's activities, its internal organisation, and, where applicable, the characteristics of the group to which it belongs.

Alternatively, Article 32(6) provides for a Member State discretion whereby the threshold (€100 million on and off-balance sheet assets) in Article 32(4)(a), below which the requirements of Articles 32(1)(j) & (l) would not apply, can be lowered.

Public Consultation Questions

2. Should Ireland exercise the discretion to raise the threshold up to a maximum of €300 million /reduce the threshold? If so, how much should the threshold be increased /reduced by?

Public Consultation Questions

3. Should Ireland restrict or prohibit the use of certain types or designs of instruments for the purposes of variable remuneration?

Public Consultation Questions

4. Should the restriction or prohibition of certain types or designs of instruments for the purposes of variable remuneration be addressed by way of transposing regulations or should the Minister for Finance delegate this discretionary power to the National Competent Authority?

Discretion 3 – IFD Article 32(7)

Member States may decide that staff members entitled to annual variable remuneration below the threshold set out in Article 32(4)(b) shall not be entitled to the exemption set out therein because of:

(a) national specificities in terms of remuneration practices; or,
(b) the nature of the responsibilities and job profile of those staff members.

Public Consultation Questions

5. Should Ireland exercise the discretion to prevent staff relying on the exemption set out in Article 32(4)(b)? If so, the basis should be clearly set out including the relevant national specificities and staff job profiles.

5 Annex – Extracts from the Directive

Article 32

Variable remuneration

1. Member States shall ensure that any variable remuneration awarded and paid by an investment firm to categories of staff referred to in Article 30(1) complies with all of the following requirements under the same conditions as those set out in Article 30(3):

   (a) where variable remuneration is performance related, the total amount of variable remuneration is based on a combination of the assessment of the performance of the individual, of the business unit concerned and of the overall results of the investment firm;

   (b) when assessing the performance of the individual, both financial and non-financial criteria are taken into account;

   (c) the assessment of the performance referred to in point (a) is based on a multi-year period, taking into account the business cycle of the investment firm and its business risks;

   (d) the variable remuneration does not affect the investment firm's ability to ensure a sound capital base;

   (e) there is no guaranteed variable remuneration other than for new staff only for the first year of employment of new staff and where the investment firm has a strong capital base;

   (f) payments relating to the early termination of an employment contract reflect performance achieved over time by the individual and shall not reward failure or misconduct;

   (g) remuneration packages relating to compensation or buy out from contracts in previous employment are aligned with the long-term interests of the investment firm;

   (h) the measurement of performance used as a basis to calculate pools of variable remuneration takes into account all types of current and future risks and the cost of the capital and liquidity required in accordance with Regulation (EU) 2019/2033;

   (i) the allocation of the variable remuneration components within the investment firm takes into account all types of current and future risks;

(j) at least 50 % of the variable remuneration consists of any of the following instruments: (i) shares or equivalent ownership interests, subject to the legal structure of the investment firm concerned; (ii) share-linked instruments or equivalent non-cash instruments, subject to the legal structure of the investment firm concerned; (iii) Additional Tier 1 instruments or Tier 2 instruments or other instruments which can be fully converted to Common Equity Tier 1 instruments or written down and that adequately reflect the credit quality of the investment firm as a going concern; (iv) non-cash instruments which reflect the instruments of the portfolios managed;

(k) by way of derogation from point (j), where an investment firm does not issue any of the instruments referred to in that point, competent authorities may approve the use of alternative arrangements fulfilling the same objectives;

(l) at least 40 % of the variable remuneration is deferred over a three- to five-year period as appropriate, depending on the business cycle of the investment firm, the nature of its business, its risks and the activities of the individual in question, except in the case of variable remuneration of a particularly high amount where the proportion of the variable remuneration deferred is at least 60 %;

(m) up to 100 % of the variable remuneration is contracted where the financial performance of the investment firm is subdued or negative, including through malus or clawback arrangements subject to criteria set by investment firms which in particular cover situations where the individual in question: (i) participated in or was responsible for conduct which resulted in significant losses for the investment firm; (ii) is no longer considered fit and proper;
(n) discretionary pension benefits are in line with the business strategy, objectives, values and long-term interests of the investment firm.

2. For the purposes of paragraph 1, Member States shall ensure the following:

(a) individuals referred to in Article 30(1) do not use personal hedging strategies or remuneration and liability-related insurances to undermine the principles referred to in paragraph 1;

(b) variable remuneration is not paid through financial vehicles or methods that facilitate non-compliance with this Directive or with Regulation (EU) 2019/2033.

3. For the purposes of point (j) of paragraph 1, the instruments referred to therein shall be subject to an appropriate retention policy designed to align the incentives of the individual with the longer-term interests of the investment firm, its creditors and clients. Member States or their competent authorities may place restrictions on the types and designs of those instruments or prohibit the use of certain instruments for variable remuneration.

For the purposes of point (l) of paragraph 1, the deferral of the variable remuneration shall vest no faster than on a pro-rata basis.

For the purposes of point (n) of paragraph 1, where an employee leaves the investment firm before retirement age, discretionary pension benefits shall be held by the investment firm for a period of five years in the form of instruments referred to in point (j). Where an employee reaches retirement age and retires, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in point (j), subject to a five-year retention period.

4. Points (j) and (l) of paragraph 1 and the third subparagraph of paragraph 3 shall not apply to:

(a) an investment firm, where the value of its on and off-balance sheet assets is on average equal to or less than EUR 100 million over the four-year period immediately preceding the given financial year;

(c) an individual whose annual variable remuneration does not exceed EUR 50 000 and does not represent more than one fourth of that individual's total annual remuneration.

5. By way of derogation from point (a) of paragraph 4, a Member State may increase the threshold referred to in that point, provided that the investment firm meets the following criteria:

(a) the investment firm is not, in the Member State in which it is established, one of the three largest investment firms in terms of total value of assets;

(b) the investment firm is not subject to obligations or is subject to simplified obligations in relation to recovery and resolution planning in accordance with Article 4 of Directive 2014/59/EU;

(c) the size of the investment firm's on and off-balance sheet trading-book business is equal to or less than EUR 150 million;

(d) the size of the investment firm's on and off-balance sheet derivative business is equal to or less than EUR 100 million;

(e) the threshold does not exceed EUR 300 million; and

(f) it is appropriate to increase the threshold, taking into account the nature and scope of the investment firm's activities, its internal organisation, and, where applicable, the characteristics of the group to which it belongs.

6. By way of derogation from point (a) of paragraph 4, a Member State may lower the threshold referred to in that point, provided that it is appropriate to do so, taking into account the nature and scope of the investment firm's activities, its internal organisation, and, where applicable, the characteristics of the group to which it belongs.

7. By way of derogation from point (b) of paragraph 4, a Member State may decide that staff members who are entitled to annual variable remuneration below the threshold and share referred to in that point shall not be subject to the exemption set out therein because of national market specificities in terms of remuneration practices or because of the nature of the responsibilities and job profile of those staff members.

6 Annex II – K-factor Formula

The Investment Firm Regulation uses quantitative indicators (K-factors) that reflect the risks that the new regime intends to address. K-factors are divided in the IFR into three groups and they aim to capture the risk the investment firm can pose to customers, to market access or the firm itself.

Risk Type	K-factors
	K-AUM – Assets Under Management – captures the risk of harm to clients from incorrect discretionary management of client portfolios or poor execution and provides reassurance and client benefits in terms or the continuity of service of ongoing portfolio management and investment advice.
	K-ASA – Assets Safeguarded and Administered – captures the risk of safeguarding and administering client assets. It 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.
Risk to Client ***(RtC)***	**K-CMH** – Client Money Held - captures the risk or potential for harm where an investment firm holds the money of its clients, taking into account whether they are on its own balance sheet or in third-party accounts and arrangements under applicable national law provide that client money is safeguarded in the event of bankruptcy, insolvency, or entry into resolution or administration of the investment firm. K-CMH excludes client money that is deposited in a (custodian) bank account in the name of the client itself, where the investment firm has access to the client money via a third-party mandate.
	K-COH – Client Orders Handled – captures the potential risk to clients of an investment firm which executes orders (in the name of the client, and not in the name of the investment firm itself), for example as part of execution-only services to clients or when an investment firm is part of a chain for client orders.

	K-NPR – Net Position Risk – based on the market risk framework (standardised approach, or if applicable, internal models) approach set out in Regulation (EU) 575/2013.
Risk to Market ***(RtM)***	**K-CMG** – Investment firm's clearing member – where permitted by a Member State's competent authority for specific types of investment which deal on own account through clearing members, based on the total margins required by an investment firm's clearing member.
	K- DTF – Daily Trading Flow – based on transactions recorded in the trading book of the investment firm trading on own account, whether on behalf of a client or for itself, and the transactions that an investment firm enters through the execution of orders on behalf of clients in its own name.
Risk to Firm ***(RtF)***	**K- CON** – Concentration - captures concentration risk in relation to individual or highly connected private sector counterparties with whom firms have exposures above 25% of their own funds, or specific alternative thresholds in relation to credit institutions or other investment firms, by imposing a capital add-on in line with Regulation (EU) No 575/2013 for excess exposures above those limits.
	K – TCD – Trading Counterparty Default - captures the risk to an investment firm of the default of its counterparties in accordance with simplified provisions for counterparty credit risk, accounting for the mitigating effects of effective netting and the exchange of collateral.

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