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Paul Rich and Hillary Neale
Financial Conduct Authority
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By email: cp21-07@fca.org.uk

2 June 2021

Dear Paul and Hillary

A new UK prudential regime for MiFID investment firms

The City of London Law Society ("**CLLS**") represents approximately 17,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

Being made up of legal practitioners in the financial services sector, the Committee recognises that the UK's departure from the EU creates both the need to make certain changes to the UK's financial services regime but also a wider opportunity to re-design it in a way that works for the UK and its future ambitions for the sector.

The Committee is therefore pleased to respond to the FCA's consultations on the Investment Firms Prudential Regime ("**IFPR**") given its importance to the future of the UK's financial services regulatory regime and we provide our feedback on several proposals in CP21/7 and CP20/24 below.

CP 21/7

1. Transitional provisions

The transitional provisions in IFPR are intended to help investment firms to build up to their full regulatory capital requirements over a five-year period. It is, however, currently unclear whether the transitional provisions in respect of own funds would also apply in respect of CPMI firms and we would welcome clarification from the FCA.

2. ICARA

Based on the current proposal for the ICARA, as set out in chapter 7 of CP21/7, the ICARA requirements will come into effect as from 1 January 2022 with no transitional relief. We are therefore concerned that, in some instances, this will effectively undermine the transitional relief for firms in respect of the permanent minimum requirement, the fixed overheads requirement and the K-factors requirement (i.e. the own funds requirement). This is because, under the ICARA requirements, firms will need to assess whether their overall capital is adequate to cover the risks to which they are exposed and to ensure an orderly winding up and hold the full amount of any capital considered to be needed following this assessment. The FCA has explained that it considers the K-factors requirement and the fixed overheads requirement to represent the minimum amount of capital required in respect of these matters. If so, in many cases, we think that this could result in firms being required to hold capital significantly in excess of that required under the transitional provisions. This is particularly relevant for those investment firms which will be subject to a significant increase in capital requirements as a result of IFPR (such as firms that are currently exempt-CAD firms). We therefore encourage the FCA to consider some form of transitional relief for firms in respect of the ICARA to reflect that applicable to the own funds requirement.

A similar point applies in relation to the correlation between the ICARA and the liquid assets assessment.

Further, in respect of small and non-interconnected investment firms ("**SNIs**"), there is a concern that the requirement to reflect in the ICARA the "harms" applicable to the firm, and potentially to hold sufficient capital to address these, would lead to SNIs effectively being required to carry out an assessment equivalent to (and possibly loosely based on) the K-factors calculation. This is because, broadly, the K-factors represent the FCA's assessment of the minimum amount of capital that firms should hold in respect of the harms that it may pose. We therefore think that the FCA should:

(i) clarify the basis on which SNIs should assess such harms and that this should reflect the policy intention for a lighter-touch regime for SNIs; or

(ii) moderate its expectations in relation to the K-factors requirement representing the minimum amount of capital to be held in respect of certain harms in the case of SNIs.

Finally, the current draft of the rules in CP21/7 provides that a firm must notify the FCA immediately where its own funds fall below the level of the firm’s early warning indicator. The FCA has said that it considers that this should generally be set at 110% of a firm’s own funds threshold requirement. Although we note that the FCA reserves the right to specify a different threshold for the early warning indicator and that the FCA has stated that this should not be seen as an additional FCA-set own funds requirement, we think that this effectively creates a requirement for firms to hold a minimum of 110% of their total capital requirement. We consider that an effective requirement for firms to hold an additional 10% in capital is a somewhat arbitrary and potentially excessive requirement and encourage the FCA to take a more nuanced approach based on the specific risks of the relevant firms.

3. K-DTF

There is uncertainty as to the intended scope of K-DTF.

Draft MIFIDPRU 4.11.4 in CP20/24 indicates that K-DTF applies only to a firm which deals on own account. We assume from this that the extension of K-DTF to transactions which an in-scope firm enters into on behalf of clients in its own name (which could include some agency trading) applies only to firms which have permission to deal on own account. This position is confused by CP 21/7 (see paragraphs 4.72 onwards), which suggests that there is a seamless fit between K-COH and K-DTF, with transactions executed by a firm in the client's name falling under K-COH and those executed in the firm's name falling under K-DTF. However, if MIFIDPRU 4.11.4 is correct, this would not be the position for a firm which does not have permission to deal on own account: if it executes transactions as agent for a client in the client's name it would include the transactions under K-COH, but the transactions would fall under neither K-COH or K-DTF if it executes transactions as agent in its own name. Is this what the FCA intended? Clarity for firms is paramount.

CP20/24

We appreciate that the CP20/24 consultation is now closed but, given the consultation for IFPR is an ongoing process, we hope you can take into account our feedback below.

1. LLP eligible capital

As regards the eligibility of LLP members' accounts as Common Equity Tier 1 (CET1) capital, we think that the regulatory capital treatment of drawings which are paid out in anticipation of final profits should be clarified. Under current rules, exempt CAD firms and BIPRU firms must deduct such drawings from Tier 1 (or equivalent) capital if the aggregate of the amounts paid out exceeds the profits of the firm. This is currently provided for in IPRU-INV Annex A 2-.5R and GENPRU 2.2.100R of the FCA handbook but there is no equivalent provision proposed under IFPR. For these purposes profit is not defined (and so, for example, is not confined to audited or independently verified profit), which enables firms to undertake a responsible assessment on the basis of management accounts when determining whether any deduction needs to be made on an intra-year basis. The absence of this flexibility would have a significant impact on firms' ability to permit LLP members to make regular monthly drawings (determined on a prudent basis) in anticipation of final profits for the accounting period.

As this provision is important to many firms, particularly private equity firms, we think that there is merit in clarifying the position under the new regime and including an equivalent mechanism in MIFIDPRU.

2. Prudential consolidation

The "consolidated situation" for the purpose of group capital requirements includes subsidiaries as defined in section 1162 of the Companies Act 2006 and "connected undertakings". The definition of connected undertakings is very broad and significantly extends the scope of the entities which are subject to consolidation. Many of the entities which would be included under this new definition are not entities which would ordinarily be expected to form part of a consolidation group for prudential purposes. The scope of consolidation also extends beyond the general concept of a corporate group under English law, which we would have expected to be the standard used.

For example, the definition includes situations where an undertaking exercises significant influence over another and the FCA indicates that this could include where there are material transactions between the two undertakings or the ability for one undertaking to the ability to appoint a representative in the management body of the other. This is extremely wide and could have significant consequences, some of which we do not believe are intended.

We think that the FCA should reconsider the scope of the entities which would fall within the definition of connected undertakings and are therefore subject to consolidation in order to ensure that this does not extend more broadly than is strictly necessary.

In addition, we feel that in many cases the concepts used for the definition of connected undertaking are unclear and may cause uncertainty as to their application in practice. Some additional clarification would be welcome. For example, it is not clear whether a right to appoint just one director on the board of another company would be sufficient for the relevant entities to be "connected" for these purposes.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours sincerely

Karen Anderson
Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
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Individuals and firms represented on this Committee are as follows:

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