

The New Prudential Framework for Investment Firms

Investment Firms Regulation (IFR)/Investment Firms Directive (IFD)

All Cyprus Investment Firms ('CIFs') authorised under the Investment Services and Activities and Regulated Markets Law of 2017 will be subject to a new comprehensive regulatory regime, different and independent from the Regulation EU No. 575/2013 (CRR) and Directive DI144-2014-14 which are applicable today. The new prudential framework consists of the Investment Firms Regulation (EU) 2019/2033 ("IFR") (on the prudential requirements of investment firms) and the Investment Firms Directive ("IFD") (on the prudential supervision of investment firms) which will enter into force on 26th June 2021. To this end, the Cyprus Securities and Exchange Commission ("CySEC") issued the **Circular C426** on the 2ⁿ of February 2021, to inform the obliged entities as regards the new regulatory framework.

Rational Behind the new prudential framework

The reason for introducing this new regime is based on the fact that the previous prudential regimes under Regulation (EU) No 575/2013 and Directive 2013/36/EU were 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. Accordingly, the existing requirements were largely calibrated to preserve the lending capacity of credit institutions through economic cycles and to protect depositors and taxpayers from possible failure, and were not designed to address all of the different risk profiles of investment firms.

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. The specific vulnerabilities and risks inherent to those investment firms therefore are specifically addressed by means of appropriate and proportionate prudential arrangements at Union level.

The new prudential framework for investment firms takes into account a number of further and more specialized factors of investment firms, such as their particular business practices, their size and

interconnectedness with other financial and economic actors. In addition, 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.

Categorization of Investment Firms

Under the new regime, a new classification system for investment firms will be applicable, based on their activities, systemic importance, size and interconnectedness. They will be categorised in the following three different categories:

Class 1A: This category will consist of large investment firms which carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU, collective investment undertakings or insurance undertakings and provided that they satisfy certain criteria, will be considered as systemically important firms and will seek authorisation as credit institutions, supervised under the legal framework of CRR2/CRDV capital framework.

Class 1B: This category will consist of investment firms which carry out any of the activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU, collective investments and insurance undertakings. These firms will remain as investment firms under CySEC's supervision, but will be supervised under CRR2/CRDV for prudential requirements provided that they meet any of the following:

- 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 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.

Class 2: An investment firm will be categorized as Class 2 if it does not meet any of the conditions of the firms of Class 1a, 1b, and 3. The firms that fall into Class 2, will be subject to the new IFR/IFD regime.

Class 3: This class consists of investment firms that meet all of the criteria below and thus qualifies as small and non-interconnected investment firms:

- (a) AUM (Assets Under Management) is less than EUR 1,2 billion;
- (b) COH (Client Orders Handled) is less than either: - EUR 100 million/day for cash trades; or - EUR 1 billion/day for derivatives;
- (c) ASA (Assets safeguarded and administered) is zero;
- (d) CMH (Client Money Held) is zero;
- (e) DTF (Daily Trading Flow) is zero;
- (f) NPR (Net Position Risk) or CMG (Clearing Margin Given) is zero;
- (g) TCD (Trading Counterparty Default) 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.

Initial Capital Requirements for Licensing

The new regime revises the previous Initial Capital Requirements for the authorization of all Investment Firms. The Initial Capital Requirements are divided into three (3) categories:

- EUR 750.000:**
- Dealing on own Account;
 - Underwriting and/or placing on a firm commitment basis;
 - Operation of an Organized Trading Facility (where the investment firm engages in dealing on own account or is permitted to do so).
- EUR 75.000:** To fall into this category a firm must not hold client money or securities belonging to its clients and must provide one of the following services:
- Reception and transmission of orders in relation to one or more financial instruments;
 - Execution of orders on behalf of clients.;
 - Portfolio management;
 - Placing of financial instruments without a firm commitment basis.

EUR 150.000 -All other investment firms.

With its Circular (C426) issued on 2 February 2021, CySEC urges CIFs to study the new framework, along with the final draft RTS, so that they are able to identify the class they will be categorized from 26th June 2021 and the general obligations imposed by the new regulatory framework. The new regulatory regime will significantly benefit small and medium-sized investment firms, by reducing a large number of regulations required for their licensing and operation. Beyond that, investment firms should make their own assessment on the impact that the IFR and IFD will have on their own funds, concentration risk, liquidity risk, disclosure, reporting, remuneration requirements, take the necessary actions and make the requisite amendments to ensure full compliance with the new regulatory framework by the date of entry into force.