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The innovations and amendments introduced for investment firms, in light of the transition from the previous CRR & CRD discipline to the new IFR & IFD discipline

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Abbreviations

ASA: Assets held on behalf of customers

AT 1: Additional Tier 1 Capital

AT 2: Additional Tier 2 Capital

AUM: Assets Under Management

BCBS: Basel Committee on Banking Supervision

BIS: Bank for International Settlements

BRRD: Bank Recovery and Resolution Directive, 2014/59/EU

CCB: Capital Conservation Buffer

CEBS: Committee of European Banking Supervisors

CESR: Committee of European Securities Regulators

CET 1: Common Equity Tier 1 capital

CMG: Clearing margin given

CMH: Client Money Held

CMHS: Client Money Held on Separated accounts

CMHNS: Client Money Held on Non-Separated accounts

COH: Client Orders Handled

COHC: Customer Orders Handled in Spot Transactions

COHD: Client Orders Handled in Derivatives Transactions

CON: Concentration

CJEU: Court of Justice of the European Union

CRD IV: Capital Requirement Directive 4, 2013/36/EU

CRD V: Capital Requirement Directive 5, 2019/878/EU

CRR: Capital Requirement Regulation, 575/2013/EU

CRR II: Capital Requirement Regulation, 2019/876/EU

DTF: Daily Trading Flow

DTFC: Daily Trading Flow in Cash

DTFD: Daily Trading Flow in Derivatives

EBA: European Banking Authority

EBU: European Banking Union

EC: European Commission

ECB: European Central Bank

EIOPA: European Insurance and Occupational Pensions Authority

ESAs: European Supervision Authorities

ESFS: European System of Financial Supervision

ESM: European Stability Mechanism

ESMA: European Securities and Markets Authority

ESRB: European Systemic Risk Board EU European Union

FOR: Fixed Overhead Requirements

FSB: Financial Stability Board

FSF: Financial Stability Forum

GC: General Court

GDLs: Guidelines

G-SIB: Global - Systemically Important Bank

G-SII: Global - Systemically Important Institution

HQLA: High Quality Liquidity Assets

ICAAP: Internal Capital Adequacy Assessment Process

IFD: Investment Firm Directive 2034/2019/EU

IFR: Investment Firm Regulation 2033/2019/EU

ILAAP: Internal Liquidity Adequacy Assessment Process

IMF: International Monetary Fund

LCR: Liquidity Coverage Ratio

LR: Leverage Ratio

MiFID II: Markets in Financial Instruments Directive 2014/65/EU

MREL: Minimum Requirement of Eligible Liabilities

MTF: Multilateral Trading Facility

NCAs: National Competent Authorities

NPR: Net Position Risk

NSFR: Net Stable Funding Ratio

OTF: Organised Trading Facility

RtC: Risk-to-Client

RtF: Risk-to-Market

RtM: Risk-to-Firm

RTS: Regulatory Technical Standards

RWA: Risk-Weighted Assets

SIFIs: Systemically Important Financial Institutions

SIM: Società d'Investimento Mobiliare (*Securities Investment Firm*)

SRB: Single Resolution Board

SREP: Supervisory Review and Evaluation Process

SRF: Single Resolution Fund

SRM: Single Resolution Mechanism

SSM :Single Supervisory Mechanism

SyRB: Systemic Risk Buffer

TCD: Trading Counterparty Default

TUB: Testo unico delle leggi in materia bancaria e creditizia (*Consolidated Law on Banking*)

TUF: Testo unico delle disposizioni in materia di intermediazione finanziaria (*Consolidated Law on Financial Intermediation*)

Introduction

In modern financial systems, *due to the activities they perform in the efficient allocation of capital*, investment firms play a fundamental role for *financial stability* and for the *proper functioning* of a thriving, healthy and prosperous economy. Within the European Union, banks and investment firms have traditionally been regulated and supervised by the same regulatory body (*the CRR - CRD regulatory package*) and by the ECB (*which has supervisory and prudential powers with respect to banks and investment firms, with the exclusion of insurance companies*). Until recently, the only regulation existing within the Union (*applied to both banks and investment firms*) was indeed represented by the CRR / CRD package which, (*taking up the dictates of the Basel Accords*), subjected investment firms to the same rules to which banks are subject, thus causing the creation of a system not fully suited to the former. By virtue of the importance of investment firms in maintaining financial stability in Europe (*and in the world*), combined with the desire to simplify and fill the shortcomings that plagued the previous legislation, have laid the foundations for the formation of a new regulatory environment *focused more on proportionality*. This has led to the introduction of a *new categorization for investment firms* based on *proportionality* and so the distinction between those of a systemic nature, (*attracted by the banking code*), and those of a non-systemic nature, (*subject to the new prudential regime*); also creating adequate supervisory requirements aimed at reducing the probability of bankruptcy of an investment firm or, (*in the event of bankruptcy*), limiting the risk of an unordered liquidation that could cause disruption to customers, counterparties or the markets in which they operate. Therefore, the regulation of investment activities and the regulation of Financial Institutions, (*such as Banks*), Credit Institutions and Investment Companies, represent a much discussed topic, of great importance, which must necessarily be treated with great attention, not only in Europe, but also internationally, on a Global stage.

Within the aforementioned thesis, we will first of all try to understand and analyze, (*describing step by step*), all the causes and reasons that led the European legislator to introduce a whole series of amendments that culminated in the birth of a separate body of rules, distinct from the previous one, (*maintaining however some points of contact*), outlining to the reader the *shortcomings* and *plagues* that afflicted the previous regime. Secondly, we will describe the new discipline object of our study, (*i.e. the IFR regulation and the IFD directive*), analysing the differences with the previous one the innovations introduced, highlighting how they aim to resolve all the defects and shortcomings that

have plagued the situation that has now passed and strengthen the discipline to which investment firms are subject.

The thesis in question consists of three main parts. The first part; aims to describe the now past prudential framework constituted by Regulation 575/2013 / EU (*known as CRR*), by Directive 2013/36 / EU (*known as CRD IV*). In it we will focus on the analysis of the reasons that led to his birth, on the innovations that, (*in his time*), he had introduced, on its setting and his past goals that he intended to achieve. The second part; it is an intermediate step. Internally, it aims to describe the transition from the CRR and CRD IV disciplines to the CRR II and CRD V. Therefore, in it I wanted to analyze the innovations introduced and the "*updates*" undergone by the old framework, also describing the differences and similarities. The third part; aims to describe the current Prudential Framework, consisting of the newly introduced Regulation 2019/2033 / EU (IFR) and the Directive 2019/2034 / EU (IFD). In it I wanted to critically analyze the passages, the motivations, (*focusing on the reasons that gave life to this new framework*), also carrying out an analysis of the costs and benefits around it, illustrating the effects of its introduction, (*within the Italian law*), on SIMs. Finally, to conclude, we will try to find an answer to the following questions: *Why was it decided to give autonomy to investment firms*? *Why did the European legislator decide to unbundle investment firms from the same discipline to which banks are subject*?, also trying to understand if it was really necessary to divide the single discipline applied to both Investment Firms and Banks within the Union European Union, through the enactment of this discipline.

Chapter - 1: The previous European regulatory framework

1 - The origins of the previous Normative Framework, the causes that led to its creation.

Speaking of the regulation on *credit institutions* and *investment firms*, with reference to the initial capital requirements, the composition of the latter, the prudential supervision by the competent authorities, the disclosure requirements to the public, and how they will change in the future, (*in light of both the new challenges and demands arising from the market and the introduction and support of new standards, including two recently discussed in the European context*[1]), we cannot fail to explain the *role*, *characteristics*, *motivations* and the steps that have characterized the *past European framework* in adapting and establishing the current laws relating to prudential requirements for *Credit Institutions* and *Investment Firms*.

The regulation of these two, as regards initial capital requirements, prudential supervision, as well as public disclosure obligations, represent an important and much debated topic; (*and that is especially true, after the 2008 financial crisis*). This is due to the problem of being able to find the right "*balance*", or the right "*Trade-off*", between the *levels of supervision*[2], (after taking into consideration the requirements required by companies[3]), and the need to make the market a *stable* and *safe place*,

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[1] In this case we are referring to the two new regulations, which entered into force on November 27, 2019, the Regulation 2019/2033 IFR and the Directive 2019/2034 IFD, (*which will begin to be applicable from June 2021*). (*For further information, please see: Regulation 2019/2033/EU IFR Available at: https://eur-lex.europa.eu/legal-content/IT/HIS/?uri=CELEX:32019R2033 and Directive 2019/2034/EU, Available at: https://eur-lex.europa.eu/legal-content/IT/TXT/?uri=CELEX%3A32019L2034*)

[2] Level of supervision placed by the competent authorities, NCAs, over *credit institutions* (i.e. Banks) and *investment firms*, operating in the financial market.

[3] With the requirements required by companies, we consider all those requirements of *initial capital*, *liquidity* and *disclosure to the public* (that companies operating in the investment sector must comply with in order to operate in the market). They have been conceived with the aim of making the market not only a solid place, but also stable and resilient

without undermining the business opportunities or discouraging any new ingress into the market, by new investment firms. The 2008's financial crisis, do not only exposed all the gaps and flaws in the European regulatory framework, (*in force up to that moment*), but we also have that it has exposed the many problems concerning the supervision of *credit institutions*, *investment firms*, and the *banking system*, (as whole), at *European* and *global level*. That situation also highlighted the *weaknesses* of the European institutions, the *lack of appropriate rules* and their *complete inadequacy*[4].

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to potential financial crises, so that it is in a position to always guarantee the safety to both the *operating companies* and its customers.

[4] Following the crisis, the absolute need arose to strengthen the cooperation of the various tax and supervisory authorities at the international level, strengthen the quality and level of the capital base, manage liquidity and the effectiveness of their internal and corporate governance. These points justified, in the first place, the modification of the Basel Accord and, consequently, the replacement of the CRD with a "*new*" framework or "*Regulatory Package*" comprising a regulation (CRR) and a directive (CRD IV). Basel II, approved in 2004, and entered into force only in 2007, is a set of international banking regulations proposed by the Basel Committee, designed with the aim of expanding and strengthening the minimum capital requirements established under the previous agreement. The second Basel Accord was based on three main points of action, which are minimum capital requirements, regulatory supervision and market discipline. Within Basel II, minimum capital requirements play an extremely crucial role, as they oblige banks to maintain minimum capital requirements with respect to risk-weighted assets. With Basel II we have the introduction of *guidelines* for the calculation of the *minimum regulatory capital ratios*, the division of the types of capital, (based on their quality) and we also have that the minimum capital requirement of 8% compared to the weighted assets for the risk, (*established in the previous Basel I agreement, is maintained*). However, despite the innovations introduced, Basel II proved to be insufficient in avoiding the 2008 crisis, or in containing the damage. *Based on the latter*, the subsequent Basel III Accord was released in 2010 and implemented only in 2013, which is a set of internationally agreed measures developed by the Basel Committee in response to the 2007-08 recession, whose aim was to strengthen the provisions contained in Basel II, strengthening supervision, regulation of banks, but also the minimum capital requirements required to banks and investment firms. (*For further information, please see:* https://www.bis.org/bcbs/basel3.htm)

In fact, like the previous agreements, Basel III imposes minimum requirements that apply to *internationally active banks*, however, more than the previous ones, it focuses on *risk-weighted assets*, on *improving bank liquidity* and on *increasing the level and quality of capital*. This agreement introduced changes to the composition of the minimum required capital, 8%, with respect to *risk-weighted assets* (RWA). It also introduced the *Liquidity coverage Ratio* (LCR) and the *Net Stable Funding Ratio* (NSFR). The former aims to ensure that a bank maintains an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a *30-day time horizon* under an acute liquidity stress scenario specified by supervisors. While the latter instead, aims to measures the amount of longer-term, stable sources of funding employed by an institution relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off -balance sheet commitments and obligations. (*For further information, please See: Pag. 3 and 5 Basel Committee on Banking Supervision: Consultative Document International framework for liquidity*

After taking into consideration the aforementioned problems within the European Union, *which have directly and indirectly caused considerable damage to the economy of many European countries including Italy*, we can appreciate, (at the Union level), *an increasement in both the number and in the intensity of regulatory interventions*[5], by the legislator. These interventions aimed at introducing, in the years following the crisis, profound innovations and changes in the field of *prudential supervision*, *capital requirements* and *transparency*, with respect to the *investment market*. It is during this period, *following the entry into force of the new Basel agreements*, that the old European regulatory framework, was completely revised and updated, with the main goal of *adapting it*, not only to the new provisions contained in Basel III, but also to the new needs, of building a *new regulatory framework*, which would *better protect* the *companies*, the *people employed*, the *markets* and which would make the latter *more resilient* to possible *future financial shocks*. In relation to this, we have the introduction of two new rules (back in 2013), the Regulation 575/2013/EU, (also known as CRR or "*Capital Requirement Regulation*", currently updated in 2019 with the issue of the new Regulation 2019/876/EU CRR II[6]), and the Directive 2013/36/EU, (also known as CRD IV or

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risk measurement, standards and monitoring, Issued for comment by 16 April 2010 December 2009). In light of this, the Basel III framework consists of three Basel Committee Reports:

- "*Basel III: a comprehensive regulatory framework for more resilient banks and banking systems*",
- "*Basel III: the liquidity coverage ratio [LCR] and liquidity risk monitoring tools*",
- "*Basel III: the net stable funding ratio [NSFR]*".

As it was recognized by, Professor Dr. Christos V. Gortsos, *The Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF): Legal Aspects of the Second Main Pillar of the European Banking Union (Fifth- Extended and Fully Updated - Edition), April 30, 2019, Page 47, Available at SSRN: https://ssrn.com/abstract=2668653*.

[5] This has resulted in the increasement in the production of new regulations and directives. Concrete examples of this fruitful legislative production can be found in the introduction and entry into force of the *CRR Regulation* and the *CRD IV Directive*. Also, we need to remember how: The Authorisation, (micro- and macro-) prudential regulation and micro-prudential supervision of credit institutions in the EU (and not only in the euro area) are governed by two legal acts of the European Parliament and of the Council of 26 June 2013: Regulation (EU) No 575/2013 "*on prudential requirements for credit institutions and investment firms and amending Regulation (EU) no. 648/2012*" and Directive 2013/36/EU *"on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms*", [...], These rules reflect to a large extent the framework developed in 2010 by the Basel Committee. as quoted by , Mario P. Chiti, Vittorio Santoro, The Palgrave Handbook of European Banking Union Law, May 16, 2019, Pag. 51 - 52.

[6] Both the *CRD IV Directive* and the CRR / CRR II Regulations represented, (*until recently*), the basis of the financial regulation in the European Union. More generally, they represented, (on the one hand), the attempt to adapt to the

"*Capital Requirement Directive*", recently amended and updated by the new Directive 2019/878/EU CRD V[7]).

Together, the *CRR Regulation* and the *CRD IV Directive* formed the *previous regulatory package*, the overall aim of which was to *strengthen the resilience of the European Union's banking sector*, so that it is in a *better* and more *suitable position* to absorb economic shocks[8]. That happened by regulating the *access to the activity*, the *supervisory framework* and the *prudential rules of credit institutions and investment firms*. This package, CRR / CRD IV, is based on three standards, which are *capital*, *remuneration policies*, *liquidity* and *corporate governance*, also including aspects relating to *prudential supervision*[9].

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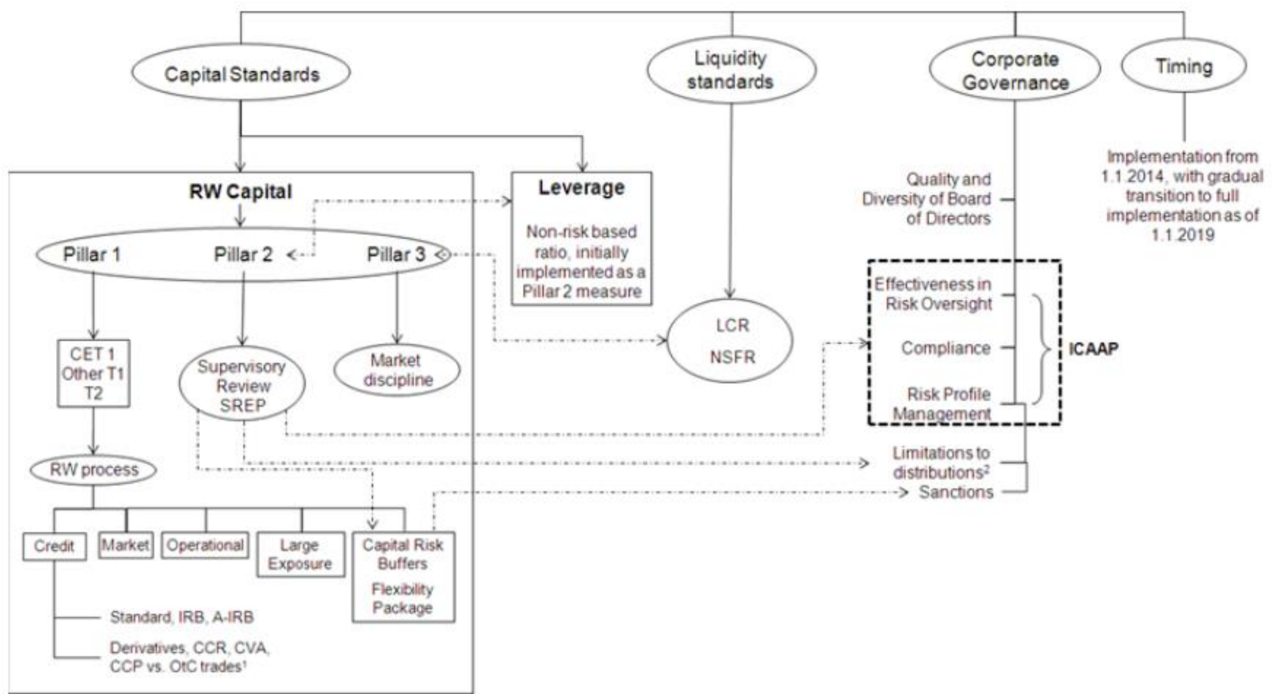
continuous change around the dynamic world of financial markets, (on the other hand), the intention of the legislator to implement the proposals and the ideas set out in the Basel III agreements, inside the new European regulatory framework. Furthermore, with the introduction of the previous CRR and CRD IV, the legislator was able to solve the problem of divergence between the national legislations that existed under the previous Community regime of "*minimum harmonization*". This was achieved only through the imposition of a single set of *harmonized prudential rules*, (applicable in all member countries), which guarantees a greater degree of harmonization. (*For further information, please see: Babis, Valia, Single Rulebook for Prudential Regulation of Banks: Mission Accomplished?, University of Cambridge Faculty of Law Research Paper No. 37/2014, July 2014, Page 8, Available at SSRN: https://ssrn.com/abstract=2456642*)

[7] We can see how, both the CRR Regulation, (*which instead concerns the prudential requirements for the same entities*), and the CRD IV Directive, (*which concerns the prudential supervision for investment firms and credit institutions*). Both CRR and CRD IV entered into force on 1 January 2014 and are complemented by several delegated and implementing acts of the European Commission, as well as by a number of technical standards. This is by no means an accident. Through their simultaneous entry into force, we have that the legislator wants to create a new "*Regulatory Package*" which reflects the rules and provisions contained within the Basel III agreements, (*in particular with regard to the discipline of access to the activity, Composition of the capital, that banks and companies must possess, in accordance with the Prudential Requirements, therefore with the Capital Standards*). Together, this Regulation and this Directive aim in the first place to reduce the likelihood of banks becoming insolvent, and this entails, secondly, the creation of provisions and rules that entail a strengthening of the market and its resilience against possible crises. It should be noted that the CRR Regulation is directly applicable in all Member States of the European Union, unlike the CRD IV Directive, which is first transposed and then adapted to the national regulations of each member country. (*For further information, please see: Reg. 575/2013 / EU and Dir. 2013/36 / E*U)

[8] While ensuring that banks continue to finance economic activity and growth.

[9] (*For further information, please see: Masera, Rainer, CRR/CRD IV: The Trees and the Forest, PSL Quarterly Review, vol. 67 n. 271, December 9, 2014, Pag. 398, Available at SSRN: https://ssrn.com/abstract=3136979*)



Note: CRR/CRD IV framework

Source: Pag. 399 CRR/CRD IV: *Rainer Masera*, *the trees and the forest*

Specifically, we have that:

- In implementing the Basel III framework, the *CRR Regulation*[10] establishes the prudential requirements that credit institutions must met, providing a harmonized definition of regulatory capital, (*establishing that it must mainly consist of common shares and retained earnings*). Moreover, it establishes and sets harmonized *minimum prudential requirements* (Pillar I[11]), in order to be able

[10] Thanks to the adoption of the aforementioned CRR Regulation, we have the introduction of a single set of *harmonized prudential rules* that banks across the EU must comply with. This so-called "*Single Rule Book*" aims to ensure the uniform application of global banking capital standards (Basel III) in all EU countries. By establishing uniform and uniformly applicable rules in all Member States, as a result, we would have that all credit institutions would be subject to the same rules across the Union, thus both enhancing confidence in the stability of institutions, (*especially in times of stress*), and a reduction in *regulatory complexity* and *regulatory compliance costs*. Furthermore, the Regulation in question reserves the application of credit institutions discipline to investment firms. The application of the same discipline, *both to investment firms* and *credit institutions*, can be explained by the will of the legislator, of ensuring the consistent application of the provisions contained in the regulation, (*for reasons of clarity*), and, to avoid both potential market distortions and regulatory arbitrage (*for reasons of legal certainty and the need for a level playing field within the Union*). (*For further information, please see: Reg. 575/2013/EU*)

[11] The Pillar I represents the **minimum capital requirement** that each bank have to respect.

to face the main risks inherent in the activities carried out by credit institutions and investment firms, among which we can include: *credit risk*, *market risk*, *operational risk* and *settlement risk*[12].

- On the other hand, *with reference to the CRD IV Directive*[13], it regulates the *access to the activity of credit institutions* and regulates the *prudential supervision* of both *credit institutions* and *investment firms*. In addition to that, it establish *rules on corporate governance*, *powers* and *responsibilities*, of the competent authorities, and *additional capital requirements* arising from the Supervisory Review and Evaluation Process (SREP) to cover the specific risks of the institution (Pillar II[14]).

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[12] It also sets out the reporting and general obligations for liquidity requirements.

[13] Like the CRR regulation, it incorporates the provisions contained in Basel III, to which we can mention the *capital reserves* and *macroprudential instruments* (born as a key component of the capital reforms contained in the Basel agreements). Among these Capital Reserves, we can find *capital conservation buffer*, the *countercyclical buffer* and the *systemic risk buffer* meant to prevent and mitigate *long-term non-cyclical systemic* or *macro-prudential risk*.

[14] The Pillar II, is a *bank-specific capital requirement* which applies in addition to the minimum capital requirement (Pillar I). Such Pillar II requirement, is determined on the basis of the *Supervisory Review and Evaluation Process* (SREP) and is a *legally binding requirements*. In case institutions fail to comply with it, then they can be subject to supervisory measures, including sanctions. (*For further information, please see: ECB, Pillar 2 requirement, Available at: https://www.bankingsupervision.europa.eu/banking/srep/html/p2r.en.html*)

2 - The Regulation 575/2013/EU "CRR"

In response to the need for greater *solidity*, *supervision*, *stability* and *resilience* of the financial market, companies and the people who work within it, (*which arose in the European Union in the immediate post-crisis*), the legislator, (*in line with what were outlined by the previous Basel III Accords*[15]), introduced new regulations. These new regulations correspond to Regulation 575/2013/EU (*also known as CRR*[16]*: Capital Requirement Regulation*), and to Directive 2013/36/EU (*also known as CRD: Capital Requirement Directive IV*).

With regard to the first of these, we have that it refers to the *Prudential Requirements*, in particular, on *capital* and *own funds*, on the one hand, *liquidity* and *credit risk*, on the other. Credit institutions are the subjects of the provisions of the aforementioned Regulation. Through the latter, we have that the legislator intends to pursue two main objectives.

On the one hand, we can affirm that he intends to ensure the uniform application of the global standards on *banking capital*, as outlined in the Basel Accords, in all the countries of the *European Union*[17]. This harmonization is call: "*Single Book of Rules*" or simply "*Single Rule Book*". Thanks to this objective, the regulation itself will be able to guarantee a uniform application of the principles of Basel III in all Member States, and thus fill the regulatory gaps and contribute to a more effective functioning of the internal market.

While on the other hand, we can affirm that the second objective that the legislator intended to achieve, was to make the financial market, (*as well as the individuals who operate within it, therefore investment firms and credit institutions*), more *stable*, *robust* and, above all, *resilient* to *potential*

[15] Which were introduced in 2010, but only came into effect in 2013.

[16] The CRR contains the so-called Pillar 1 of prudential supervision; *it refers to the minimum capital requirements*. The CRR/CRD IV continues to place *primary emphasis* on *capital requirements* measured as a percentage of RWA and retains the basic traditional formula: $\frac{\textbf{Required Capital}}{\textbf{RWA}} > 8\%$, as mentioned by Masera, Rainer, *CRR/CRD IV: The Trees and the Forest, PSL Quarterly Review, vol. 67 n. 271, December 9, 2014, Pag. 399, Available at SSRN: https://ssrn.com/abstract=3136979*.

[17] The pursuit of this objective takes place through the *creation* and *imposition* of a *single set of harmonized prudential rules* that the banks of all the member countries of the European Union must comply with.

periods of stress, *negative economic shocks* or *financial crises*. The achievement of this objective could only be reached by strengthening the *Prudential Requirements*[18]. In fact, the legislator, through the CRR Regulation, has "*tightened up*" the latter, obliging both *banks* and *investment firms*, (which are subject to these requirements, through the provisions of the regulation itself), *to hold greater reserves of capital and liquidity*[19], or in any case in a sufficiently large quantity, in order to make the market and the entities operating within it more stable and more resilient to situations of stress and shocks.

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[18] Within the financial regulation for credit institutions and investment firms, for prudential requirements, we refer to a series of *regulations* and *requirements*, which mainly concern the obligation to hold an adequate amount of capital and an adequate amount of liquidity; therefore, we refer to the Capital and Liquidity requirements, but also to disclosure obligations to the public. These prudential requirements, *which were applied to both investment firms and credit institutions*, have as their main objective that of *strengthening the resilience of the banking sector* and of the *investment market* within the EU so that it can *better absorb the economic shocks*, and be more *resilient* to the latter. Among these prudential requirements, we can include: *capital* and *own funds requirements*, *supervisory*, *liquidity requirements* and *disclosure requirements*, as well as prudential requirements, correlated with Credit Risk, which aim to limit the impact and effects of *financial leverage*. (*For further information, please see: https://ec.Europa.eu/info/business-economy-Euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-requirements_en and https://www.consilium.Europa.eu/it/policies/banking-union/single-rulebook/capital-requirements/#)*

[19] Precisely at this point, through the tightening of the *capital* and *liquidity requirements* that a company must possess and maintain, we can appreciate the compliance of the legislator, in adapting Regulation 575/2013/EU to the provisions of Basel III.

2.1 - The capital requirements established by the CRR Regulation, analysis of the characteristics and the reasons behind their selection

To achieve these objectives, the legislator has introduced changes on *three points*, identifiable in the *Capital and Own Funds Requirements*, in the *Liquidity Requirements* and in the *Leverage Ratio*. In relation to the first of these, the *Capital and Own Funds Requirements*[20], it represents one of the most important and most treated points, both by the legislator in the *CRR Regulation*[21], and by the *Basel Committee* (BCBS) in its various Agreements issued up to Now. Regarding the same, the latter provides that both credit institutions and investment firms were obliged to set aside a *sufficient amount of capital*[22] to cover any losses that may occur in the future. This amount of capital must correspond to at least 8% of the *Risk Weighted Assets* (RWA) owned by the companies in question. However, this amount is not unique; on the contrary, it is variable. This variability of the amount of capital depends on the *type of risk* associated with the activity that is undertaken by the company in question[23]. This means that: "*the more an institution or entity holds risky assets, the greater the amount of capital it will have to hold*". Nevertheless, *why, both companies and banks have to set*

[20] Capital must be fully loss absorbing, (notably in times of crisis and of unexpected losses). It should also be easily observable by market participants. Minimum own funds are the amount of capital a bank is required to hold, compared to the amount of assets. (*For further information, please see: Masera, Rainer, CRR/CRD IV: The Trees and the Forest, PSL Quarterly Review, vol. 67 n. 271, December 9, 2014, Pag. 399, Available at SSRN: https://ssrn.com/abstract=3136979*)

[21] The Capital Requirements is important, also due to the fact that it represents a fundamental condition for the exercise of a business. For example, a bank that falls below its minimum capital requirement of 8% risks losing its license and therefore no longer operating. In reference to it, it is also identified as the first pillar of Prudential Supervision. (*The other two are respectively: supervisory review, the second, and market discipline, the third*).

[22] Capital is important, for its main purpose, which is to absorb losses that a bank does not expect to make in the ordinary course of business, (*the so-called unexpected losses*). In particular, the more capital a bank has, the more losses it can suffer before going bankrupt, so that, it's necessary, almost mandatory, for a company to have as much capital as possible, without compromising its ability to do business, to avoid insolvency and eventually the default. *These are the motives behind the Importance of Capital*.

[23] What we would have, with the CRR Regulation on Capital Requirements, will be that *safer assets* will be allocated a *lower capital allocation*, while for riskier activities, a higher capital allocation will be attributed, due to the higher risk. In other words, *the more the assets are at risk*, *the higher the amount of capital that the company will have to set aside* and vice versa.

aside this capital threshold, equal to 8%, in relation to RWAs? First of all, the *Capital Ratio* is calculated, taking into consideration the definition of both *Regulatory Capital* and *Risk-Weighted Assets* (RWA). The minimum required capital ratio, *equal to at least 8%*, was initially set with the previous Basel I Accord and maintained until today[24]. This is the reason, the motivation, which underlies the enforcement of 8% as a minimum capital requirement, set by the Basel III agreements, within the CRR Regulation. For this reason, we would have that the total amount of capital that both *investment companies* and *credit institutions* have to hold must be at least 8% compared to the *risky assets* covered by the aforementioned Companies (*Total Risk Assets*)[25].

$$\text{Capital Ratio}^{26} = \frac{\text{Total Capital}^{27}}{\text{Total Risk Assets}} = 8\%^{28}$$

[24] (*For further information, please see: International Convergence of Capital Measurement and Capital Standards, available at: https://www.bis.org/publ/bcbs128.pdf*)

[25] The most notable thing about the amount of the minimum capital required by Regulation 575/2013/EU, which incorporates the rules of Basel, is that main figure, equal to 8% of risk-weighted assets (RWA), which was established by the first Basel Accord, and has remained so ever since. However, this does not exclude its evolution. Although the amount of this requirement has remained the same, 8%, what has changed, however, is the composition of the minimum capital required to be set aside. (*Now a bigger emphasis is given to the CET 1 Capital*)

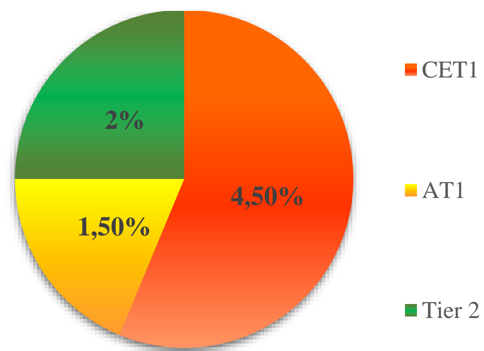
[26] The **Capital Ratio**, also known as *capital-to-risk weighted asset*, is the total amount of capital set aside or held by the companies or banks in question, made up of different types of capital, divided by the amount of Risk Weighted Assets (RWA), which include assets such as *Debentures* or *Government Bonds*. In order to increase the Capital Ratio, we can take two ways, *we can either increase directly the total amount of capital, in relation to the RWAs*, or we can instead *reduce the RWAs quota*, thereby reducing the number of risky activities and assets. Generally, the greater the amount of risk-weighted assets, the greater the capital required and vice versa. (*For further information, please see: Explanatory note on the minimum capital requirements for market risk, January 2019, Available at: https://www.bis.org/bcbs/publ/d457_note.pdf and Finalising Basel III In brief, December 2017, Available at: https://www.bis.org/bcbs/publ/d424_inbrief.pdf*)

[27] **Total Capital**, It concerns the total amount of capital that is required both from *investment firms* and from *banks* to set aside, to cover the risky assets to which they are subjected. Their amount is given by the sum of the CET1, AT1 and T2 type capital. (*It should be noted that both CET 1 and AT 1 Capital can essentially be defined as Tier 1 Capital, therefore high quality capital*). With reference to the Capital Ratio, the total amount of capital required to cover the *Risk Weighted Assets (RWA),* must be composed of *75% of Capital belonging to Class 1.* Therefore we would have that the *Tier 1 capital ratio must be equal to 6%, while the Total Capital ratio will be equal to 8%*). (*For further information, please see: Article 92, Reg. 575/2013 CRR*)

[28] Two points should be noted, the first although 8% is the *minimum percentage required* by banks of capital to hold, in relation to RWAs, this threshold is rarely met. In reality, banks tend to ***hold more capital***. The second, although officially

The CRR Regulation, *in relation to the Capital Requirements*, in addition to specifying the *minimum amount of capital* required from investment firms and banks, also specifies its composition and the differences in existing capital types. In particular, we would have that certain classes are assigned to *capital* according to *quality* and *risk*. What turns out will be:

Tier 1: CET 1 (Common Equity Tier 1), which is considered the *highest quality capital*, represented by subscriptions of ordinary shares, shareholders' equity (*funds contributed through the subscription of ordinary shares and undistributed profits held within the bank*). It allows a bank to continue its business and maintains its solvency. The total amount of CET 1 ratio required must be 4.5% compared to the Capital Ratio.



Tier 1: AT 1 (Additional Tier 1), which concerns equity instruments with no fixed maturity, includes *non-cumulative*, *non-redeemable preference shares*. Its amount must be equal to 1.5%, (with respect to the Total Capital Ratio).

Tier 2: subordinated debt and general credit risk reserves, which includes *revaluation reserves*, *general credit risk reserves* and *undeclared reserves*, *hybrid equity instruments*, and *subordinated term debt*. (Such capital, represent a lower quality capital, compared with the Tier 1)

Finally, the CRR regulation states that the total amount of capital that investment firms and credit institutions, (or banks), are required to hold should be at least 8% of the Risk Weighted Assets (RWA). The percentage of high quality capital, *therefore we refer to CET 1* (*Common Equity Tier 1*), should represent 4.5% of the *Risk Weighted Assets* (RWA), as established by the aforementioned Basel agreements.

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the 8% threshold is the minimum limit, also including the *Capital Conservation Buffer* (CCB), which, equal to 2.5% CET1, it addresses the problem of "*pro-cyclicality*", increases the minimum capital requirements at 10.5%. The CCB is "*designed to ensure banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred*" (*For further information, please see: BCBS, Basel III, par. 122*)

2.2 - Analysis of the Liquidity Requirements established by the CRR Regulation

With reference to the *measures*[29] concerning *liquidity* and *liquidity requirements*[30], (in order to ensure that credit institutions have *sufficient liquid resources*, among which we can mention for example*:* *Cash* or *Readily Liquid Assets*[31]), the regulation in exam establishes that institutions must hold enough liquid assets, *the sum of the values of which covers liquidity outflows minus liquidity inflows under stressed conditions*. This was done, in order to ensure that institutions maintain levels of *liquidity reserves* adequate to cope with any possible imbalance between *inflows* and *outflows of liquidity* under conditions of severe stress[32] for a period of at least 30 days[33]. In times of stress, institutions may use their liquid assets to hedge their *net liquidity outflows*, or require nationally authorized institutions to be able to maintain a higher Liquidity Coverage Ratio, up to 100%[34].

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[29] The reasons behind this intervention lie in the will of the legislator to follow the objectives set by the CRR and guarantee greater solidity and resilience of the banks themselves.

[30] Note that, Liquidity Requirements differ from Capital Requirements. The former

[31] Which can be quickly converted into cash with little or no impairment.

[32] During such times of stress, such as *recessions*, *financial crises* or *economic shocks*, institutions can use liquid assets to hedge net liquidity outflows. (*For further information, please see: Art.412 Reg. 575/2013 / EU CRR*)

[33] (*For Further information, please see: Ojo D Delaney PhD, Marianne, Pag.5 Implementing Basel III Through the Capital Requirements Directive (CRD) IV: Leverage Ratios and Capital Adequacy Requirements, March 6, 2016. Journal of Business Law and Ethics, Vol 3 No 1, June 2015, Available at SSRN: https://ssrn.com/abstract=2574908*)

[34] This pending the full introduction of the minimum binding standard at a rate of 100%, in accordance with the provisions of Article 460 of the same CRR Regulation, where the liquidity coverage requirement (LCR), and therefore its gradual increasement, shall be introduced in accordance with the following phasing-in:

- starting from 60% of the liquidity coverage requirement in 2015, (when it was introduced for the first time),
- 70% as from 1 January 2016,
- 80% as from 1 January 2017,
- and 100% as from 1 January 2018.

This graduated approach was designed to ensure that the LCR can be introduced *without material disruption to the orderly strengthening of banking systems or the ongoing financing of economic activity*. Also remember that, although the LCR was discussed with Basel III and treated slightly in this regulation, it became effective only on 1 January 2015, with a minimum requirement set at 60%, with Regulation (EU) 2015/61. The final rules, regarding both the LCR and the NSFR, will be decided after an appropriate observation period. (*For Further Information, please see: Art. 412 and Art.460, Reg.*

The regulation in question[35], based on the provisions of the Basel III agreements on Liquidity, (*and on the basis of the provisions of the CRD IV Directive*), anticipates two new liquidity buffers, (definitively introduced only subsequently with the CRR II & CRD V package), which are the *Net Stable Funding Ratio* (NSFR) and the *Liquidity Coverage Ratio* (LCR). So that, we have:

- The *Net Stable Funding Ratio* (NSFR), which aims to ensure that banks have an acceptable amount of stable funding to support their assets and activities over the medium-long term, (*usually around 12 months*), requiring banks to *finance long-term assets* with *medium to long-term liabilities* [36]. It is

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575/2013/EU, and Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013, Pag.8, Available at: https://www.bis.org/publ/bcbs238.pdf)

[35] In itself, it does not introduce *binding minimum requirements* on liquidity, as regards the short-term (LCR) and structural (NSFR) indicator. What it introduces are *initial liquidity provisions*, in line with the provisions of the Basel Accords. Therefore, these requirements do not find a definitive or binding entry with the CRR - CRD IV Package. The two minimum standards in question, (LCR and NSFR), have been implemented through *appropriate technical implementation standards* and/or revised by *Regulation (EU) 2019/876, which amends the previous CRR*, after an initial monitoring period, starting from 2014, (*where both banks and investment firms were required to fulfil specific reporting obligations for the detection of their exposure to liquidity risk*), they find their definitive and binding application only in 2018. (For further information, please see: *Applicazione in Italia del Regolamento (UE) n.575/2013 e della Direttiva 2013/36/UE, Available at:* https://www.bancaditalia.it/compiti/vigilanza/normativa/consultazioni/2013/reg-UE-575-quadro-generale/Doc_consultazione.pdf and *Masera, Rainer, CRR/CRD IV: The Trees and the Forest, PSL Quarterly Review, vol. 67 n. 271, December 9, 2014, Pag. 405, Available at SSRN: https://ssrn.com/abstract=3136979*)

In this regard, the Regulation itself specifies that: "*pending the introduction of the net stable funding ratio (NSFR) as binding minimum standard, institutions should observe a general funding obligation, [...], pending the introduction of the NSFR, a stable funding ratio is introduced as a minimum standard by way of a national provision, institutions should comply with this minimum standard accordingly* ". (*For further information, please see: Reg. 575/2013/EU*)

[36] (*For further information, please see: Basel III: the net stable funding ratio, October 2014, Available at:* https://www.bis.org/bcbs/publ/d295.pdf*, Ojo D Delaney PhD, Marianne, Implementing Basel III Through the Capital Requirements Directive (CRD) IV: Leverage Ratios and Capital Adequacy Requirements, March 6, 2016, Pag 5. Journal of Business Law and Ethics, Vol 3 No 1, June 2015, Available at SSRN:* https://ssrn.com/abstract=2574908 *and Masera, Rainer, CRR/CRD IV: The Trees and the Forest, PSL Quarterly Review, vol. 67 n. 271, December 9, 2014, Pag. 405, Available at SSRN:* https://ssrn.com/abstract=3136979)

define as the *amount of available stable funding*[37] relative to the *amount of required stable funding*[38]. In doing so, the legislator aspires to prevent banks from *overfunding* their long-term assets with short-term liabilities, (*thereby seeking to avoid, or at least limit and mitigate the potential for future funding stress*). The NSFR[39] serves as a complementary standard to the LCR in serving to "*Limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items*", as well as a "*minimum enforcement mechanism*"[40].

- The *Liquidity Coverage Ratio* (LCR) aims to promote *short-term resilience for banks*, ensuring that banks have or maintain an adequate stock of *High Quality Liquid Assets* (HQLA)[41], sufficient to survive any imbalances between *inflows* and *outflows*, during an acute stress or crisis scenario, in the short term, lasting one month (30 days)[42]. With the entry into force of the CRR regulation, we have

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[37] Which is the portion of *capital* and *liabilities* expected to be reliable over the time horizon considered, *1 year*.

[38] Which is a function of the liquidity characteristics and residual maturities of the various assets held by that institution as well as those of its off-balance sheet exposures.

[39] Which can be represented as: $\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$

[40] (*For further information, please see: Ojo D Delaney PhD, Marianne, Implementing Basel III Through the Capital Requirements Directive (CRD) IV: Leverage Ratios and Capital Adequacy Requirements, March 6, 2016, Pag 5. Journal of Business Law and Ethics, Vol 3 No 1, June 2015, Available at SSRN: https://ssrn.com/abstract=2574908*)

[41] These HQLAs must necessarily be *easily convertible into cash*, in private markets, in order to satisfy the banks' liquidity needs, in a 30-calendar day liquidity stress scenario. (*For Further Information, please see: Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013, Available at*: https://www.bis.org/publ/bcbs238.pdf). It should be also stressed that the LCR standard establishes a minimum level of liquidity for *internationally active banks*. So that, banks are expected to meet this standard. Moreover, within the *LCR*, Supervisors and *National Competent Authorities*, are free to require additional levels of liquidity or require *higher minimum levels of liquidity*.

[42] Therefore, these firms, should hold and maintain a LCR of at least ≥ 100%. Pursuant to Article 412 of the CRR and Article 4(3) of the Commission Delegated Regulation (EU) 2015/61, credit institutions can make use of their *liquid assets* to cover their *net liquidity outflows* under *stressed circumstances*, even if such a use of liquid assets, (*to cover their cash outflow*), may result in their *liquidity coverage ratio* falling below 100% during such periods, (*because their stock of HQLA is used to cover the cash outflow*). However, (*as further specified in Article 414 of the CRR and Article 4(4) of Commission Delegated Regulation (EU) 2015/61*), when credit institutions do not meet or expect not to meet the requirement, including during times of stress, they *shall immediately notify the competent authority*.

the gradual application of the *LCR liquidity requirement*[43], (starting initially from a minimum of 60% in 2015, up to reaching the minimum limit of 100%[44] of net liquidity outflows in 2018).

The objectives of two standards, *NSFR* and *LCR*, complement each other and are necessary to address liquidity risks in the banking sector by aiming to increase the *resilience of banks in periods of stress*, trying to guarantee an adequate level, in *different time horizons*. (*While the first standard, NSFR, focuses on the long term, we have that the second one, LCR, focuses on the short term instead*)[45].

(*For further information, please see: Article 412 Reg. 575/2013/EU and Update on the EBA Report on Liquidity Measures under Article 509(1) of the CRR, 30 June 2018, Page 8, Available at: EBA Report on Liquidity Measures - 2Q 2018.pdf (Europa.eu)*)

[43] The Liquidity Coverage Ratio (LCR) is defined as the ratio between the *total amount of net liquidity outflows*, in the next 30 days, and the amount of liquidity needed to cover such possible outflows:

$$\text{LCR} = \frac{\text{Stock of High Quality Liquidity (High Quality Liquid Assets)}}{\text{Total Net Liquidity Outflow (in the next 30 Calendar days)}} \geq 100\%$$

[44] The imposition of a 100% minimum LCR means, (*on the one hand*), increasing the level of security and solidity, and also, the resilience of a bank. On the other hand however, it means putting a "brake" on the company's activity in question, because it is forced, for every risky activity it undertakes, to hold at least a quantity of liquid assets equal to or greater than the amount of the latter. *These rules have been and continue to be the subject of criticism from businesses and governments, as, by limiting the activity of banks, it is feared that this could limit the economic growth*.

[45] (*For further information, please see: Markus Behn, Renzo Corrias and Magdalena Rola-Janicka, On the interaction between different bank liquidity requirements, October 29, 2019, Available at: https://www.ecb.Europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu201910_2~3237802727.en.html*)

2.3 - Analysis of the characteristics and reasons behind the introduction by the CRR Regulation of the Leverage Ratio

With the entry into force of the aforementioned CRR Regulation, we have the introduction of additional measures, not only regarding *capital* or *liquidity requirements*, but also measures aimed at *containing the accumulation of financial leverage* in the banking system. As a result of this, we have the entry of a new regulatory instrument, the purpose of which is to measure and / or assess the exposure of entities and investment firms to the risk of *excessive leverage*, or the *Leverage Ratio*[46]. The Basel Committee initially introduced the *Leverage Ratio* in 2010, through the *Basel III Accords*, as a *non-risk-based measure*, an additional tool that could be applied to individual institutions at the discretion of supervisory authorities, designed to address regulations shortcomings, that emerged during the 2008 financial crisis, on capital requirements and to supplement the Basel risk-based capital framework. The Leverage Ratio finds its legal bases within the aforementioned CRR Regulation, (*whilst it has found its definitive application, only later, with the introduction of the CRR II, becoming a binding minimum requirement, as June 2021*).

The Leverage Ratio is define as the *measure of capital* divided by the *measure of exposure*, expressed as a *percentage*[47]. This measure is calculated as the ratio between the *high quality capital*, that a bank must hold, (i.e. CET 1), and the *total exposure* of the entity/institution itself in the financial market[48].

$$\text{Leverage Ratio} = \frac{\text{Capital Measure}}{\text{Exposure Measure}} \geq 3\%$$ [49]

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[46] The *Leverage Ratio* is a measure that allows us to assess the *exposure* of institutions to the risk of *excessive leverage*, thanks to which, therefore, we can avoid an excessive accumulation of leverage in companies and credit institutions, thus avoiding too excessive exposure. (*For further information, please see: Leverage ratio, Available at: https://www.eba.Europa.eu/regulation-and-policy/leverage-ratio*)

[47] (*For further information, please see Basel III leverage ratio framework – Executive summary, Available at: https://www.bis.org/fsi/fsisummaries/b3_lrf.pdf*)

[48] Calculated in this way, a *high leverage ratio* will indicate that a bank has a *low level of leverage* (*indebtedness*) compared to CET 1 and therefore has a *low exposure to the financial market*. On the other hand, a *low leverage ratio* will indicate the exact opposite, i.e. a bank that has a *high level of leverage* (*indebtedness*) compared to its CET 1 and therefore has a *high exposure to the financial market*.

[49] With the CRR, we therefore have the introduction of this *binding leverage ratio*, equal to 3%. In December 2017, the Basel Committee had decided to set the *Leverage Ratio* equal to a minimum of 3.0%. (*This amount of 3% was selected*

Its introduction into the European Union took place in 2013, (*through the entry into force of the CRR Regulation*), in order to follow the dispositions contained within Basel III agreement, even if not in a *binding manner*[50].

after years of careful monitoring of the effects that the Leverage Ratio has had on credit institutions, following the introduction by Basel III). The reasons behind this limit lie in the fact that the financial crisis has revealed that: "*institutions were excessively leveraged, meaning that they set aside relatively limited capital for ever increasing balance sheets, thanks to risk weights applied to asset*". This is the main reason of why Basel III, propose to limit the overall leverage of financial institutions (*leverage ratio*), providing that the regulatory capital (CET 1, *capital of high quality*), is at least 3% of all non-risk-weighted assets. As it explained by Carla Stamegna, *Amending capital requirements The "CRD V package", July 2019, Pag. 5, Available at: Amending capital requirements (Europa.eu).*

As regards the amount that this instrument imposes, the BCBS has determined that the capital measure must always be at least 3% of the exposure measure. Furthermore, in this regard, in its report of 3 August 2016 on the leverage ratio requirement, the EBA stated that: "*the minimum credible level of Leverage Ratio that an institution must possess must be at least 3%*", in line with what has also been agreed internationally by the *Basel Committee on Banking Supervision* (BCBS). (*For further information, please see: Par.10 Reg. 2019/876 / EU*).

For this reason, *in accordance with what was stated by the European Banking Authority (EBA) in its report of 3 August 2016 on the leverage ratio requirement*, it was stated that the minimum level of *Leverage Ratio* required to credit institutions, **to be credible**, must be at least 3%. This Leverage Ratio became mandatory from June 28, 2021. (*For further information please see: Consultative Document Revisions to the Basel III leverage ratio framework, April 2016, Available at: Revisions to the Basel III leverage ratio framework - consultative document (bis.org), and EBA Report on the Leverage Ratio Requirements under Article 511 of the CRR, August 3, 2016, Available at: EBA-Op-2016-13 (Leverage ratio report).pdf (Europa.eu)*)

[50] Its introduction constitutes the legal basis for the leverage ratio requirements for EU Member States, and after its application, in line with the BCBS, to allow for the risk assessment of excessive leverage, follows a period of observation, from 1 January 2013 to 1 January 2017, during which the leverage ratio, its components and its evolution were monitored. Furthermore, since 2015, institutions have been obliged to disclose their leverage ratio and its components. It found its definitive and binding introduction, only later, with the CRR II, (*becoming a binding minimum requirement within the EU as of June 2021*). (*For further information, please see: Below Chapter 2 and Leverage Ratio, Available at: Leverage Ratio | Deutsche Bundesbank*)

3 - The Directive 2013/36/EU “CRD IV”

Within the previous *regulatory package*[51], in addition to the CRR regulation, we have the support of another legislation, represented by Directive 2013/36/EU[52], also known as the CRD IV Directive[53] (*Capital Requirements Directive IV*). Both share the same objectives[54], (*however, the achievement of the latter starts through different points in the CRD IV*). The *European Parliament* and the *European Commission* adopted it in April 2013, and the changes it has made can be group into two main areas:

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[51] Directive 2013/36 / EU CRD IV, is part of a “*Regulatory Package*” aimed at *consolidating the resilience of the Union banking sector*. The “Regulatory Package” in question, is composed by the CRR regulation, (establishes the supervisory requirements that banks must comply with), and by the CRD IV Directive itself. The latter are the result of the actions implemented by the Legislator, with the intention of *strengthening the financial system* at the level of the European Union, (*on the one hand*), and therefore wanting to implement and transform the provisions present in the Basel III agreements, in something binding for the various Member States of the Union, (*on the other*). However, although both the CRD IV and the CRR have essentially the same final objectives, they, in truth, deal with completely different themes.

[52] The directive in question differs from the CRR regulation, due to the fact that the provisions contained in the former must be transposed into the national law of each individual member country, while in the case of the latter we have that they are directly applied, without the need for adaptation. Furthermore, while in the CRR, credit institutions are the main subjects of the provisions of the latter, we have that in the CRD IV, the subjects of its provisions and rules, are both credit institutions and investment firms.

[53] Like the previous versions of the CRD, the main body of the CRD IV is closely linked to the publications of the Basel Committee on Banking Supervision. The CRD IV builds upon the already implemented Basel II accord and subsequent changes and now includes the European transposition of the Basel III accord. This Directive is *the implementation of Basel III*, *the Single rulebook*, […], *the CRD IV will be applied to credit institutions and most investment firms*. (*For further information, please see: Capital Requirements Directive (CRD IV), January 2014, Available at: https://www.dnb.nl/en/sector-information/supervision-laws-and-regulations/laws-and-eu-regulations/capital-requirements-directive-crd-iv/#idj9azo8uhg*)

[54] That is, the increase in the resilience and solidity of the financial market and of those who work within it, (*namely credit institutions and companies*), in order to better resist possible stressful situations.

On the one hand we have that the Directive in question focuses on the *regulation of access to the deposit-taking activity of credit institutions* and of the *activities carried out by investment firms*[55], therefore it aspires to reform the question of capital for *investment firms* and for *credit institutions*;

While, on the other hand, *it aims to regulate and establish all those rules concerning the powers and instruments of prudential supervision for the institutions*, by the *National Competent Authorities* (NCAs)[56], including the publication requirements for the competent authorities in the field of *prudential regulation* and the *supervision* of institutions. (Furthermore, CRD IV, together with the CRR regulation, aspires to *address*, *define*, and *strengthen* the liquidity standards).

[55] In this regard, the directive refers to both investment firms and credit institutions simply as "*Institutions*". (*For further information, please see: Art. 1 Par. A Dir. 2013/36 / EU*)

[56] Always organized in a way that such rules on the prudential supervision of institutions by NCAs are consistent with the rules set out in Regulation 575/2013 / EU. (*For further information, please see: Art. 1 Par. C Dir. 2013/36 / EU*)

3.1 - Requirements for Access to the Activity of Credit Institutions and Initial Capital of Investment Firms

Following the objective set by the "CRR-CRD" regulatory package, the Directive under exam intervened by making amendments on issues such as the *requirements for access to the activity*; *initial capital*[57]; *prudential supervision* and *disclosure requirements*[58]. With reference to the first of these[59], we have that they are applied to *all investment firms* and to *all credit institutions* that want to operate in the financial market. However, these requirements are not applied in a uniform manner for all companies. On the contrary, their application varies both on the basis of the nature, (*or typology*), of the companies, (*or entities*), considered, thus differentiating between investment firms (*on the one hand*) and credit institutions or banks (*on the other hand*), and on the *basis of activities carried out by the latter*[60].

With reference to credit institutions (i.e. *Banks*), the discipline established by the CRD IV directive essentially states that the respective NCAs, must refuse the granting of the authorization, (*and therefore the start of the business activity*), to all those *banks* or *companies* engaged in the business of credit institutions, in the event that: "*a credit institution does not have separate own funds or in cases where its initial capital is less than €5 million*[61]".

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[57] With reference to the initial capital requirements, their compliance, and maintenance, is a fundamental requirement, both for investment firms and for banks, to request access to banking or investment firm activities. Furthermore, through these requirements, the legislator is able to regulate both the access and maintenance of the business, of investment firms and banks.

[58] The purpose of the changes made by this directive is to ensure greater solidity of the market, of the companies that operate there aspiring to block or avoid potential future crises in the bud.

[59] In choosing these criteria, both for credit institutions and for investment firms, the legislator aims to ensure the achievement of the objectives set in the CRR-CRD package, while still trying to maintain a certain operability of the companies subject to the CRD IV directive.

[60] In this regard, the *riskiness of the activities carried* out and the fact that *they were carried out or not on behalf of third party customers* will weigh heavily.

[61] Therefore, if a Bank owns less than €5 million as initial Capital, *then it cannot start a banking activity*, without prejudice to other general conditions laid down in national law. (*For further information, please see: Art. 12 Dir. 2013/36/EU*). However, in special cases, it is possible to grant authorization to "*special*" credit institutions for an amount lower than

With reference to investment firms, the directive in question reserves *different requirements* with respect to *credit institutions*. Firstly, within the latter, the legislator wanted to differentiate the required requirements, and therefore, consequently, the treatment reserved for investment firms, (*based on the scope of their activities and on the basis of the activities they perform*). In general, the directive requires that all investment firms, in order to access, or otherwise carry out, their investment activities, must necessarily have an initial capital of an amount equal to at least €730,000.00. This requirement is mandatory for all investment firms that *deal with financial instruments* on their own account or that carry out an *irrevocable underwriting service* for financial instruments on behalf of their clients. With reference to investment firms, (which can be defined as "*Particular*" or "*Special investment firms*"[62]), the directive imposes different capital requirements for them, forcing them to have at least an initial capital quantifiable in €125,000.00[63]. Finally, with reference to "*Local Businesses*"[64], they are required to have the initial capital amount equal to at least €50,000.00.

Investment Firm Initial Capital Requirement		
	Investment Firm	€730,000.00
	"*Particular*" Investment Firm	€125,000.00
	"*Local*" Investment Firm	€50,000.00

the previous one, provided that it is not lower than €1 million; example of this can be found in *cooperative credit banks*, which require a minimum capital of at least €1 million.

[62] With the term "*Special investment firms*", we refer to all those investment firms that do not deal with financial instruments for their own account, *or that do not perform an irrevocable underwriting service for financial instruments on behalf of clients*, but which still hold *funds*, *securities* or *liquid assets* (money) of their clients, and also offer at least one service for the collection and *transmission of investor orders on financial instruments*; *investor order execution services on financial instruments*; and / or *management services for individual investment portfolios in financial instruments*. (*For further information, please see: Art. 28 Dir. 2013/36/EU*).

[63] Is worth noting that, this amount here is not fix either, because member states may reduce that amount to just €50.000,00 where and if a firm *is not authorised to hold neither* ***client money*** *nor* ***securities***, to deal for its own account, or to underwrite issues on a firm commitment basis. (*For further information, please see: Par. 1 and 3 Art. 29 Dir 2013/36/EU, Available at: https://www.eba.Europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/30*)

[64] With the term "*Local Company*" we mean a firm which, (*pursuant to Article 4 of Reg. 575/2013/EU*), operates on its own account on the *financial futures*, *options markets* or *other derivative instruments* and on *spot markets* for the sole purpose of *hedging positions* on the markets of derivative instruments, or operating on behalf of other members of the same markets, provided that the execution of the contracts entered into by such company is guaranteed by the direct participants of the same markets, who assume the responsibility. (*For further information, please see: P.4 Art.4 (2) Reg. 575/2013 / EU*)

3.2 - The Prudential Requirements set by the Directive CRD IV

Secondly, with the aim of strengthening the *prudential supervision* of entities and companies operating in the financial market, *as well as the protection of the customers of the entities themselves*, we have, *through the aforementioned directive*, the introduction of *amendments* and *innovations regarding the prudential supervision*. However, it should be noted that, contrary to the changes previously made to the requirements necessary to be able to carry out the activity of investment firm and / or bank, these amendments were almost mild. This is because they were limited to guaranteeing just a *sufficient harmonization* to achieve a *mutual recognition of authorizations* and *prudential supervision systems*, which allows the application of Home Country Control, (*principle of supervision by of the home Member State*), as well as the issue of a single authorization valid throughout the Union. Therefore, the directive provides that the prudential supervision of the *institution in question*[65], (*including the due exceptions which provide for a competence of the authority of the Host Member State*[66]), shall be responsibility of the competent authorities of the home Member State. In addition, the directive fixed communication and disclosure obligations, which must be followed by all member countries. In detail, all NCAs of the Home Member State are obliged to immediately inform the competent authorities of all Host Member States if liquidity tensions occur or there is a reasonable probability that they will occur[67]. However, such disclosures[68] can only be made when this is truly necessary and for reasons of *prudential supervision*, *prevention* and *resolution* of institutions in *financial distress*.

[65] In this regard, the directive also provides that all companies that fall within the definition of Credit Institutions Art. 33 Dir CRD IV and Financial Institution Art. 34 CRD IV are included. (*For further information, please see: Art. 33 (Credit Institutions), Art. 34 (Financial Institution), Art. 49 and Art. 155 Dir. 2013/36 / EU*)

[66] Which must not allow discriminatory or restrictive treatment, as illustrated by Articles 49 and 155 of Directive 2013/36/EU.

[67] Through this obligation, (*to immediately inform the competent authorities if liquidity tensions occur*), the directive aims to avoid and effectively counteract the spread of potential economic shocks their formation in the bud. (*For further information, please see: Par. 3 Art. 50 Dir. 2013/36 / EU*)

[68] In this regard, the directive requires that all persons or individuals dealing with such information are subject to obligations of professional secrecy. (*For further information, please see: Par. 1 Art. 59 Dir. 2013/36 / EU*)

3.3 - The reasons behind the changes made in the matter of Remuneration, Diversity and Additional Capital, by the CRD IV Directive

Finally, in order to ensure a higher level of *Governance* and *Transparency*, the directive introduces binding rules aimed at ensuring the strengthening of the latter[69]. In addition to this, new mechanisms and requirements, (regarding *Remuneration*, *Diversity* and *Additional Capital*), are introduced, in order to facilitate the *supervision of risk* and to guarantee the *strengthening of the previous objectives*. In detail, in order to guarantee a *better level of Governance*, the CRD IV Directive introduces binding rules aimed at promoting their strengthening, which therefore stimulate, (*or in any case guide towards*), an effective supervision by the management bodies of the banks, thus improving the *management of the risks*.

These rules take the form of the introduction of new rules aimed at increasing the effectiveness of risk supervision by the boards, which improve the status of the risk management function, thus guaranteeing effective monitoring by the *supervisory authorities* on *risk governance*[70]. In reference to this, we have as a result a greater diversification of the members of the councils, thus guaranteeing better *supervision*[71]. However, is good to highlight how *diversity in board composition* should contribute to *effective risk oversight by boards*, *providing for a broader range of views and opinions* and therefore avoiding the phenomenon of groupthink, and so *helping in avoiding excessive risk-*

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[69] The objective of these additional provisions contained in the CRD IV Directive, concerning both *Corporate Governance* and *Transparency*, on the one hand is related to the purpose for which this CRR-CRD package was originally introduced, i.e. to make credit institutions, businesses and the market more resilient and solid., while on the other hand the objective of these binding rules is to strengthen prudential supervision and, with reference to Corporate Governance, reduce excessive risk-taking by banking organizations and also avoid excessive risk-taking by individual institutions and ultimately the accumulation of excessive risk in the financial system. (*For further information, please see: Masera, Rainer, CRR/CRD IV: The Trees and the Forest, PSL Quarterly Review, vol. 67 n. 271, December 9, 2014, Pag. 406, Available at SSRN: https://ssrn.com/abstract=3136979*)

[70] The main purpose of these additional provisions of the CRD IV directive, concerning Corporate Governance, is to reduce excessive risk-taking by banking organizations, as explained by Masera, Rainer, *CRR/CRD IV: The Trees and the Forest, PSL Quarterly Review, vol. 67 n. 271, December 9, 2014, Pag. 406*, and also avoid excessive risk-taking by individual institutions and ultimately the accumulation of excessive risk in the financial system.

[71] (*For further information, please see: Dir. 2013/36/EU CRD IV*)

taking by individual institutions and improving the risk-oversight[72]. Having said that, institutions are therefore required to employ a wide range of *quality*, *professional* and *gender* skills when hiring members of the management body in order to promote diversity in the latter.

With regard to the *Additional Capital Requirements*[73], the CRD IV directive provides for higher capital requirements, which include additional capital reserves, the purpose of which is to ensure a *higher level of protection for credit institutions*, establishing guarantees and limitations on the amounts of dividend payments and premiums payable by the bank itself. Depending on the extent to which a bank draws from the reserve, the restrictions become stricter, thus avoiding the erosion of the bank's capital. Based on the provisions of Basel III, we have the introduction of a number of different *capital buffers*[74], among which we can mention:

Capital Conservation Buffer[75]: This capital conservation buffer (CCoB) is a capital buffer amounting to 2.5% of a bank's total exposures. This buffer is in addition to the 4.5% Capital Minimum Requirement for Common Equity Tier 1 capital, and it sits on top of the 4.5% CET1 capital requirement. *Its scope is to conserve a bank's capital*[76]. When its CET1 capital ratio falls below 7%, or when the capital conservation buffer itself, falls below 2.5%, then the automatic safeguards kick in and immediately limit the amount of dividend and bonus payments a bank can make.

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[72] The achievement of this is possible through the introduction of binding rules that guarantee an increase in the diversity of the composition of the board. (*For further information, please see: Masera, Rainer, CRR/CRD IV: The Trees and the Forest, PSL Quarterly Review, vol. 67 n. 271, December 9, 2014, Pag. 406, Available at SSRN: https://ssrn.com/abstract=3136979*).

[73] In addition to the provisions expected by the CRR regulation. In this regard, we refer to the Capital Ratio. (*For further information, please see up*)

[74] These Add-on or Capital Buffer, are set in addition of to the 8% Capital Requirement set out in the CRR Regulation.

[75] The capital conservation buffer is designed to ensure that banking firms build up excess capital outside periods of stress, which can be drawn down as losses materialise. (*For Further Information, please see: Pag. 401 CRR/CRD IV: the trees and the forest Rainer Masera*). This buffer must be made up of Common Equity Tier 1 capital. (*For further information, please see: https://www.esrb.Europa.eu/national_policy/capital/html/index.en.html*).

[76] Thanks to is, we are able to prevent the bank's capital to be eroded.

Countercyclical Buffer: Its purpose is to counteract the effects of the economic cycle on banks' lending activity, thus making the supply of credit less volatile and possibly even reduce the probability of credit bubbles or crunches. Essentially, it is designed to constrain lending by banks during an economic boom and to prepare banks for the coming bust. The *Countercyclical buffer* must set between 0% and 2.5% of CET1, calibrated in multiples of 0.25%[77].

Systemic Risk Buffer: The *systemic risk buffer* (*SyRB*) aims to address systemic risks of a long-term, non-cyclical nature that are not covered by the *Capital Requirements Regulation*[78]. This buffer is optional to cover systemic and/or structural risks. It can be introduced by each Member State for the financial sector or one or more subsets of the sector with a view to preventing and mitigating long-term noncyclical or *macro-prudential risks*[79].

G-SIB Buffer[80]: This buffer is an additional CET1 requirement that applies to only some banks, but all of the time[81]. This buffer varies from 1.0 to 3.5% of CET1, although no bank has received so far the maximum top-up of 3.5% of CET1.

Finally, the CRD IV introduces new *devices* and *requirements*, in terms of *Transparency* and *Remuneration*. With regard to the first, (*or in the matter of Transparency*), the directive achieves the objective of improving the transparency of the various activities carried out by *banks*, *funds* and *investment firms*, in the various countries of the Union, through the imposition of *new binding rules*.

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[77] However, this Countercyclical buffer, can be set at a rate higher than 2.5%, in certain condition.

[78] (*For Further Information, Please see:* https://www.esrb.Europa.eu/national_policy/systemic/html/index.en.html)

[79] The rationale for this buffer is to be ascribed to the intention expressed by some Member States to cope with the ring fencing of commercial banking activities in complex banking groups. (*For Further Information, please see: Pag. 403 CRR/CRD IV: the trees and the forest Rainer Masera*)

[80] This Buffer, deal specifically with Global Systemically Important Banks and with "other" systemically important banks at EU level. This surcharge should reduce the moral hazard of implicit government support and bailout by taxpayer money, and partially internalise the cost of systemically important banking organisations. (*For Further Information, please see: Pag. 403 CRR/CRD IV: the trees and the forest Rainer Masera*)

[81] Once this requirement is apply to a bank, then it have to be respected all the time.

In particular with respect to *profits*, *taxes* and *subsidies* in *different jurisdictions*[82]. While, with reference to the *Remuneration Policies*[83], the legislator, through this directive, *aspires not to incentivize the assumption of excessive risks by investment firms*. More specifically, with the aim of fighting excessive risk-taking, (*and to ensure that remuneration policies do not compromise the sound and effective risk management*), the CRD IV incorporates the existing provisions on remuneration, (*present in the previous directive*), introducing *additional transparency* and *disclosure requirements* relating to the number of people earning more than €1 million per year.

[82] An example of this greater transparency is represented by the obligation for companies to have to communicate, country by country, certain information, including profits, taxes and public contributions received (*For further information, please see: Dir. 2013/36/EU, Available at: https://ec.Europa.eu/commission/presscorner/detail/en/MEMO_13_690*)

[83] The subjects of this provision are both *investment firms* and *banks* throughout the European Union, and the various National Competent Authorities will guarantee the application of the latter.

Chapter - 2: The Amendments Brought by the New Regulation 2019/876/EU and Directive 2019/878/EU

Although the *legislative measures adopted*[84] have contributed substantially to the strengthening of the financial system of the whole Union, (*making the different institutions more stable and resilient to the innumerable types of shocks and crises that could occur in the future*), despite their *innovative content* and their *extremely broad scale*[85], these measures failed to address all identified shortcomings at *institution level*[86]. Therefore, due to their "*incompleteness*" and the way in which the provisions contained in the latter proved not to be sufficiently "*clear*"[87] or "*complete*", the need to intervene has arisen, addressing these problems and gaps. It is in the light of this context and these considerations, that the reforms and amendments of the CRR II package (*also known as Regulation 2019/876/EU*)[88] and CRD V (*also known as Directive 2019/878/EU*)[89] find their application and their *raison d'être*.

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[84] Made up of the CRD IV directive and the CRR regulation.

[85] It is good to specify how, (*although the scope of the regulatory interventions was actually extended*); these measures did not address all identified shortcomings at the level of the institutions, and furthermore, some of the measures initially proposed were subject to review clauses or were not sufficiently specified to facilitate their implementation. (*For further information, please see: Dir. 2019/878 / EU CRD V*)

[86] One reason for this was the fact that at the time the international standardization bodies, including the BCBS, had not yet completed the work to arrive at internationally agreed solutions on these issues. (*For further information, please see: Reg. 2019/876 / EU CRR II*)

[87] Due to their lack of "*clarity*", the provisions contained in the previous CRR / CRD IV package may be subject to diverging interpretations.

[88] The amendments made to the CRR Regulation are related to various aspects, which we can mention the leverage and the net stable funding ratios; requirements for own funds and eligible liabilities; counterparty credit and market risks; exposures to central counterparties and collective investment undertakings; large exposures; reporting and disclosure requirements, as pointed out by Professor Dr. Christos V. Gortsos, in Th*e New EU Regulatory Framework Governing the Approval and Consolidated Supervision of Financial Holding Companies and Mixed Financial Holding Companies*, April 25, 2021, Page 5, Available at SSRN: https://ssrn.com/abstract=3834246.

[89] The changes made to the CRD IV Directive are related to *various aspects*, such as we can mention *remuneration*, *supervisory measures and powers*, *capital conservation measures*, as well as *financial holding companies* and *mixed financial holding companies*. (*For further information, please see: Pag.5, The new EU regulatory framework governing the approval and consolidated supervision of financial holding companies and mixed financial holding companies,*

With the entry into force of the new *CRR II regulation*[90], we have that it amends the previous CRR regulation, introducing and establishing *new uniform rules* concerning in particular the various prudential requirements, (*which institutions and numerous financial companies must meet with regard to the own funds*[91] *and eligible liabilities, requirements that limit large exposures, liquidity requirements relating to elements of liquidity risk and counterparty risk*), settlement and financial leverage, and finally reporting and disclosure obligations to the public.

While, with reference to the changes and interventions made by the *CRD V Directive*[92], we have that through it, the legislator wanted to *pursue* and *address* all those issues, (*in relation to the provisions contained in the previous directive*), which have not proved, in certain respects, neither *sufficiently clear* nor *sufficiently effective* and therefore have been subject to diverging interpretations or have been found to be excessively burdensome for *certain institutions*[93]. Secondly, the legislator aspired, *with the aforementioned directive*, to improve the alignment of the regulatory framework, (*in force*

Professor Dr. Christos V. Gortsos, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3834246). Most of these amendments are largely based on aspects of the Basel Committee's "*Basel III regulatory framework*", which were not included in these two pieces of EU legislation at the time of their adoption (*i.e. in 2013*). The proposed changes improve the alignment of the existing regulatory framework with international developments to promote coherence and comparability between different countries. (*For Further information, please see: Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010, Available at: https://www.bis.org/publ/bcbs189.pdf, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013, https://www.bis.org/publ/bcbs238.pdf, Basel III: the net stable funding ratio, October 2014, Available at: https://www.bis.org/bcbs/publ/d295.pdf and Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19, March 27, 2020, Available at: https://www.bis.org/press/p200327.htm*)

[90] Which applies from June 28, 2021, even if other different provisions were already in effect from June 27, 2019, and while other provisions are applicable from December 28, 2020 or will apply from June 28, 2023.

[91] These requirements relate to elements of credit risk, market risk, operational risk, settlement risk and financial leverage. (*For further information, please see: Art. 1 Reg. 2019/876/EU*)

[92] By 28 December 2020, Member States had to adopt and publish the provisions necessary to comply with the CRD V Directive of 20 May 2019.

[93] Furthermore, it contains adaptations to Directive 2013/36 / EU, which have become necessary due to the adoption of other relevant legal acts of the Union and due to the amendments proposed in parallel with the introduction of the CRR II regulation, regarding the CRR regulation. (*For further information, please see: Dir. 2019/878/ EU*)

at the time), to the international developments of the moment, with the intention of *promoting consistency* and *comparability* between different countries.

What the legislator aspires to achieve through the changes introduced with the package in question[94], is to *reduce the financial leverage considered excessive in investment firms*[95], *Address various market risks by increasing the risk sensitivity of existing requirements and strengthening the prudential framework proportionally*, *Coping with long-term financing risk*, *Increasing the loss-absorbing and recapitalization capacity of systemic banks*[96], and finally *seeking to promote the review of the methods for calculating the requirement for market risk and the inclusion of proprietary financial instruments in the trading book*[97]. The purpose of the latter is to establish, in the first place, *clearer rules* on the scope to avoid regulatory arbitrage (*i.e. trying to choose the most favourable capital treatment between the trading book and the banking book*). While secondly, the legislation in question seeks to strengthen the conditions for the use of internal models in order to *improve the consistency* and *comparability of risk weights* between banks.

With the entry of the CRR II - CRD V package, we have the introduction of additional measures, not only regarding *capital* or *liquidity requirements*, but also aimed at limiting the accumulation of financial leverage in the *banking system*[98]. As a consequence of this, we have the definitive entry in

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[94] With respect to the Capital and Liquidity Requirements, introduced with the previous CRR II Regulation and CRD V.

[95] Through the definitive and binding introduction of the Leverage Ratio.

[96] That is, try to increase the resilience of systemic banks, including capital and liquidity requirements, the second pillar (*i.e. the ICAAP / SREP prudential supervision and finally the third pillar (therefore the disclosure obligations to the public*).

[97] These changes are reported in Article 1 points 48 to 55, and point 89, of the CRR II Reg. (*For Further Information, please see: Reg. 2019/876 / EU Art.1 (From 48 to 55, and 89)*)

[98] The financial crisis revealed that institutions were overly indebted, meaning that they were setting aside relatively limited capital for ever-growing balance sheets, thanks to the risk weights applied to assets. Because of this, the Basel III accords set themselves the goal of limiting the overall leverage of financial institutions. To implement this rule, the amendments made by the CRR follow, in a broader context, the Provisions of the Basel agreements of 2010. (*For further information, please see: For further information, please see: Carla Stamegna, Amending capital requirements The 'CRD V package', Pag. 5, available at: Amending capital requirements (europa.eu)*)

force of the *Leverage Ratio*[99]. Its main purpose is to measure and / or evaluate the exposure of credit institutions and investment firms to the risk of *excessive financial leverage*, also allowing to evaluate the exposure of institutions to the risk of excessive leverage, thanks to which, therefore, we can avoid an excessive accumulation of leverage in companies and credit institutions, thus avoiding too *excessive exposure*[100].

This *Leverage Ratio*[101] was initially introduced by the Basel Committee in 2010, as a supplementary tool applicable to individual institutions at the discretion of the supervisory authorities, in order to limit the overall financial leverage of financial institutions (*which during the crisis proved to be dangerously high*), providing that the regulatory capital (CET 1) is at least 3% of all non-risk weighted assets (*including off-balance sheet assets and derivatives*). The amendment proposal carried out by CRR II, (*with respect to the CRR*), provides for its introduction, binding and mandatory ratio, equal to 3% for all entities subject to the CRD[102].

Furthermore, also the *Net Stable Funding Ratio* (NSFR)[103] finds a definitive application, within this discipline. The aim of this Ratio is to promote a more resilient banking sector. In order to ensure the achievement of such goal, this Ratio ensure that *all institutions have the ability to have sufficient*

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[99] As said above, (*in the First Chapter*), it was officially created with Basel III Agreements, and finds its legal bases within the Regulation 575/2013/EU CRR.

[100] (*For further information, please see: Leverage Ratio, Available at: https://www.eba.europa.eu/regulation-and-policy/leverage-ratio*)

[101] This additional tool, initially with the CRR, applied to individual financial institutions at the discretion of the supervisory authorities, was designed to address the regulatory weaknesses that emerged during the 2008 financial crisis, and to complement the capital framework based on the Basel Accords. (*For further information, please see: Basel III leverage ratio framework – Executive summary, Available at: https://www.bis.org/fsi/fsisummaries/b3_lrf.pdf*)

[102] the agreement on the modification of the CRR and the CRD aims to strengthen the capital requirements of banks, so as to reduce the incentives for EU financial institutions to take excessive risks, while preserving a level playing field with competitors from other jurisdictions . With this in mind, the binding leverage ratio was confirmed at 3% of Tier 1 capital as proposed by the BCBS standard. (*For further information, please see: Carla Stamegna, Amending capital requirements The "CRD V package", July 2019, Pag. 5, Available at: Amending capital requirements (europa.eu)*)

[103] Which is a long-term structural coefficient established by Basel III, established with the aim of addressing liquidity mismatches in banking activity.

stable funding[104] *to meet its funding needs over a period of one year,* both under *normal conditions* and under *stress conditions*. The NSFR limits overreliance on *short-term wholesale funding*, encourages *better assessment of funding risk* across all on- and off-balance sheet items, promotes *funding stability* and, consequently, reduces the likelihood that a disruptions in the bank's regular sources of funding, could erode its liquidity position in a way that would increase the risk of its failure, potentially leading to broader systemic stress. Therefore, as set out in the Basel III Accords and under CRR II, entities and businesses will now need to meet a minimum NSFR requirement of at least 100%[105].

Finally, with reference to the changes made by the package in question to the *Capital* and *Own Fund Requirements*, they aimed at establishing capital requirements that are more sensitive to the market risk. In particular, the amendments proposed by the new package, aim to establish *clearer rules on the scope of application of these requirements*, (the purpose of this intervention is to prevent *regulatory arbitrage*), *make the requirements proportionate to the activities undertaken by businesses* and *credit institutions*, so as to more accurately reflect the risks to which banks are exposed.

These amendments, (*despite their contribution in overcoming the various shortcomings present in the previous discipline*), with the introduction of new ratios and measures, (*and despite their merit in the strengthening of the whole financial system within the European Union*), we still have important flaws. These *requirements* and *amendments* are still based on the Basel Accords, and so they are designed exclusively for banks, rather than investment firms. A solution will be found only later, with the introduction of the "new" Prudential Framework, (*composed by the IFD Directive and IFR Regulation*), which will be discussed in the following chapter.

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[104] Here, for "*Available stable funding*", we meant the portion of *capital* and *liabilities* expected to be reliable over the time horizon considered by the NSFR, which extends to one year. The amount of stable funding, that a specific institution require, is in function of the liquidity characteristics and residual maturities of the various assets held by that institution as well as those of its Off-Balance Sheet (OBS) exposures. (*For further information, please see: Basel Committee on Banking Supervision, Consultative Document, Basel III: The Net Stable Funding Ratio, April 11, 2014, Available at: https://www.bis.org/publ/bcbs271.pdf*)

[105]This requirement, must be equal to: $\frac{\text{Available amount of stable funding (ASF)}}{\text{Required amount of stable funding (RSF)}} \geq 100\%$. Where:

- ASF can be defined as the amount of capital and liabilities expected to be reliable over the one-year time horizon.
- RSF can be defined as the amount of funding required by the bank, depending upon the *liquidity characteristics* and *residual maturities* of an institution's assets and Off-Balance Sheet exposures over the next one year.

Chapter - 3: The New Regulatory Framework IFR - IFD

1 - The Reasons behind the introduction of a new Prudential Framework, that juxtapose the previous one

As we have seen, the existence of the previous Regulatory Frameworks, *namely the CRR & CRD IV Regulatory Package and the subsequent "Update" carried out by the CRR II & CRD V Regulatory Package*, was due to the need to follow the contents marked within the *Basel III accords*. However, although the existing prudential regimes pursuant to the *Regulation CRR (575/2013/EU)* and to the *Directive CRD IV (2013/36/EU)*[106] certainly represented a great innovation, they only partially address the specific risks associated with the various activities of investment firms, not fully applying the provisions contained in Basel. In addition, both *investment firms* and *credit institutions*, within the previously mentioned CRR I/II and CRD IV/V packages, are subject to the same prudential rules of the EU, (*as set out in the CRR, Capital Requirements Regulation and in the CRD IV, Capital Requirements Directive*[107]*, both based on Basel III standards*). This equality in the application of prudential rules is applied, despite the fact that investment firms have both different primary business models and risk profiles. The prudential framework for investment firms in CRR / CRD IV works in conjunction with MiFID II. The prudential requirements that apply to investment firms, (*under the current prudential regime*); depend on the MiFID II services and activities that investment firms performs.

Therefore, *the more risky the activities that an investment firm carries out, the more onerous and higher will be the prudential obligations to which they are subject*. Hence, the risks faced and posed by most investment firms are substantially different from the risks faced and posed by credit institutions. Investment firms generally speaking, *do not have large retail and corporate loan*

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[106] Both based largely on the successive versions of the international regulatory standards established for large banking groups by the BCBS that is, based on the Basel Accords. (*For further information, please see: Reg. 2019/2033 / EU IFR and Dir. 2019/2034 / EU IFD*)

[107] And therefore, consequently, both CRR II and CRD V.

portfolios, and they *do not accept deposits*. So that, the likelihood of their failure to have a negative impact on the overall financial stability is lower than that of credit institutions. Therefore, these situations of partial inadequacy, (*characterized by vulnerability and by the presence of specific risks and needs for both investment firms and credit institutions*), had led on the one hand, to the need of simplify the existing regimes and disciplines. While on the other, it had led to the need of addressing these problems[108] through *effective*, *adequate* and *proportionate* prudential mechanisms at Union level, helping to create a level playing field across the European Union, ensuring in this way an effective prudential supervision, (*while keeping compliance costs[109] under control*), and ensuring sufficient capital for the risks of investment firms.

Due to these needs, it led the European Commission to introduce[110], on November 27, 2019[111], the new *regulatory package*[112], consisting of the Regulation 2019/2033/EU IFR also known as "*Investment Firm Regulation*", (*which deals with the prudential requirements, which investment firms are subject to*), and the Directive[113] 2019/2034/EU IFD also known as "*Investment Firm Directive*",

[108] Which are: the existence of *specific risks* and *needs* for both investment firms and credit institutions and the fact that the externalities coming from the failure of the former, have a different magnitude (*usually lower*) than the latter.

[109] (*For further information, please see: Directive (EU) 2019/2034 and Regulation (EU) 2019/2033 of the European Parliament and of the council of 27 November 2019, Point 2*)

[110] The introduction of this new regulatory package, which implies substantial and important innovations and changes, has also entailed the conferment, among other things, of a large number of mandates to the *European Supervisory Agencies* (ESAs), among which we can mention, the mandates granted to the *European Banking Authority* (EBA). Among the various mandates conferred on it, we can mention the fact that the EBA has been tasked with developing of new instructions and new reporting models.

[111] The IFD and the IFR, were published in the *Official Journal of the European Union* on 5 December 2019 and entered into force on 26 December 2019. (*For further information, please see: Consultation Paper, Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034, November 18, 2021, Available at: CP on RTS on Pillar 2 add-ons under IFD.pdf (Europa.eu)*)

[112] Which modifies and supports, without however replacing, the previous regulations in force.

[113] Regulation and Directive have profoundly different meanings and consequences. When we refer to a "*Regulation*", we are essentially referring to a binding legislative act; this means that a regulation, by definition, is something "binding" or in any case something immediately binding. Therefore, a regulation is in fact a legislative act characterized not only by a total application of its content, in all its points, (*without margin of discretion or modification*), but also by an immediate application of its content. Furthermore, another fundamental characteristic, it always prevails over the national laws of

(*which is related to the prudential supervision of investment firms*). As of June 26, 2021, we have the *direct application* of the IFR regulation, in all Member States of the European Union, while by that date, we have the deadline for the adoption and reception of the IFD Directive, in the various local legislations, (*with the exception for the various requirements of the disclosure on environmental, social and governance risks, including various physical risks as well as transition risks, which are postponed to December 26, 2022*).

Thanks to the introduction of the *IFR Regulation* and the *IFD Directive*, we have that the Legislator aspires to achieve a triple objective. Firstly, it want to create a new, articulated discipline[114], *placing a greater emphasis on proportionality and flexibility*, also seeking to ensure that the same discipline, do not apply to both *banks* and *investment companies*[115]. Secondarily, the legislator is favouring a

the various member states. On the other hand, a "*Directive*" differs from the latter. Like a regulation, it is a legislative act, which however is characterized by not immediate applicability, in fact a directive is never immediately applied but, on the contrary, it establishes a series of various guidelines and objectives that all the member countries of the European Union undertake to reach, adapting the original directive in their legislation within predefined time limits. So, while a Regulation is something very stringent, binding that does not leave much discretion, a Directive is less stringent, less binding, and leaves much more discretion, much more "*room for maneuver*" in its reception, compared to a regulation.

[114] This represents, perhaps the main objective, which underlies the introduction of the IFR and IFD

[115] Here we can see how the aim of the discipline IFD and IFR, is to subdue investment firms not only to obligations, (*in terms of capital, liquidity, other fundamental prudential aspects*), that are adequate and commensurate with the activities they carry out, but also to obligations that are in any case sufficiently rigorous to provide, (*from a prudential point of view*), a solid response to the risks they pose, with the aim of: "*protecting the stability of financial markets in the EU*". In addition to that, the legislator, *through the aforementioned package*, aims to: "*introduce an articulated prudential*

strengthening of the rules and supervision, *both informative and consolidated*, of investment companies. Thirdly, it want to *amends* and *adapt* the current regime composed of CRR I/II & CRD IV/V, simplifying or facilitating the access and conduct of the activity of investment firms, thus increasing the number of firms operating in the market, without giving up, or compromising, the security and resilience aspect of the market itself. Specifically, referring to the objectives, that the aforementioned prudential framework governs, we have that:

In relation to the IFR Regulation, we have that it establishes *uniform prudential requirements*, which apply to all those investment firms authorized and subject to supervision pursuant to the MiFiD directive, in order to *monitor compliance with the prudential requirements* under the IFD directive in relation to *capital and own funds requirements*, *requirements that limit the concentration risk for the customer and market*[116], *liquidity requirements* and finally *disclosure obligations to the public*.

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discipline with connotations of flexibility suitable for embracing different operational paradigms and adequacy to the risks deriving from the assumed commercial profile". As a matter of Fact, we can state that: "*the legislator aims to introduce more proportionate and risk-sensitive rules for investment firms*". Therefore, the IFR/IFD regime aimed at most, *non-systemic*, investment firms, and has as a consequence *their total subtraction from the provisions of the previous CRD IV and CRR,* which leads to the *termination of the application of a single discipline for both Banks and Investment Companies*. This change of approach, followed the recommendations of the EBA, (*which asked to leave all investment firms classifiable as systemic subject to the discipline of the European banking code*). What was outlined was therefore the *alignment of the regulatory and supervisory framework of large investment firms* to that of *credit institutions*, (*i.e. Banks*), with the aim of subjecting certain investment firms (*based in member countries of the EU*), to the supervision of the ECB, in its supervisory functions, guaranteed by the *Single Supervisory Mechanism*. Hence, with the IFR/IFD package, the legislator intends to respond to the need to give *greater solidity* to the *regulatory environment of investment firms*, moving from the diversity of ratios of the intermediary's prudential requirements and the dominance in the past regulatory framework based on the Basel accords. Therefore, what the legislator aspires to achieve, *with this IFD/IFR regime*, is the creation of an "*ad Hoc*" prudential regime for investment firms that meets their demands and needs. (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 396, 417, Available at:* https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/ and *Deloitte New Investment Firms Regime, Available at:* https://www2.deloitte.com/ie/en/pages/risk/articles/new-investment-firms-regime.html)

[116] We should point out that all firms belonging to category III that meet the conditions set out in Article 12(1) of IFR, therefore classifiable as not significant or not particularly interconnected, *may be exempted from liquidity and other requirements by their competent authority*. (For further information, please see: *Consultation Paper Draft Guidelines on liquidity requirements exemption for investment firms under Article 43(4) of Regulation (EU) 2019/2033*)

Furthermore, the Regulation also contains the level of application of the requirements on a subject or on a consolidated basis in relation to groups of investment firms.

- While the directive in question establishes rules concerning the *level of initial capital of investment firms*[117], *their composition*, it introduces rules concerning both the powers and the instruments of *prudential supervision*[118] of investment firms by the competent authorities[119]. Finally, it governs the disclosure obligations for the competent authorities in the sector of prudential regulation and supervision of investment firms.

- In addition to that, the IFR/IFD prudential framework includes and retain the SREP and both the *capital adequacy assessment processes*, (also known as *ICAAP*[120]), and the *liquidity adequacy assessment processes*, (also known as *ILAAP*[121])[122].

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[117] In particular, for Class III companies (*small and non-interconnected*), we have the power to submit them to internal capital adequacy assessment processes, and the risk assessment processes, were left to the competent authorities.

[118] As regards the scope and frequency of the disclosure, they differ in terms of application and content, between Class I, I-Minus, II and III companies. It is necessary to specify how the latter are subject to limited disclosure obligations.

[119] In a manner consistent with the provisions of Regulation (EU) 2019/2033 IFR.

[120] The Internal Capital Adequacy Assessment Process (ICAAP) is the firm's own process for ensuring it has adequate levels of internal capital, (*it ensure capital adequacy*). (For further information, please see: *Deutsche Bundesbank, ICAAP/ILAAP, Available at: https://www.bundesbank.de/en/tasks/banking-supervision/individual-aspects/risk-management/icaap-ilaap and ECB, Guide to the internal capital adequacy assessment process (ICAAP), November 2018, Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.icaap_guide_201811.en.pdf*)

[121] The Internal Liquidity Adequacy Assessment Process (ILAAP) is the firm's own process for ensuring it has adequate levels of internal liquidity, (*it ensure liquidity adequacy*). (For further information, please see: *Deutsche Bundesbank, ICAAP/ILAAP, Available at: https://www.bundesbank.de/en/tasks/banking-supervision/individual-aspects/risk-management/icaap-ilaap and ECB, Guide to the internal liquidity adequacy assessment process (ILAAP), November 2018, Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.icaap_guide_201811.en.pdf*)

[122] As a matter of fact, although the IFD/IFR regime, does not explicitly refer to Pillars, it adopts the same three Pillar structure used in the Basel standards and implemented in CRD IV, composed by: the "Pillar I", which represents the minimum capital requirement applicable to all firms, the "Pillar II", which regards the ICAAP and SREP process with the possibility of capital add-ons and the "Pillar III", which imposes a compulsory disclosure regime. (*For further information, please see: The new EU investment firm prudential regime - an overview, June 27, 2019, Available at: https://www.simmons-simmons.com/en/publications/ck0a4tj6smzq70b36crqapd32/270619-the-new-eu-investment-firm-prudential-regime-an-overview*)

2 - The New Regulation IFR

2.1 The new Definition of Investment Firm introduced by IFR, the expansion in the Definition of Credit Institution and their consequences

The new IFR regulation, which entered into force in November 2019, (*but became effective only in June 2021*), establishes *new prudential rules* and introduces innovations, which modify different aspects of the previous regulation, including the *prudential rules* regarding the *own funds requirements*, *liquidity requirements*, *concentration risk* as well as the *reporting obligations* of the aforementioned requirements and the *disclosure obligations to the public*. In addition to that, the IFR it also taking an interest in the different levels of application of these requirements, both on an individual and consolidated basis, in relation to groups of investment firms. (*The introduction of this regulation, together with the IFD directive, brings a number of significant changes compared to the previous prudential framework over investment firms*).

Following the need to adapt the old European discipline to the present situations and also, due to the desire to simplify the rules that make up the latter, we have the entry on November 27th, 2019[123], of the Regulation 2019/2033/EU (IFR). Its introduction[124] involves the modification, but not the replacement, of the *previous regulations*[125]. The subject of amendment by the IFR are the *pre-existing prudential rules* on the requirements of own funds, application of requirements on an individual or consolidated basis, requirements on *concentration* and *liquidity risk*, applicable to investment firms, authorized and supervised, pursuant to MiFiD II and supervised for compliance with the prudential requirements pursuant to directive 2019/2034/EU (IFD). Furthermore, it deals with the reporting

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[123] On that date, we have the approval, *by the European Parliament*, of the new regulatory package consisting of Directive 2019/2034 (IFD) and Regulation 2019/2033 (IFR). (*For Further information, please see: Regulation 2033/2019/EU, Available at: https://Eur-lex.Europa.eu/legal-content/IT/HIS/?uri=CELEX:32019R2033 and Directive 20134/2019/EU, Available at: https://Eur-lex.Europa.eu/legal-content/IT/HIS/?uri=CELEX:32019L2034*)

[124] Among which we can mention, changes made to the Regulation on 1093/2010 (EU), concerning the EBA, and obviously, the most important, the regulation 575/2013 (EU) CRR, which, more than any other, represented the true subject of modification and the true work of the just introduced regulation.

[125] Among other things, the IFD Directive also extensively covers it.

obligations of the various prudential requirements required to the investment firms themselves, and with the obligations of "*transparency*" or "*disclosure obligations*" to the public, (*always required by investment firms*). With its entry, the IFR regulation, (together with the IFD directive), introduced major amendments concerning both *investment firms* and *credit institutions*. In particular, with their introduction, we have that they have replaced the "*existing*"[126] prudential and supervisory framework for investment firms, with the definition of investment firms now aligned with the one set out in Article 4(1) of Directive 2014/65/EU (MiFID)[127]. Among these "*Major Amendments*", we can mention the: "*termination of the application of a single discipline for both Banks and Investment Companies*". The reasons behind this change can be found in the desire to: "*make the current discipline better articulated, ensuring more space for proportionality*". Nevertheless, how long this reasoning is correct, in my opinion, it is not sufficient to clarify the whole situation.

According to my way of thinking, the real motivation is also to be found in the *lack of specific prudential regimes*, (referring to the vulnerability and risks inherent within investment firms), and in the fact that the *corporate exemptions*[128] *in the previous banking code*, (based on the diversity of risks between investment firm and banks), *do not reflect the reality of the sector*[129], *nor the nature of the risk of investment firms*[130]. To confirm this, we must consider all the problems that have emerged, with respect to the *effectiveness of the previous discipline*, towards large investment firms considered as systemic and with business models and risk similar to banks[131]. Therefore, thanks to the new

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[126] As known in the previous CRR/CRD IV and CRR II / CRD V package.

[127] (*For further information, please see: Consultation Paper, Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034,November 18, 2021, Available at:* CP on RTS on Pillar 2 add-ons under IFD.pdf (Europa.eu))

[128] Since the previous prudential regime was substantially based on the dictates of the Basel Accords, (*and therefore was strongly focused on the operations and business model of banks*), and was applied to both *banks* and *investment firms*, the only way it had to work for both of these actors, it was to guarantee a series of *exceptions* and *amendments* for the latter.

[129] We refer to the investment sector.

[130] Investment firms and banks have different business models and risk profiles, and therefore the application of the same discipline, regardless of their characteristics, is not only wrong, but also ineffective.

[131] This point is particularly interesting, because it highlights how: "*the subjection of investment firms on the basis of MiFid II, to the supervision of individual national authorities, has made possible adverse phenomena, (which needs to be eliminated), referring to the misalignments of laws of the various countries and competitive distortions with the same banks*". (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation*

IFR/IFD package and through the aim of building a specific prudential regime, more articulated, (*regarding the Capital and Liquidity management of other risks*), suitable for investment firms deemed non-systemic[132], (*on the one hand*) and through the implementation of a strengthened prudential perspective for larger investment firms, (*on the other*), we can find the basis and raison d'être, for important and significant amendments of the package in question. Hence, that is to say:

- The definition of conditions, such that the largest (*and therefore systematic*) investment firms would remain subject to the previously predefined banking code[133];
- The creation of a much more articulated categorization for investment firm;
- The expansion of the concept of credit institution[134].

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e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 397, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/)

[132] In light of the dimensional and interconnection criteria.

[133] Thus ensuring a level-playing field, between large financial institutions, as suggested by Brozzetti Antonella. (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 397, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/*)

[134] The objective here is to *treat* and *subdue* all those investment firms, perceived as systematically important for the European financial stability, (*and therefore representing a "threat" to it*), within the orbit of the supervision applicable to significant banks, (*at the time carried out with the SSM*), thus decreeing a submission of the same to the watchful eye of the ECB. (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 397, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/*)

Indeed, in addition to that, we have the *extension of the definition of credit institution*[135], as known in the previous Regulation[136]. This change[137] takes the form of the incorporation within the definition of Credit Institution of all *investment companies*[138], *deemed as Systemic*, which carry out one of the activities listed in Annex I of the *MiFid II Directive*[139], with the sole condition that: "*the total value*

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[135] As underlined by Brozzetti Antonella, in: The reform prepared with Investment firms regulation and directive (IFD / IFR): first observations revolving around the new bipolar structure of European regulation and the new definition of "*credit institution*", widening of the definition of credit institution, (*concerning the modification of article 4 (1) CRR, maintains firm the business connotation that distinguishes it, instead expanding the operating space allowed*). (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (Ifd/Ifr): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 391-426, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/*)

[136] Prior to the amendment, in the CRR regulation, a "*credit institution*" was defined as "*a company whose business consists in collecting deposits or other repayable funds from the public and granting credits on its own account*". (*For further information, please see: Art. 4 Reg. 575/2013 / EU*)

[137] The amendment of the notion of *credit institutions* carried out by the IFR Regulation, (*within a reform aimed at creating a new Prudential and Supervisory framework for investment firms calibrated on the size and characteristics of the same*), represents a Transformation of great importance, because this modification, goes beyond the total parification, (*with respect to the performance of investment services*), between banks and investment companies, (*carried out by the European legislator with the package CRR / CRD IV, within which they were enclosed, with the term "Entities", both banks and investment firms without distinguishing them*). (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 416, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/*)

[138] Exception made for all other institutions that carry out trading activities on their own account of commodities and / or emission quotas, or that carry out collective investment or insurance activities, to quote the law: "*the company is not a trader on behalf of commodity and emission allowance company, a collective investment undertaking or an insurance company*". (*For further information, please see: Regulation 2019/2033 (EU) Article 62, 3.a*)

[139] Annex I of Directive 2014/65 / EU, in section A, points 3 and 6, concerns trading on own account and underwriting of financial instruments and / or placement of financial instruments on the basis of a commitment irrevocable. (*For further information, please see: Annex I, MiFid II*)

of the consolidated assets of the investment firm is equal to or greater than €30 billion[140]". This new Definition[141], implies that all those *investment firms*[142], will henceforth be forward, considered as credit institutions, and therefore, means that all investment firms, which will be considered as such, in order to operate, or to carry out their business, must necessarily apply for a "*banking license*". Furthermore, this novelty more specifically entails that investment firms, considered as banks[143], *will have to request authorization*, (in accordance with the CRD directive), *no longer pursuant to the MiFiD II directive*, and therefore, they will be subject to the same regulation as banks are currently submitted, (*i.e. under the regulatory package consisting of CRR / CRR II & CRD IV / CRD V*).

Moreover, the investment firms considered as Credit Institutions will consequently be subjected to the *Single Supervisory Mechanism* (SSM), which, (*based on the systematic nature and importance that this investment firm has towards financial stability*), may involve Direct supervision, (*or Indirect in the case of "less significant" credit institutions*), of the ECB[144]. Therefore, what we will have is a new classification of investment firms. Previously, under the *old regime*[145], (*consisting of the CRR / CRD IV and CRR II / CRD V package*), both *investment firms* and *credit institutions* were subject to

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[140] The threshold of €30 billion, equals a threshold present in the more significant criteria, (Art 6 par 4 co 2 lett i reg 104/2013 SSM), adopted for the purposes of subduing banks, and, in this case, for investment firms, to be put under the centralized supervision of the ECB. The reference, for investment companies, goes to consolidated activities and therefore to the group of which it heads *or of which it belongs. (Compared to banks, the parameter of systemic importance, at an individual level, is lower). (For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 391-426, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/*)

[141] The extension of the definition of Credit Institution, with respect to what is established by the CRR.

[142] Which are characterize by a *large size* or which in any case have a *great systemic importance*.

[143] Here we are referring to Class I Firms, as we will see in the following chapters.

[144] In this case, it is good to remember how, according to SSM, we would have direct supervision by the ECB in the case of "*Systematically Important Entity*", while in the case of "*Not Systematically Important Entity*", we would have direct supervision by the National Competent Authority, for example, supervision by the Bank of Italy in Italy, and indirect supervision by the ECB.

[145] Under the old regime, the prudential requirements to which investment firms were subject depended on the services and activities of MiFID II, *which the investment firm carries out during its activities*.

the same prudential rules, despite the fact that investment firms have *different business model* and *different risk profiles* than *credit institutions*[146].

As a result of these *amendments*[147], we have that the legislator aims, first of all, to *increase the resilience of the financial system*.6z1 Secondly, we would have a *new reclassification* of the classes or categories of *investment firms*[148], which clearly differs from the previous categorization based on MiFID II services[149]. It will differ from the previous one, because, this new *investment firms classification*, will be based on *quantitative indicators*, (also known as K-Factors *which will be addressed in the next chapter*), which reflect the risk that the new prudential regime intends to face. Thirdly, this new regime will distinguishes between investment firms deemed similar in terms of *business models* and *risk profiles* to credit institutions[150], (*on the one hand*), and firms that became subject to the new requirements of the IFR and IFD regulatory package (*on the other hand*)[151].

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[146] Which worked in conjunction with the MiFID II Directive.

[147] Especially those regarding the Investment Firms, and their "*New Definition*".

[148] In terms of what is an investment firm for the purposes of the IFR and IFD, this is defined by Art.4 of MiFiD II. Moreover, both the IFD and the IFR directly affect MiFID II investment firms; however, they do not affect credit institutions or other financial services firms. Nevertheless, the IFD has certain implications for alternative investment fund managers and UCITS management companies in the sense that it provides that own funds of these entities can never be less than the IFR's fixed overheads requirement. (*For further Information, please see: Par.22 Art.4 Reg.2019/2033/EU IFR, and Par.19 Art.3, Art.60 and Art.61 Reg.2019/2034/EU IFD and The new prudential regime for investment firms, November 2019, Available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms#section2*)

[149] We should point out that, within the older CRR-CRD regime, there were 11 different prudential categories of investment firm, (*with further categories existing under national law*). So the need to simplify such a complicated situation, in my opinion, can be seen as one of the many reasons that prompted the legislator to reform the previous regulation with the issue of the IFR and IFD.

[150] (*Here we are referring to Systematic Important Companies*). Therefore, because of that, they will continue to remain subject to the prudential and supervisory requirements of the CRR and CRD. (*For further information, please see: Consultation Paper, Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034, November 18 2021, Available at: CP on RTS on Pillar 2 add-ons under IFD.pdf (Europa.eu)*)

[151] (*Here we are referring to not Systematic Important Companies*).

2.2 – Another novelty, the K-Factors and their Correlations to the new classification n of Investment Firms

With the entry into force of the new IFR / IFD prudential framework, in August 2021, we have, (*in addition to the amendment of the rules regarding the capital requirements for MiFiD investment firms in the EU*), the introduction and adoption of K-Factors which represent one of the most significant innovations introduced by the *new regime*[152]. They can be defined as *parameters* or *indicators*, which represent the risks faced by investment firms, the risks to which customers and markets are subjected and how the new prudential regime, *represented by IFR & IFD*, intends to offset these risks. Hence, based on the riskiness that an activity possesses and represents for the market or customers, we would have more *stringent* and *higher* capital requirements. (*Therefore, the more an asset has a high intrinsic risk, the greater the capital and remuneration requirements required to cover this risky asset would be*). A peculiar characteristic of K-Factors is the fact that they, in the first place, specifically address those services and activities that are more likely to generate risks for the *market*, for the *clients of an investment firm*, for the *firm itself*, and in general for *financial stability*.

Secondly, the K-Factors are applied solely and exclusively for second-class investment firms[153]. This is due to the fact that such *firms will be required to calculate their capital requirement based on the K-factor formula and because they will be required to hold minimum own funds based on the higher of their permanent minimum capital requirement, their fixed overhead requirement or the new K-factor own funds requirement*[154].

[152] The IFR uses these quantitative indicators, K-Factors, which reflect the risk that the new regime intends to face. The K-Factors are divided into three groups in the IFR and aim to capture the risk that the investment firm may represent for clients, for market access or for the firm itself.

[153] The calculations of the K-Factor will be more relevant for "*Class II*" companies pursuant to the IFR than for "*Class III*" companies and Class I & I-Minus companies.

[154] Another aspect to consider, regarding "*second category*" companies, is the fact that they are required to continuously monitor the level and composition of their capital and to ensure that they hold sufficient capital to cover the risks to which the company is exposed. This is an important aspect to consider, because in the event that the composition of the capital or the amount of the same changes, then it is possible that a Class II company could become a Class III company. (*For further information, please see: All you need to know about K-factors, January 11, 2021, Available at: https://www.wolterskluwer.com/en/expert-insights/all-you-need-to-know-about-k-factors, and IFR/IFD: K-factors - what are they?, January 27 2021, Available at: IFR/IFD: K-factors - what are they? - Lexology*)

While this does not apply to companies belonging to Categories I / I-Minus and III (*although in some extent*). This is because, with reference to the former, that is the Class I / I-Minus companies defined as the "*Biggest, Riskiest and Systematically Important*". So we have that the IFD Directive and the IFR Regulation require that they remain subject to the *previous prudential regime*[155]. Therefore, for them, the K factors are not useful for the purpose of calculating their *capital requirements*.

Instead, with reference to the latter, that is the Class III investment firms defined as the "*Smallest, systematically less important and less interconnected firms*", we have that they are *not required to calculate their capital based on the formula of the K-Factors*, but they will only be required to hold *minimum own funds* based on the higher of their *Fixed Overhead Requirement* (*25%*) or *Minimum Permanent Capital Requirement*. However, despite this, they will still need to calculate the K-factors, just for categorization purposes[156].

The IFR Regulation introduces *nine different types of K-Factors*[157], which are grouped into three different main macro classes (*or groups*), the *Risk-to-Client* (RtC), the *Risk-to-Market* (RtM) and the *Risk-to-Firm* (RtF). These macro-classes reflect the risks of investment firms, aiming to assess the risk that the investment firm may represent for customers, for access to the market or for the firm itself. (*As described in paragraphs 19 → 27 and in article 4 of Regulation 2019/2033/EU IFR*). In the table below, I have represent the various classes that comprise the K-Factors.

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[155] Consisting of the CRR / CRR II regulations and the CRD IV / V directives

[156] In essence, Class III companies have to calculate the K-factors, just to know *if they are suitable to be defined as Class III Firms or Class II Firms*, so for *categorization purposes*. Therefore, although their specific prudential requirements will not relate to the K-factors, they will still need to calculate their K-factors scope for categorisation purposes. Instead, Class III Investment Firms, should possess *own funds* equal to the higher of their permanent minimum capital requirement or a quarter of their fixed overheads measured on the basis of their activity in the preceding year. (*For further information, please see: All you need to know about K-factors, January 11, 2021, Available at:* https://www.wolterskluwer.com/en/expert-insights/all-you-need-to-know-about-k-factors, *IFR/IFD - A new prudential regime for EU investment firms, January 10, 2020, Available at:*https://www.burges-salmon.com/news-and-insight/legal-updates/ifr-ifd-a-new-prudential-regime-for-eu-investment-firms *and IFR/IFD: K-factors - what are they?, January 27 2021, Available at:* IFR/IFD: K-factors - what are they? - Lexology)

[157] The nine existing K-Factors are defined in Article 4 of the IFR, and in this regard, EBA is tasked with developing regulatory technical standards to measure these K-Factors.

Type of Risk	K-Factor
Risk to Client (RtC)[158]	• **K-AUM**[159] (*Assets Under Management*): This variable, which represents the client's assets entrusted to an investment firm to manage, captures the risk of potential damage to clients, due to poor management or execution of client portfolios. By defining a need to hold capital against this risk, it provides support and client benefits in terms of the continuity of service. • **K-CMH** (*Client Money Held*): This variable, which represents the client's money withheld by an investment firm, captures the risk of potential damage caused by the firm towards a client, in the event that the former holds the client's money both on the *own balance sheet* and on *third party accounts*. This variable is further divided into: ▪ (**K-CMHS**): "*Client money held on separate accounts*". ▪ (**K-CMHNS**): "*Client money held on non-separated accounts*". • **K-ASA**[160] (*Assets held on behalf of customers*): This variable, which represents the client's assets protected and administered by an investment firm, ensures that

[158] Risk-to-Client (RtC) measures are approximations that cover the business areas of investment firms from which harm to clients can manifest as problems that will impact the firm's own funds, and so on the capital requirements. (*It is divided into 4 K-Factors*). By adding these variables together, each adjusted by a proper coefficient, *as defined by Art.16 IFR*, we can find the necessary requirements to cover the risk for customers (RtC). So, we have: $[(a \times K-AUM) + (b \times K-CMHS) + (c \times K-CMHNS) + (d \times K-ASA) + (e \times K-COHC) + (f \times K-COHD)]$. (*For further information, please see: The new prudential regime for investment firms, November 2019, Available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms and All you need to know about K-factors, January 11, 2021, Available at: https://www.wolterskluwer.com/en/expert-insights/all-you-need-to-know-about-k-factors*)

[159] It constitutes a sort of investment advice on an ongoing basis.

[160] This K-factor ensures that an investment firm holds capital in proportion to such assets, regardless of whether they are on its own balance sheet or in third-party accounts. (*For further information, please see: All you need to know about K-factors, January 11, 2021, Available at: https://www.wolterskluwer.com/en/expert-insights/all-you-need-to-know-about-k-factors and The new prudential regime for investment firms, November 2019, Available at:*

an investment firm *holds capital in proportion to these assets*, regardless of whether they are in its balance sheet or in third party accounts.

- **K-COH** (*Client Orders Handled*): This variable represents the risks faced by the customers of an investment firm that executes orders on behalf of the former and not on behalf of the firm itself. (*So, this captures the risk to clients of an investment firm that executes orders in the names of clients, and not in the firm's name*). This variable is further divided into:
    - (**K-COHC**): "*customer orders handled in Spot Transactions*"
    - (**K-COHD**): "*client orders handled in Derivatives Transactions*"

Risk to Market (RtM)[161]

- **K-NPR**[162] (*Net Position Risk*): This variable is based on the *market risk framework* of the CRR, and it indicates the *value of transactions recorded in the trading book of an investment firm*[163]. This can be seen as a point-in-time measure that follows the standardized approach of market risk rules set out under the CRR Regulation. Under the IFR Regulation, firms should calculate their **K-NPR** as frequently as is proportionate, which means that, *the more volatile the **K-NPR** of a company is, the more frequently it must be calculated* and vice versa, *the more stable the **K-NPR** of a company is, the less frequently it must be calculated.*

https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms)

[161] Risk-to-Market (RtM) K-factors only apply to firms with a *trading book that deals on their own account or on behalf of their clients*. It will include other two K-Factors. Note that "*the RtM K-factor requirement for the trading book positions of an investment firm dealing on own account, whether for itself or on behalf of a client, shall be either K-NPR calculated in accordance with Article 22 or K-CMG calculated in accordance with Article 23 of Regulation 2019/2033 IFR*".

[162] This variable is designed to hedge the potential risks of an investment firm that trades on its own behalf or executes for clients on behalf of the investment firm.

[163] According to Par. 34 Reg. 2019/2033 IFR.

Risk to Firm (RtF)[165]	**K-CMG[164]** (*Clearing margin given*): This refers to the derivative positions of a MiFID investment firm subject to clearing. (*Those investment firms that trade financial instruments with positions that are subject to netting use this variable*). **K-DTF[166]** (*Daily trading flow*): This variable refers to the operational risks for an investment firm that trades on its own account, for itself or on behalf of a client, and of the transactions that an investment firm carries out by executing orders on behalf of clients. It is designed to ensure that: *investment firms have sufficient capital to cover replacement costs and*, in some cases, *take into account changes in specific exposures*. Similarly, to before with **K-COH**, **K-DTF** will be measured separately in: **K-DTFC**: for transactions in Cash, based on the amount paid or received. **K-DTFD**: for derivative transactions, based on the value of the contract.

[164] In order to be used, for all *netting positions*, or on a *portfolio basis*, (*if the entire portfolio is netting or* ***marginalized***), an investment firm will require *regulatory approval*. In particular, we have that Article 23, IFR Regulation, described and enlist *five conditions* that investment firms, would need to meet for approval by the competent authority. (*For further information, please see: Art.23 Reg. 2019/2033/EU IFR*)

[165] In relation to the Risk-to-Firm (RtF) K-Factors, this is the final set of K-Factors, and investment firms that deal on their own account must model it. (*In this regard, the IFR Regulation defines that, for investment firms that trade on their own account, these RtF K-Factors K-TCD and K-CON, in a certain sense, constitute a simplified application of the rules of the regulation (UE) n. 575/2013, for credit / counterparty risk and for the risk of large exposures*). It regards three different K-Factors, which are the *K-TCD*, *K-DTF* and *K-CON*. The total value of the RtF-factor requirement is equal to the summation of the of K-TCD, K-DTF and K-CON, calculated in accordance with the IFR requirements and in relation to K-DTF multiplied with the respective coefficient. So that, we have **K-TCD** + **K-DTF** + **K-CON**. (*For further information, please see Reg. 2019/2033/EU IFR and The new prudential regime for investment firms, November 2019, Available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms*)

[166] According to Par. 33 Reg. 2019/2033 IFR, "*daily trading flow or DTF means the daily value of transactions that an investment firm enters through dealing on own account or the execution of orders on behalf of clients in its own name, excluding the value of orders that an investment firm handles for clients through the reception and transmission of client orders and through the execution of orders on behalf of clients which are already taken into account in the scope of client orders handled*". (*For further information, please see: Par. 33 Reg 2019/2033 IFR*)

- **K-TCD**[167] (*Trading counterparty default*): This variable indicates the *exposure of an investment firm to the insolvency of its trading or trading counterparties*, or to the fact that *they may not fulfil their obligations towards the investment company*, in accordance with the simplified provisions for the risk of CRR-based counterparty credit. It applies to a finite set of transactions within a firm's trading book.

- **K-CON**[168] (*Concentration*): It represents the *concentration risk* in the trading book associated with the *large exposures of an investment firm* to certain counterparties, where the *exposure exceeds the limits* established by the IFR, 25% of its funds or €150 million if the client is a credit institution. *If the amount of €150 million is higher than the own funds*, the permitted concentration limit rises to 100% of the investment company's own funds[169].

In the end, by summing together the K-Factors requirements, we can end-up with the total capital requirement needed by the investment firm. So that, we will end up with this:

$$\text{Total Capital Requirement} = \text{RtC} + \text{RtM} + \text{RtF}$$

Therefore, this new classification divides investment firms on the basis of their *systematic nature*, on the basis of their *size*, *complexity* and finally on the basis of the *riskiness of the activity carried out*. Hence, *based on the novelty introduced and amendments made by the regulation in question*, we have

[167] The greatest peculiarity of this K-Factor is represented by the fact that it only applies to investment firms that trade on their own account. (*For further information, please see: Par. 26 Reg 2019/2033 IFR*)

[168] It is a simplified version of the CRR's large exposures framework and will require daily monitoring, as firms will have to notify their supervisor of any limit breaches immediately. (*For further information, please see: All you need to know about K-factors, January 11, 2021, Available at: https://www.wolterskluwer.com/en/expert-insights/all-you-need-to-know-about-k-factors*)

[169] In a sense, its goal can be seen as to protect the firm from exposures to a single client or group of connected clients, which can be large in proportion to the size of the investment firm, and which can therefore presents an increased risk to investment firms. (*Exposure must not exceed 25% of the firm's regulatory capital, unless the excess is capitalised through K-CON and the supervisor is notified*).

that, investment firms are now "divided", into *three main different categories*[170], to which we apply different rules that are differentiated according to plenty and various elements, such as their *systemic importance*, their *risk profile*, *complexity* or their *business model*[171]. The table below shows the different classes in which investment firms are now classified.

Category I and I-Minus[172]	**Investment firms that can be classified as belonging to category I or I-Minus, include all those large investment firms, which are classifiable as systematically important and for this reason they are considered as "Credit Entity" or "Credit Institution".** **This entails the application, for both Category I and Category I-Minus companies, of the regulatory framework of credit institutions, and therefore will be subject to the regime of the regulation on capital requirements (CRR / CRR II) and the directive on capital requirements (CRD IV / V).**

[170] Before the entry in force of the IFD/IFR Regime, (*within the older prudential framework*), there were 11 different prudential categories of investment firm, with further categories existing under the national law of each member state.

[171] (*For further information, please see: Consultation Paper, Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034, November 18, 2021 Available at: CP on RTS on Pillar 2 add-ons under IFD.pdf (Europa.eu)*)

[172] In Category I, it is necessary to specify how it is divided into two sub-categories, which are Category I and Category I Minus. Both of them, Class I and Class I-Minus, share the same Prudential Regime, since both of them are under the CRD-CRR Package. The difference between the two is based on the fact that: On the one hand the undertakings belonging to category 1 are reclassified as "credit institutions", (*pursuant to the amendments made to the CRR by article 62, paragraph 3, IFR regulation*), and will be subject to prudential requirements and existing remuneration under the CRR and CRD IV. Therefore, they will be subject to the same authorisation process that credit entities and institutions undergo. So that, Class I investment Firms are required to apply for authorisation as credit institutions. On the other hand, Class I-Minus Investment Firms, follow the same authorisation process that Class II and III Firms undergo, (*the one described by the Mifid Directive*). So both Category I and I-Minus companies remain subject to CRR and CRD IV, what is different is the Authorisation regime. (*For further information, please see: Donato Varani, Partner, Annunziata & Conso, Il Nuovo Framework Regolamentare delle SIM, December 16, 2021, Available at: https://annunziataconso.eu/it/il-nuovo-framework-regolamentare-delle-sim/, New Investment Firms Regime, June 2021, Available at: https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Risk/New-Investment-Firms-Regime.pdf* and *New prudential rules will apply from 26 June 2021, January 25, 2021, Available at:https://www.arthurcox.com/knowledge/investment-firms-new-prudential-rules-will-apply-from-26-june-2021/*)

Within this category, there are two categories of enterprises, those defined as Class I and those of Class I-Minus.

Category I

The largest investment firms that provide *key services* for the *wholesale market* and *investment banking services*, and have business models and risk profiles similar to those of major credit company, are classified as "*Credit Institutions*"[173]. Such investment firms, reclassified as credit entity, will therefore be subject to the same prudential requirements as *large credit institutions* under the CRR and CRD IV regimes[174], and will undergo to the same authorisation regime as Credit Institutions, (*the one envisaged by the CRD Directive*). The IFR amends the definition of a *credit institution* in the CRR, to include all the entities whose business includes *trading on own account* or the *subscription* or *placement of financial instruments on a firm commitment basis* or both, (which is not a *merchant enterprise* of commodities and emission allowances, a *collective investment undertaking* or an *insurance company*), and above all, the whose total value of consolidated assets is equal to or greater than €30 billion.

[173] The reasoning behind the fact that Class I Investment Firms, (*the ones deemed to be of systemically importance*), are considered to be credit institutions, (*under CRD IV and CRR*), is due to the fact that such investment companies have business models and risk profiles similar to those of significant credit institutions (i.e. *Banks*). This fact, exposes them to credit risk, (*mainly in the form of counterparty credit risk*), as well as to market risk for positions they take on their own account, (*whether related to customers or not*). Therefore, given that they represent a risk to the financial stability, and by considering them as financial institutions, they will be placed under the supervision of the ECB. (*For further information, please see Investment Firms: New prudential rules will apply from 26 June 2021, January 25, 2021, Available at: https://www.arthurcox.com/wp-content/uploads/2021/01/IFD-and-IFR-January-2021-v4.pdf and The new prudential regime for investment firms, November 2019, Available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms#Asdefined*)

[174] In this regard, the companies belonging to or classifiable as Category I, will include all those entities that can be authorized, (*pursuant to the CRD IV / V directive*), as trading activities for own account and / or placement of financial instruments on an irrevocable basis, (*with the condition that the total consolidated assets exceed €30 billion*).

Investment firms meeting these conditions will have to be licensed as a *credit institution* and will be subject to the same prudential requirements as large credit institutions[175].

Category I-Minus

Secondly, all those investment firms which, although *not large enough to be defined as of systemic importance*, (as Class I Firms), or *possess consolidated assets of less than €30 billion*, but whose size and activities present some risks to financial stability, are definable as Companies belonging to Category I-Minus, and therefore will remain subject to the CRR and CRD IV but will not have to be re-authorized as a credit institution[176], (*unlike Class I investment firms*), but they will nonetheless be subject to the more onerous prudential and remuneration requirements under CRR II/CRD V[177].

These investment firms that can be classified as belonging to the I-Minus category, (*including all those entities that are authorised to deal on own account and/or underwrite or place financial instruments on a firm commitment basis*), must have a

[175] The possibility of labelling as banks / credit institutions all investments firms deem to be systemic (*based on the criteria seen*), or following a decision taken by the supervisory authorities on a consolidated basis, (*after consulting the college of supervisors*), intends to contain all the potential Regulatory Arbitrage of a *de facto regulatory framework fragmented national wide*, hence considered to be dangerous for the safeguard of the stability of the common financial market. (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 401, Available at:* https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/)

[176] In particular, the IFR Regulation, pursuant to Article 1, Paragraph 2, provides that large investment firms will also be subject to the prudential regime envisaged by the CRR, without however being required to request authorization as a credit institution to under the IFD. (*For further information, please see: Par.2, Art.1, Reg. 2019/2033/EU*)

[177] (*For further information, please see: Arthur Cox, Investment Firms: New prudential rules will apply from 26 June 2021, May 25, 2021, Available at: https://www.arthurcox.com/knowledge/investment-firms-new-prudential-rules-will-apply-from-26-june-2021/#:~:text='Class%201%20minus'%20firms%20are,billion%20'Class%201'%20threshold*)

total value of *consolidated assets* that exceeds € 15 billion but does not meet the € 30 billion "Class 1" threshold[178].

However, unlike before, *such companies are authorized, pursuant to the MiFiD II Directive*, and so, *they will undergo the authorisation regime envisaged by the MiFiD II Directive*. In accordance with the latter, (and specifically at Annex 1 points 3 and 6), Class I-Minus firms are authorized to *carry out trading activities on their own account* and / or *underwriting of financial instruments* and / or *placement of financial instruments based on an irrevocable commitment*, (with consolidated assets of the company equal to or greater than €15 billion). The sole condition here is to never exceeding the threshold of €30 billion of consolidated assets, *typical of investment companies belonging to Category I*, or to belong to a group of investment firms with consolidated group activities in *trading on own account* and / or in *placement* with a guarantee equal to or greater than €15 billion[179].

Such Class I-Minus companies are classifiable as such by their respective National Competent Authorities (NCAs). As a Matter of Fact, the various NCAs can classify investment firms with consolidated business activities equal to or greater than €5 billion, (*of which between €5 billion and €15 billion, considered to be of "systemic importance or highly interconnected activities"*), as "*Category I-Minus*" companies.

These two "*sub-categories*" include all those activities that represent a risk to financial stability, and this arises due to the *size they possess* or the *activity they carry out*, which by nature are subject to a certain level of risk, which mainly takes the form of market, and / or counterparty risk.

Since they, (*as they are also defined by Article 62 of Regulation 2019/2033 IFR*), are classifiable as "*credit institutions*", they must be authorized as such, and therefore, they will be subject to the current CRR-CRD regime in relation to *capital*

[178] (*For further information, please see: Arthur Cox, Investment Firms Update: New prudential regime applies to MiFID investment firms across the EU, June 30, 2021, Available at: https://www.arthurcox.com/knowledge/investment-firms-update-new-prudential-regime-applies-to-mifid-investment-firms-across-the-eu/*)

[179] With the exception of any subsidiaries established outside the Union, which are excluded.

requirements, and direct supervision of the ECB under the *single supervisory mechanism*.

Category II[180]

Investment firms included in this category[181] **are subject to the new prudential regime dictated by the IFR regulation and the IFD directive (*which refers to some methodologies present in banking regulations and introduces a requirement for liquidity risk*) and they will also be placed under the supervision of the National Supervisory Authority**[182]**.**

This category can be defined as a middle category, in the sense that it includes all those investment firms too small to be of systemic importance, but too large to fit the thresholds and requirements defined by article 12 IFR, *for small and non-interconnected investment firms*[183]. Companies belonging to this category can carry

[180] Investment firms that belong to this category can be seen as non-systemic firms which, however, at least exceed one of the limitations set in Category III, by article 12 IFR. Therefore, these companies must comply with all IFR and IFD regimes, including with regard to own funds, concentration risk and public disclosure obligations. All companies belonging to this category, Class II, will be subject to the full IFR / IFD prudential regime. (*For further information, please see: The new prudential regime for investment firms, November 2019, Available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms#section2*)

[181] These Class II firms, essentially, are characterized by the fact that they include all those investment firms that exceed the categorization thresholds for small and non-interconnected investment firms, also known as class III.

[182] In addition, Class II firms must comply with the new requirements on *own funds*, *concentration risk*, *liquidity*, *reporting* and *disclosure to the public*, maintaining a *minimum level of own funds* based on greater than their permanent minimum capital requirement. Their fixed overheads requirement or a new "K-Factors" own funds requirement a directly proportional capital requirement based on the specific risks that investment firms face and the risks they pose to clients / markets (*in practice a set of risk parameters / indicators*). (*For Further information, please see: Investment Firms: New prudential rules will apply from 26 June 2021, Available at: https://www.arthurcox.com/wp-content/uploads/2021/01/IFD-and-IFR-January-2021-v4.pdf*)

[183] However, it is worth remembering how it is possible that these "sizeable investment firms", (*although not of systemic importance, but which trade on their own account or underwrite financial instruments or place financial instruments on the basis of an irrevocable commitment*), still have business models and risk profiles similar to those of other systemic entities. (*For Further Information, please see: (47) 2019/2033 IFR*). Hence it is possible that they may pose risks to financial stability and, although their conversion into credit institutions is not considered appropriate in light of their nature and complexity, they should remain subject to the same prudential treatment as such credit institutions (*systemic*

out one or more of the activities set out in Annex I, Section A, of the MiFiD II Directive. In addition to that, they are also authorized to *hold client money* and *financial instruments*. Such companies more importantly, (*to be define as such*), must exceed at least 1 of the limitations posed by article 12 IFR[184], which consist of:

- *Asset Under Management* (AUM) including advisory activities equal to or greater than €1.2 billion
- *Client Order Handling* (COH) of €100 million / day or more for spot transactions or €1 billion / day for derivatives
- Total gross annual revenues from investment services and investment activities of the investment firm exceed €30 million (*calculated as an average based on annual data for the two-year period immediately preceding a given financial year*)
- Total on- and off-balance sheet assets over €100 million
- Trading on own account and / or placement with guarantee of less than €15 billion, for which the competent authorities have not adopted the decision pursuant to art. 5 of the IFD[185].

Moreover, we should point out that, the new prudential regime dictated by the IFR and the IFD is applied to these Class II investment firms, (*which refers to some methodologies present in banking regulations and introduces a requirement for liquidity risk*), subjecting the companies to the supervision of the National Supervisory Authorities. Furthermore, for Class II Companies, we have that

ones, belonging to category I). Thus to avoid a certain "*overlapping*", or "*In order to prevent regulatory arbitrage and reduce the risks of circumvention*" (*For Further Information, please see: (47) 2019/2033 IFR*), competent authorities should: "*make sure that investment firms structure their operations, so that the total value of the assets at individual or group level does not exceed the threshold of €15 billion*". The intent here, is to limit the discretion with which the competent authorities can subject the various investment firms to the application of the requirements of Regulation 575/2013 (CRR), and so avoid subordinating them to compliance with the prudential requirements established in Directive 2013 / 36 / EU (CRD IV), in accordance with the provisions of article 5 of Directive (EU) 2019/2034 (IFD).

[184] The article that define the companies that can be deemed as Class III.

[185] Article 5 of the IFD has a certain importance, in the sense that it gives the competent authorities of the Member States a certain discretion in subjecting investment firms to the requirements outlined in the previous CRR Regulation.

competent authorities should determine additional own funds requirements, in order to decrease the likelihood of a failure of the investment firm, by covering *material risks* related to their *ongoing activities*, including risks to clients, markets and to the investment firms itself[186].

Category III[187]

The investment firms included in Class III, (*as defined by Article 12 of the IFR Regulation*), are considered as "*small-sized and non-interconnected companies*"[188] and are characterized by the fact that they do not carry out trading on their own account and / or placement with guarantee, they are not authorized to hold client money and financial instruments[189]. In order to be defined as such, investment firms, pursuant to Article 12 of the IFR Regulation, must necessarily comply with the *categorization thresholds*, also known as indicators, which indicators selected are the *K-Factors*[190]. Class III companies, should respect these requirements:

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[186] (*For further informations, please see: Consultation Paper Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034, November 18, 2021, Available at: CP on RTS on Pillar 2 add-ons under IFD.pdf (Europa.eu)*)

[187] All investment firms that fall within this categorization are firms that do not carry out risky activities and follow the provisions of Article 12 of the IFR Regulation. The aforementioned article defines the limits and thresholds that companies must comply with and / or not exceed, in order to be defined as Class III investment companies. (*For further information, please see: IFR/IFD - A new prudential regime for EU investment firms, January 10, 2020, Available at: https://www.burges-salmon.com/news-and-insight/legal-updates/ifr-ifd-a-new-prudential-regime-for-eu-investment-firms and Art.12 Reg. 2019/2033/EU IFR*)

[188] Because of their small size, in some ways, they are less likely to cause widespread negative impacts for customers and markets if the risks inherent in their business materialize or if they fail.

[189] Some companies are characterized by the fact that in any case, the activities they carry out are never risky, or at least, do not involve a high risk for customers, markets or for themselves and, moreover, do not represent a threat to financial stability. (*For further information, please see: IFR/IFD - A new prudential regime for EU investment firms, January 10, 2020, Available at: https://www.burges-salmon.com/news-and-insight/legal-updates/ifr-ifd-a-new-prudential-regime-for-eu-investment-firms*)

[190] The methodology in question is based on a threshold approach, where the various indicators, so the investment firm is precluded from being a Class III firm if an indicator exceeds one of the predefined thresholds. Therefore, even if the companies belonging to the aforementioned category are not subject to the K Factors, they must nevertheless respect them. (*So that they can be classified as Class III enterprises*).

- *Assets Under Management* (*measured in accordance with Article 17 IFR*) < € 1.2 billion;
- *Client Orders Handled* (*measured in accordance with Article 20 IFR*) < either €100 million per day for cash trades, or €1 billion per day for derivatives;
- *Assets Safeguarded* and *Administered* (*measured in accordance with Article 19 IFR*) is zero;
- *Client Money Held* (*measured in accordance with Article 18 IFR*) is zero;
- *Daily Trading Flow* (*measured in accordance with Article 33 IFR*) is zero;
- *Net Position Risk* or *Clearing Margin Given* (*measured in accordance with Article 22 and 23 IFR*) is zero;
- *Trading Counterparty Default* (*measured in accordance with Article 26 IFR*) is zero;
- On- and Off-Balance Sheet Total < € 100 million;
- *Total Annual Gross Revenue* from Investment Services and Activities[191] < € 30 million.

The companies belonging to the category in question are subject to a *new simplified prudential regime*[192] based on *minimum capital* and *liquidity risk* and are subject to the supervision of the *National Supervisory Authority*[193]. For the latter, a simple

[191]Calculated as an average on the basis of the annual figures from the two-years immediately preceding the given financial year. (*For further Information, please see: Par.1(i) Art.12 Reg. 2019/2033/EU IFR*)

[192] Non-large and non-systemic investment firms as well as small and non-interconnected ones are excluded in principle from the scope of the EU Banking Code, and therefore from the provisions of the previous CRR / CRD package, this is because, as suggested by Brozzetti Antonella, reform prepared with the Investment Firms Regulation and Directive (IFD / IFR): first observations revolving around the new bipolar structure of European regulation and the new definition of "credit institution", the aim is to: "*separate the prudential framework preceding the current framework consisting of the IFD / IFR package*". (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 391-426, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/*)

[193] Furthermore, in addition to being subject to the new and simplified IFR / IFD regime together with Class II companies, (*as regards the Capital requirements*), the companies in question will have the opportunity to benefit from various

application of a *minimum own funds requirement* is envisaged. Such investment firms should have own funds equal to the *greater* of their *permanent minimum capital requirement* or a *quarter* (25%) *of their fixed overheads*[194] measured on the basis of their *previous year's activity*[195].

The categorization to which investment firms are subject is in no case definitive or permanent. As a matter of fact, it is possible for them to be able, in a certain sense, to "*Change*" the class they belong

exemptions and modifications, with respect to the regime to which they are subject, due to the fact that the risks they bear are mostly limited, or at least not systemic, and moreover, they do not represent a threat to financial stability. (*For further information please see: New prudential rules will apply from 26 June 2021, https://www.arthurcox.com/wp-content/uploads/2021/01/IFD-and-IFR-January-2021-v4.pdf, Investment Firms: New prudential rules will apply from 26 June 2021, Available at: https://www.arthurcox.com/knowledge/investment-firms-new-prudential-rules-will-apply-from-26-june-2021/ and The new prudential regime for investment firms, November 2019, Available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms*)

[194] Here you should remember that: "*Class III firms are subject to lighter requirements than Class II firms. Specifically, the capital requirement for a Class III firm is equal to the higher of its Fixed Overheads Requirement and Permanent Minimum Capital requirement*". Moreover: "The capital requirements set in the IFR, (*for Class II*) are composed of three items: 1) a fixed overheads requirement equal to a quarter of the annual fixed overheads of the firm; 2) a permanent minimum capital requirement of €75 000, €150 000, or €750 000, depending on the activities of the investment firm; 3) an overall "K-factor" capital requirement, which is the sum of "*K-factor requirements*" grouped in three categories: Risk-to-Client (RtC), Risk-to-Market (RtM), Risk-to-Firm (RtF). (*For further information, please see: For further information, please see: The new prudential regime for investment firms, November 2019, Available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms#Asdefined and Prudential rules for investment firms, Investment firms in the EU are subject to a dedicated prudential framework, proportionate to their size, activities and risks, available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-rules-investment-firms_en*)

[195] Class III Companies, are not be subject to the new K factor Requirement and do not use them to determine capital requirements (as Class II Companies do). For that, they only use the higher between the *Permanent Minimum Capital Requirements* or the *Fixed Overhead Capital Requirements*. However, Class III firms still need to calculate and respect the K-factors in order to determine in which class they fall. (*So they need to calculate their K-factors only for not for categorisation purposes the calculation of their capital requirements*). (*For further information please see: New prudential rules will apply from 26 June 2021, Available at: https://www.arthurcox.com/wp-content/uploads/2021/01/IFD-and-IFR-January-2021-v4.pdf and Deloitte, The impact of the new IFD/IFR regime An article series with five different perspectives, Available at: https://www2.deloitte.com/nl/nl/pages/financial-services/articles/what-does-this-categorization-of-firms-mean-for-me.html*).

to, if some conditions and requirements are met. (*For example, it is possible for a Class III investment firm to change its class, and become a Class II firm and vice versa*). A Class III Company may transform into a Class II Company immediately or after three months (*depending on the threshold in question*)[196]. If an investment firm no longer meets all the requirements to be considered as Class III, then it ceases to be regarded as a small, non-interconnected investment firm with immediate effect[197]. However, if it continues to meet certain requirements[198], then it will cease to be considered a small Class III after a period of three months after those thresholds have been exceeded. In a similar fashion to before, if a Class II Investment Company meets all the classification thresholds required[199], for an uninterrupted period of *six months*[200], without breaching those threshold during that period, and after the company informs its regulator without delay[201], we would finally have a transformation from a Class II investment firm to a Class III investment firm.

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[196](*For Further Information, please see: Paragraph (19) and Paragraph 3, Article 12 Reg. 2019/2033*)

[197] This happens, as indicated in Article 12 paragraph 3 of IFR regulation 2019/2033: "*If an investment firm no longer meets all the conditions referred to in paragraph 1, it immediately ceases to be considered a small non-interconnected investment firm*". (*For further information, please see: Par.3 Art.12 Reg. 2019/2033/EU IFR*)

[198] An investment firm, […], continues to meet the conditions set out in points (c) to (g) of that paragraph as indicated in Article 12 paragraph 3 Reg. 2019/2033/EU IFR.

[199] Reported in the same previous article, Paragraph Article 12 1 Reg. 2019/2033/EU IFR

[200] *Starting from the date on which those conditions are met*. Pursuant to Article 12 paragraph 4 of IFR Regulation 2019/2033, Article 25 paragraph 2 of Directive 2019/2034 IFD. (*For further information, please see: Art.12 Reg. 2019/2033 and Art. 25 Dir.2019/2034*)

[201] Furthermore, during this period, no breach of the thresholds in question must occur.

2.3 - Analysis of the Own Funds Requirements and Capital Requirements

As seen, due to the introduction of the new IFR/IFD Framework, we have an extension of the definition of *credit institution* and a new method of classification of investment firms, in different classes, based on their *riskiness* and/or *systemic importance*[202]. Furthermore, the Regulation establishes the various levels of application of the requirements, on an individual basis (*in relation to individual investment firms*), or consolidated basis (*in relation to groups of investment firms*). As previously mention, even though the aforementioned prudential framework, does not explicitly refer to the three Pillars, it adopts the same approach used in the Basel standards and implemented in the previous CRR II & CRD IV Package. (*Pillar I represents the minimum capital requirement applicable to all firms, Pillar II the supervisory discretion to impose capital add-ons and Pillar III a compulsory disclosure regime*). Investment firms subject to the IFR regulation will have to comply with and meet respective requirements relating to the *composition of own funds*, *capital requirements*, *concentration risk*, *liquidity requirements*, *disclosure requirements*, as well as the *publication of information* and *reports* to the *competent Authorities*[203]. Finally, they must comply with the requirements, and the methodology, referred to the *K-Factors*[204], always on an individual basis.

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[202] This new classification has meant that some companies (*Class I and I-Minus*) will remain subject to the previous CRR and CRD regulatory framework, while others (*Class II and III*) will be subject to the new IFR and IFD regime.

[203] In this regard, we can state how the various National Competent Authorities (NCAs), can exempt **all investment firms** from applying these rules on an individual basis, (*with the exception of the liquidity requirement*), when the companies in question can be classified as **belonging to Category III**, and when they come under supervision on a consolidated basis (*as they belong to a banking group or investment company and a series of other conditions are met as established by Art.6 of the IFR*). Furthermore, the exemption on an individual basis from the *liquidity requirement* is also possible for those Investment Companies subject to consolidated supervision because they belong to a banking group or because they belong to a SIM group to which prudential consolidation applies. (*For further information, please see: Donato Varani, Partner, Annunziata & Conso, Il Nuovo Framework Regolamentare delle SIM, December 16, 2021, Available at: https://annunziataconso.eu/it/il-nuovo-framework-regolamentare-delle-sim / and Art.6 Reg. 2019/2033/EU IFR*)

[204] In particular, it is worth noting that, as described above, *only **Class II Firm** have the obligation to Follow and Comply with the provisions of the **K-Factors***, and with those contained in the Regulation IFR itself. While, although this obligation doesn't exist for Class III Firms, they still have to respect them, or use them, only for their Categorization Purposes, in order to be classified as such.

2.3.1 – (Follow) Capital requirements and own funds for Class I & I-Minus companies

With the new IFR Regulation, all investment firms that can be defined as Category I and I-Minus, (*which include investment firms that can be deemed as Credit Institutions pursuant to the new article 4 CRR II, amended by article 62 IFR*[205]), must calculate their capital requirements in accordance with the same CRR II Regulation, thus remaining subject to the previous *prudential* and *remuneration* requirements existing in the previous regulatory framework[206].

2.3.2 – (Follow) Capital and own funds requirements for Class II companies

The same thing, however, cannot be sad for investment firms that fall into categories II and III. This is because, unlike the former, *they neither represent a serious threat to financial stability, nor do they constitute a threat to the financial system*. This feature, together with the fact that both Class II and Class III companies, (*within the new IFR / IFD framework*), are not defined as credit institutions, has meant that the latter two hold and calculate their capital requirements pursuant to IFR regulation[207], instead of following the provisions of CRR II regulation.

However, (*although these two apply the rules contained in the IFR*), the amount of funds that companies must possess, (*and the dynamics to which they will be subjected*), will differ widely between one category and another. In particular, we should stress that, (*in line with the provisions of Article 9 IFR and Article 11 IFD*), investment firms shall have *Own Funds* consisting of the sum of

[205] The "new" article 4 CRR II , (*which regards the definition of investment firm*), amended by article 62 IFR, sets the definition of a credit institution as a company whose value of the company's consolidated assets is equal to or greater than €30 billion. (*For Further Information, please see: Regulation 2019/2033/EU Art.62 Par.3 Lett.b Point I, II, III*)

[206] As previously mentioned, the logic behind this decision, have to be found in the fact that such companies have a business model, risk profile and a systematic importance, very similar to banks and, moreover, they possess a much higher riskiness than other "smaller" investment firms. Therefore, *from my standpoint*, in order to guarantee a greater safeness and stability for the whole European financial market, it actually makes sense to subdue such companies to the "older" and much "strict" regulatory framework (CRR-CRD).

[207] In this regard, the companies subject to the discipline established by the IFR Regulation, on the subject of own funds requirements, follow the provisions of articles 9 and 10. (*For further information, please see: Arts. 9 and 10, Reg. 2019/2033/EU*)

their *Common Equity Tier 1 capital*, *Additional Tier 1 capital* and *Tier 2 capital*. Such "*qualitative composition*"[208] should be equal to:

a. $\frac{\text{Common Equity Tier 1}}{\text{D}^{209}} \geq 56\%$

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

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

In particular, with reference to Category II companies[210], they must hold an amount of *Own Funds*[211], (*calculated by applying the provisions contained in the CRR II with certain exceptions provided for in the IFR*), which at least is equal to the higher of the following values:

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[208] So, the structure of the total *Own Funds* required by investment Firm. (*How the total Own Funds Requirements, should be divided*). 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. (*For further information, please see: Art. 9 IFR, Art. 11 IFR, Art. 11 IFD*)

[209] **D** is defined by Article 11 of IFR regulation 2019/2033, as the highest of the following elements:

- their requirement relating to overhead fixed costs calculated in accordance with Article 13: (*Requirement relating to overhead fixed costs*)
- their permanent minimum capital requirement pursuant to Article 14: (*Permanent minimum capital requirement*)
- their requirement relating to the K-Factors calculated pursuant to Article 15: (*Requirement relating to the K-factors and applicable coefficients*).

(*For Further information, please see: Regulation 2019/2033/EU Art.11/ Art.13/ Art.14/ Art.15 and Prudential rules for investment firms, Investment firms in the EU are subject to a dedicated prudential framework, proportionate to their size, activities and risks, available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-rules-investment-firms_en*)

[210] Class II companies are the only ones to calculate their capital requirement on the basis of K-Factors. In addition, Class III companies do the same, but unlike the former, the latter calculate these K-Factors only for Categorisation purposes and not to quantify their Capital and Own Funds Requirements.

[211] Own Funds Consisting of the sum of Common Equity Tier 1, additional Tier 1 and additional Tier 2, under certain conditions. (*For further information, please see Investment Firms: New prudential rules will apply from 26 June 2021,*

1. **Fixed Overhead Requirement**: A requirement equal to 25% of the annual fixed overheads (*referring to the previous year*)[212];

2. **Permanent Minimum Capital Requirement**: A *minimum initial capital requirement*, (*as defined pursuant to art. 9 and 11 of the IFD*)[213]. Through the new K-Factor regime, introduced with the IFR, we have that the *minimum initial capital requirement* plays the role of "*threshold*" for all the levels of capital required by the new framework. The permanent minimum capital requirement (*required on an ongoing basis*) must amount at least to the levels of the initial capital requirement (*required in the authorization phase*). The initial capital requirement, (*as established by Article 9 of the IFD Directive*), is based on the MiFID II *services* and *activities* that an investment firm is authorized to perform or intends to offer. The *Minimum requirements* are equal to:

Activities (***Pursuant to Annex I of the MiFID II directive***)	**Minimum initial capital requirement**
• Trading on own account, subscription, and/or placement of financial instruments on the basis of a firm commitment	**€ 750,000.00**

January 25, 2021, Available at: , https://www.arthurcox.com/knowledge/investment-firms-new-prudential-rules-will-apply-from-26-june-2021/, The new prudential regime for investment firms, November 2019, Available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms#section3 and Arts. 9 and 10, Reg. 2019/2033/EU)

[212] (*For further information, please see: European Commission, Prudential rules for investment firm, Investment firms in the EU are subject to a dedicated prudential framework, proportionate to their size, activities and risks, Available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-rules-investment-firms_en*)

[213] This **Minimum Capital Requirement** or **Permanent Minimum Capital Requirement** is usually included between €75,000 and €750,000, depending on the *investment services* and *activities* provided by the firm. (*For further information, please see: European Commission, Prudential rules for investment firm, Investment firms in the EU are subject to a dedicated prudential framework, proportionate to their size, activities and risks, Available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-rules-investment-firms_en*)

• Operation of an organised trading facility (*only for investment firms that trade on their own account, or which are authorized to carry out transactions on their own account*)	**€ 750,000.00**
• Other firms that do not hold client money or securities	**€ 150,000.00**
• 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 (*but not holding client money or securities*)	**€ 75,000.00**

3. **K-Factor**: Finally, the Requirement calculated according to the *K-Factors methodology*. With reference to this methodology, (*regarding K-Factors*), it was introduced with the Regulations in question. It divides the risks into three different types, *which aim to capture the risk that the investment firm may pose to clients, to market access or liquidity or to the investment firm itself*. So that, we will have the *Risk-to-Client* (RtC), *Risk-to-Market* (RtM) and *Risk-to-Firm* (RtF). For each of these types of risk, various variables are required to calculate the *capital requirement*.

Risk Type	K-Factor	Coefficient (%)
Risk-to-Client (RtC)[214]	**Assets under management (K-AUM)**	**0.02%**
	Customer money held (K-CMH)	

[214] This represents the most important risk element for investment firms, because it represents the potential damage that a company can cause to its customers with its business. The value that RtC assumes, as previously described, will be equal to the sum of the different elements that compose it, hence K-AUM, K-CMH, K-ASA and K-COH, multiplied by a corresponding coefficient, as outlined in Article 16 IFR. (*For further information, please see: Donato Varani, Partner, Annunziata & Conso, Il Nuovo Framework Regolamentare delle SIM, December 16, 2021, Available at: https://annunziataconso.eu/it/il-nuovo-framework-regolamentare-delle-sim/, The new prudential regime for investment firms, November 2019, available at: https://www.nortonrosefulbright.com/en/knowledge/publications/f6b2e0a7/the-new-prudential-regime-for-investment-firms,and Art.15, 16 Reg. 2019/2033/EU*)

	• (**K-CMHS**): "*Client money held on separate accounts*"	**0.4%** (*segregated accounts*)
	• (**K-CMHNS**): "*Client money held on non-separated accounts*"	**0.5%** (*non-segregated accounts*)
	Assets held on behalf of customers (K-ASA)	**0.04%**
	Customer orders processed (K-COH)	
	• (**K-COHC**): "*customer orders handled in spot Transactions*"	**0.1%**
	• (**K-COHD**): "*client orders handled in derivatives transactions*"	**0.01%**
Risk-to-Market (RtM)[215]	**Net Position Risk (K-NPR)**	**N/A**
	Clearing Margin Given (K-CMG)	**N/A**
Risk-to-Firm (RtF)[216]	**Trading Counterparty Default (K-TCD)**	**N/A**
	Daily Trading Flow (K-DTF)	
	• (**K-DTFC**): "*Daily Trading Flow on Cash*"	**0.1%**

[215] RtM, covers all positions in the trading book of an investment firm, trading on their own account, for themselves or on behalf of a client, which relate to positions in *debt instruments*, *equity entities*, and *collective investment schemes*. RtM, comprise the *Net Position Risk* (K-NPR), and the *Clearing Margin Given* (K-CMG), both calculated, respectively, in accordance with Articles 22 and 23 of the IFR Regulation.

[216] The K-Factors under the RTF, concern the *exposure of an investment firm to a possible insolvency of its commercial counterparties*, (K-TCD*)*, the *risk of concentration in the large exposures of an investment firm towards specific counterparties*, (K- CON) and finally concerns the *operational risks deriving from the daily trading flow of an investment company*, (K-DTF), which can take place with *Cash*, (K-DTFC) or via *Derivatives* (K-DTFD). The RtF is equal to the sum of its K-Factors, K-TCD, K-DTF and K-CON, calculated and multiplied with the respective coefficient in accordance with the IFR regulations.

• (**K-DTFD**): "*Daily Trading Flow on Derivatives*"	**0.01%**
Concentration Risk (K-CON)[217]	**N/A**

The sum of the products between K-Factors and the coefficient, represents the capital requirement for investment firms. (*The overall position of the K factor is a sum of the K factors with respect to the three risk heads*).

2.3.3 – (Follow) Capital and own funds requirements for Class III companies

While, regarding the Investment Firms, that can be categorized as belonging to Class III, for them is expected a different regime, slightly different from those applied to Class I/I-Minus and II Firms. Since these firms are defined as "*small, non-systematically important and not so much interconnected*", they will pose a smaller "*threat*", to the financial stability. Consequently, they are only required to hold minimum own funds based on the *greater* of their *Fixed Overhead Requirement* or *Permanent Minimum Capital Requirement*, and so, because of this, they will not be subject to the K-Factor requirement. So that, here, *for Class III Investment Firm,* the minimum level of Own Funds, *cannot be lower than the highest amount*, between 25% of the annual fixed overheads (*referring to the previous year*) or the Permanent Minimum Capital Requirement, (*as described in the preceding points*). Moreover, these firms *are not subject to the K-Factors methodology, like Class II Firms* (Although they still have to calculate these K-Factors for Categorisation purposes only).

The following table summarizes the various capital requirements for each company from Class I to Class III[218].

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[217] Referring to the concertation risk, treated with K-CON, the value of the exposure to a single customer or a group of connected customers cannot exceed 25% of own funds or €150 million, if the client or group of related clients is a credit institution or an Investment Firm. However, in the event that the amount of €150 million is greater than 25% of the investment firm's own funds, then, the *permitted concentration limit* must be equal to, or in any case must not exceed, 100% of the investment firm's own funds. (*For further information, please see: Art.37 (1), Reg.2019/2033/EU IFR*). If this limit is exceeded, then the company in question must notify this exposure to the competent authorities and hold an additional own funds requirement represented by the K-CON, calculated following the provisions contained in The Regulation IFR, Article 39 (2).

[218] Remember that: "The IFR and the IFD apply to investment firms deemed sufficiently small and non-interconnected ("Class III" firms) and to investment firms not falling under any of the other categories ("Class II" firms). The large

Category	Requirements
I & I-Minus	As outlined by IFR & IFD, the companies belonging to category I and I-Minus, (*the largest and most risky defined as credit institutions*), must calculate the capital requirements pursuant to the previous Regulation CRR / CRR II & CRD IV / V, (*the same applied also to Banks and Credit Institution*), for this reason the K-Factors are not used to calculate the capital requirements. (*Therefore, while Class I Firms have to apply to be authorised as credit institutions, Class I-Minus Firms remain authorised as investment firm*[219]).
II	The own funds requirements composition, should be equal to: a) $\frac{\text{Common Equity Tier 1}}{\text{D}} \geq 56\%$ b) $\frac{\text{Common Equity Tier 1+ Additional Tier 1 capital}}{\text{D}} \geq 75\%$ c) $\frac{\text{Common Equity Tier 1+ Additional Tier 1 capital+Additional Tier 2 capital}}{\text{D}} \geq 100\%$ The Capital Requirements for a Class II Firm is equal to the higher than its *Fixed Overheads Requirement*, *Minimum Permanent Capital Requirement* and the *overall capital requirement calculated according to the K-Factor method*. Specifically, we have: • **Fixed Overheads Requirement:** Requirement equal to 25% of overhead fixed costs referring to the previous year;

majority of EU investment firms fall in these two categories". (*For further information, please see: Prudential rules for investment firms, Investment firms in the EU are subject to a dedicated prudential framework, proportionate to their size, activities and risks, Available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-rules-investment-firms_en*).

[219] (*For further information, please see: Prudential rules for investment firms, Investment firms in the EU are subject to a dedicated prudential framework, proportionate to their size, activities and risks, Available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-rules-investment-firms_en*).

	• **Minimum Permanent Capital Requirement**: The initial capital as defined by art. 9 and art. 11 of the IFD[220]; • **Requirement calculated according to the K-Factor method**.
III	The own funds requirements composition, should be equal to:

a) $\frac{\text{Common Equity Tier 1}}{\text{D}} \geq 56\%$

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

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

Class III Firms are subject to lighter requirements than Class II Firms. The Capital Requirements for a Class III Firm, must be equal to, *and therefore cannot be lower than*, the higher of its *Fixed Overheads Requirement* or *Minimum Permanent Capital Requirement*. Specifically, we have:

• **Fixed Overheads Requirement:** Requirement equal to 25% of overhead fixed (*costs referring to the previous year*);

• **Minimum Permanent Capital Requirement:** The initial capital as defined by art. 11 of the IFD.

K-Factors are still calculated, although only for Categorisation purposes.

[220] The initial capital of investment firms was determined and selected in accordance with Article 9 of Regulation (EU) 2019/2033. (*For Further information, please see: Regulation 2019/2033/EU Art.9*)

2.4 - The Liquidity Requirements defined by the IFR Regulations

The introduction of the new framework has also brought news regarding liquidity. The IFR/IFD Regulatory Package, bring change to the liquidity requirement for investment firms, requiring all investment firms to have *internal procedures* to *monitor* and *manage* their *liquidity requirements*. (*Those procedures should support liquidity management in an orderly manner over time so that the firm does not need to set aside liquidity specifically for times of stress*).

In detail, with the new regulation, investment firms will be required to comply with a new discipline regarding the *liquidity requirement*[221], which represents a *proportionate* and *additional requirement*, (compared to the capital and own funds requirements described above[222]). It request that all investment firms deemed as *not small and interconnected*[223], (*and therefore classified as belonging to categories I, I-Minus and II, with the exception of Class III Firms*), will have the obligation to hold

[221] In addition to this, we must remember how, according to this regulation, all investment firms, or almost all, will have the obligation to comply with the liquidity requirements. However, while it is undoubtedly true that all firms that fall within the scope of the IFR / IFD **must meet this liquidity requirement**, (*at least one third of the fixed capital requirement for overheads*), it is equally true that, in some cases, (*pursuant to Article 43 IFR*), the competent authorities of the Member States have the right, upon notification to the EBA (*European Banking Authority*), in consultation with the ESMA (*European Securities and Markets Authority*), to exclude or exempt a class III company, from compliance with the requirement in question, due to the "Low" risk that these companies represent towards financial stability. Pursuant to Article 43 Point 4: "*The competent authorities may consider, in exempting from the liquidity requirement, investment firms, [...], small and not interconnected*". (*For further information, please see: Art. 43 Par. 1 and 4 Reg. 2019/2033/EU IFR and IFR/IFD – liquidity requirements,* https://www.dnb.nl/en/sector-information/supervision-sectors/investment-firms/prudential-supervision/ifr-ifd/ifr-ifd-liquidity-requirements/).

[222] Which are characterized by a *non-uniform application*, based on the *systematic nature*, *importance*, *size*, *riskiness* and *interconnection* that characterize the companies in question, which has a certain importance, because, through it, it is possible to ensure that investment companies have *sufficient liquidity* to operate and / or liquidate your operations, in an orderly manner.

[223] *As indicated by Article 12 IFR, (which do not comply with Article 43 Par. 4 IFR), "By way of derogation from the first subparagraph of this paragraph, competent authorities* ***may exempt investment firms*** *that meet the conditions for qualifying as* ***small and non-interconnected investment firms*** *set out in Article 12(1) from the application of the first subparagraph of this paragraph and shall duly inform EBA thereof". (For further information, please see: Article 43 Reg. IFR)*

liquid assets or *readily liquid assets*[224], equal to at least *one third of the requirement relating to fixed overheads* or the *requirement for overhead fixed costs*, (*calculated in accordance with Article 13 (1)*[225]). Also within the IFR, investment firms have the right to temporarily reduce the amount of liquid assets held, (*only in exceptional circumstances*[226] and only with the approval of the competent authority[227]). Furthermore, the new IFR Regulation, identifies all the types of assets that can be constitute as liquidity assets, (*in line with Article 43*). Specifically, firms may treat and consider the following *assets* as *liquid assets*:

- The HQLA referred to in Articles 10 to 13 and 15 of *Delegated Act on the Liquidity Coverage Ratio*. However, *for the assets referred to in Article 15*, there is a threshold of €50m rather than €500m (*shares or units in collective investment schemes*).
- Financial instruments trading on a liquid market (*subject to a haircut of 55%*).
- Unencumbered short-term deposits at a credit institution.
- Finally, only for investment firms that meet the conditions for qualifying as *small and non-interconnected*, (*Class III Firms*), and firms *not dealing on own account*, *underwriting* or *placing financial instruments* on a *firm commitment basis*, may include, (and consider as

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[224] For *readily liquid assets*, (pursuant to Article 43, part 5 1, IFR Regulation), we may include current *accounts*, *liquid assets* identified under Regulation 2015/61/EU and *financial instruments* traded on a trading venue and for which there is a liquid market subject to a *55% haircut*, as well as *unrestricted short-term deposits* with a credit institution. The Investment Firms of Category III and those of Category II, (that do not carry out *trading on their own account* and *placement with guarantee*), may also include among **their liquid assets**: *trade receivables* and *commissions* to be received within thirty days, under certain conditions. (*For Further information, please see: Donato Varani, Partner, Annunziata & Conso, Il Nuovo Framework Regolamentare delle SIM, December 16, 2021, Available at: https://annunziataconso.eu/it/il-nuovo-framework-regolamentare-delle-sim/ and Art.43 Reg. IFR*)

[225] (*For further information, please see: Article 43 Reg. IFR*)

[226] With exceptional circumstances, we define, all those circumstances in which the investment firm fails to otherwise meet its short-term liquidity needs.

[227] In this regard, in order to temporarily reduce the amount of liquid assets, companies must provide the competent authorities with information regarding the reasons underlying this request, (*for which it is not able to meet this requirement*), a plan in which the investment firm demonstrates how it will be able to meet liquidity needs again within thirty days and finally a recent liquidity report dating back no more than three days. (*For further information, please see: IFR/IFD – liquidity requirements, https://www.dnb.nl/en/sector-information/supervision-sectors/investment-firms/prudential-supervision/ifr-ifd/ifr-ifd-liquidity-requirements/*)

liquid assets), *receivables from trade debtors*, *fees* and *commissions receivable* within 30 days. (*If those receivables comply with certain conditions*[228])

In the Table below, we summarize the *new liquidity requirement*, set by the new discipline:

IFR - Liquidity Requirement

- Investment firms should hold a minimum of one third of their fixed overheads requirement in liquid assets at all times. ($Liquidity\ Assets\ \geq \frac{1}{3}\ Fixed\ Overheads\ Requirement$)[229]

- Investment firms shall increase their liquid assets by 1,6 % of the total amount of guarantees provided to clients[230].

That said, the objective that the legislator aspires to achieve, *with the new regulations on Liquidity*, is in the first place that of obliging companies, *which can or could represent any threat to financial stability*, to possess enough liquid assets, readily usable, in case of need, or during times of stress, to *cover the expenses that could ari*se. Secondly, is to try to ensure that investment firms can function in an orderly manner over time, *without the need to set aside liquidity specifically for periods of stress*[231].

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[228] Although, in this case, those receivables should comply with these conditions: they are account for up to a maximum of one third of the minimum liquidity requirements; they are not to be counted towards any additional liquidity requirements required by the competent authority for firm-specific risks; and they are subject to a haircut of 50%. (*For further information, please see: Article 43 Reg. IFR*)

[229] Where: $\left(Fixed\ Overheads\ Requirement\ \geq \frac{1}{4}\ Fixed\ Overheads\ for\ the\ Preceding\ Year\right)$

[230] In line with Article 45, Reg. IFR. (*For further information, please see: Article 45 Reg. IFR*)

[231] For this reason, it was decided to place the obligation on investment firms to possess, **at all times**, at least one third of their fixed overheads requirement in *liquid* or *readily liquid assets*.

3 - The New Directive IFD

Another great emphasis is brought forward by the entry into force of the new Directive 2019/2034/EU "IFD", which, similarly to the *IFR Regulation*, complements the previous regulatory regime without however *replacing it*[232]. This directive completes the "*reform cycle*", started on the one hand with the *IFR Regulation*[233], aimed at modifying and "*updating*" the previous regulatory framework, however focusing more on issues concerning the initial capital required of investment firms.

Therefore, what the IFD directive achieves is to establish *new prudential requirements* and *supervisory measures* adapted to the risk profile and business model of investment firms, thus pursuing the aim of *safeguarding financial stability*. The achievement of these objectives, *through these measures*, results in the creation of rules aimed at regulating the level of initial capital required by *investment companies*[234], and in defining rules concerning the supervisory tools and powers. It also resulted in the development of a *prudential supervision* by competent authorities, as well as disclosure requirements for competent authorities in the area of prudential regulation and supervision of investment firms. The Topic on which the IFD Directive has possibly put greater emphasis, or on which, in my opinion, has introduced more changes, is certainly represent by the *Initial Capital*[235], required to all investment firms. With the entry into force of the new IFD Directive, we have introduced important changes to the previous Directives, (*concerning in particular the previous CRD*

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[232] A very important and innovative aspect from certain points of view is correlated with the fact that, before the adoption of the new regulatory package composed of the IFR & IFD, investment firms were subject to the same rules on capital management, liquidity and risk management, applied to banks. (*For further information, please see: Directive 2019/2034 /EU*)

[233] The IFR Regulation, unlike the IFD Directive, mainly focused on the prudential requirements that investment firms must comply with, making changes and defining the rules on own funds requirements, on concentration risk requirements, of liquidity, even going so far as to include the related reporting and disclosure obligations to the public, as well as the methods for determining the capital requirements.

[234] Taking into consideration both the type of activity carried out and the possibility for investment firms to hold or not client assets, such as money and / or financial instruments.

[235] When we refer to the "Initial Capital", we refer to the amount of resources, money that companies need to own in order to operate in the market as investment firms, and start their investment business. (*For further information, please see: Articles 9 and 11 Directive 2019/2034/EU*)

IV), aimed at changing both the *discipline* and the *minimum amount required* to the companies operating in the investment sector and in the management of customer's money. Secondarily, going as far as the complete replacement[236] of the previous regulations on the subject of *Initial Capital*[237].

Therefore, if with the previous directive, (CRD IV), the minimum capital required of companies operating in the investment sector, *with some exceptions as indicated in articles 28 to 31*, was quantifiable in € 1 million, with the introduction of the new IFD directive, we have that this threshold is reduced to € 750,000.00. In Particular, we have that that reduction affects only all those investment companies that carry out one of the activities listed in Annex 1, points 3 and 6, of the MiFiD II directive, (*thus those companies that they carry out a trading activity on their own account, or an activity of Underwriting of financial instruments and / or placement of financial instruments on the basis of an irrevocable commitment*). Therefore, thanks to the new IFD Directive, we would have that the capital requirements for these companies drop to € 750,000.00.

However, *the innovative intervention carried out by the legislator*, does not stop there. It is not limited to the companies authorized to carry out certain activities, but rather, it goes deeper, reaching, *albeit with different interventions and amendments*, all the types of companies that carry out at least one of the nine activities listed in the aforementioned previous Annex, discriminating against companies, also on the basis of their possibility of being able to *hold or not customer money or securities*. For this reason, similarly to before, we would have that in the case of companies that carry out an activity of *management of multilateral trading facilities (MTF)*, as indicated in point 8 of the previous Annex, we would have that the requirements will be set at € 150,000.00, instead of € 1,000.000.00[238]. Whilst, the initial capital of an investment firm authorised to provide or carry out an activity of management

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[236] With the introduction of the new Directive 2019/2034 / EU, we have that the references to the initial capital levels, which were previously set by Directive 2013/36 / EU in articles 28 → 31, are "De Facto" completely replaced.

[237] We must add that, as regards both the application of the new capital requirements and their amount, introduced with the new discipline, we have that one of the aspects that most characterize it is represented by the "*discrimination*" or "*classification*" existing between the investment firms. That discrimination is mainly base on the activities carried out, on their work, as well as on their possibility, whether or not they are authorize to hold financial instruments (*such as stocks or bonds*) or the money of their clients. These aspects characterize the innovative intervention of the legislator, made with the new discipline and its intent.

[238] Therefore, we will have a drop from € 1 million to € 150 thousand. (*For more Information, please see: Dir. 2019/2034, Art. 9. Par. 3*)

of *organized trading facilities (OTF)*[239], (*that carries out trading on its own account or is authorize to do so*), shall be equal to € 750,000.00[240].

The changes made by the legislator to the previous directive, come to include all those investment firms that carry out one of the following activities: *Reception and transmission of orders (1)*, *Execution of orders on behalf of clients (2)*, *Portfolio management (4)* or *Consultancy activities (5)* in the field of investments, as well as the *placement service of financial instruments (7)*[241]. However, in this case, the modifying intervention makes a distinction between companies *who are authorize* to hold client money or securities, and those *who are not authorize* to hold client money or securities.

The former, *the companies enabled to carry out one of the activities listed above and authorized to hold customer money or securities*, would see the required initial capital threshold drop to € 150,000.00. The previous directive provided for an initial capital of € 1 million, (*only in the case of companies authorized to hold client money or securities*).

While the latter, *the companies enabled to carry out one of the activities listed above without being authorized to hold customer money or securities*, similarly to the first, will see the required initial capital threshold drop to € 75,000.00, (*only in the event that Investment firms are not authorized to hold customer liquidity and securities*). Originally, the previous directive provided for a minimum capital threshold of € 125,000.00 for such companies that met this *last requirement*[242].

The following table below shows the new *levels of initial capital* required by the various investment companies under the new Directive 2019/2034/EU IFD, (*on the basis of the investment activity or service carried out, pursuant to Directive 2014/65/EU MiFiD II Annex I*), which replace those required by the previous Directive 2013/36/EU CRD IV.

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[239] As reported in point 9, Section A of the same Annex. (*For further information, please see: Directive 2014/65/EU MiFiD II, Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN*)

[240] (*For more Information, please see: Dir. 2019/2034, Art. 9. Par. 4*)

[241] *Again, by virtue of the MiFiD II Directive in points 1,2,4,5, and 7 of Annex 1.*

[242] Investment firms that not authorized to hold client money or securities.

Activities carried out by investment firms *(Pursuant to Directive 2014/65 / EU MiFiD II Annex I)*	**Initial capital *(Previous Regime, Directive CRD IV / V, until June 26, 2021)***	**Initial capital *(Current Regime, IFD Directive, from 26 June 2021)***
Dealing on own account (Point 3) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis. (Point 6) Management of organized trading facilities (OTF). (Point 9)	**€ 1.000.000,00**	**€ 750.000,00**
Investment firms not authorized to hold client money or securities		
Reception and transmission of orders in relation to one or more financial instruments. (Point 1) Execution of orders on behalf of clients. (Point 2) Portfolio management. (Point 4) Investment advice. (Point 5) Placing of financial instruments without a firm commitment basis. (Point 7)	**€ 125.000,00**	**€ 75.000,00**
Investment firms authorized to hold client money or securities		

Reception and transmission of orders in relation to one or more financial instruments. (Point 1)	**€ 1.000.000,00**	**€ 150.000,00**
Execution of orders on behalf of clients. (Point 2)		
Portfolio management. (Point 4)		
Investment advice. (Point 5)		
Placing of financial instruments without a firm commitment basis. (Point 7)		
Management of multilateral trading facilities (MTF). (Point 8)	**€ 1.000.000,00**	**€ 150.000,00**

Therefore, based on the amendments introduced by the IFD directive to the initial capital requirements required by investment firms, (*as reported in the previous table*), we can affirm that the main objective that the Legislator has set itself to achieve is the *general lowering*[243] of the various thresholds required to investment firms in order to operate[244]. Although these changes aimed at reducing capital requirements, at first glance, may seem like some kind of contradiction, apparently in contrast with the desire to make the market and operating companies more solid and resilient to potential crises and periods of stress[245], in reality, they follow a very specific logic and objective. The new *prudential regime*[246], and the *related supervisory action*, are proposed as more attentive to the business models chosen by financial intermediaries and investment firms, *also appearing to be much more risk-sensitive than the previous regim*e, and therefore, it should ensure a *reduction in compliance costs*, thus also *stimulating the entry of new operators* and *new businesses* into the single

[243] In general, the main change is, with some exceptions, the reduction of the capital requirements from €1 million to €750 thousand, as reported in the table above.

[244] This is based both on the activities carried out and on the basis of whether or not they are authorized, or not, to hold client money or securities.

[245] Therefore appearing as a sort of involution that nullifies all the work and progress made previously.

[246] Composed by the IFR and IFD.

financial market[247]. So that, the goal that the legislator wants to achieve, through the new regime and amendments, *according to my way of thinking*, is to try to increase[248] the number of companies operating in the investment sector or carrying out one of the activities listed in the MiFiD II directive. Furthermore, through the achievement of the aforementioned objective, the legislator aspires to make the regulation behind such enterprises much lighter and "*efficient*". Therefore, we can affirm how, through them, the legislator wanted to make the discipline for investment firms *more simplified*, so as to be able to *increase the number* and *presence of the latter in the market*.

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[247] (*For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (Ifd/Ifr): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 396, 417, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/*)

[248] In fact, by reducing the initial capital requirements that companies must possess, we can increase the number of companies operating in the investment sector and customer capital management, making access to certain activities listed in the Mifid directive considerably easier.

4 – The Italian Case: The impact of the new discipline over the Italian SIMs

The previous regulatory framework around Italian investment firms, the SIM ("*Società di Intermediazione Mobiliare*" or *Securities Brokerage Company*), through the presence of the TUB and the TUF, was characterized by the existence of a separation of supervision between the two main Italian NCAs, (*namely the Bank of Italy and CONSOB*). With the publication of the IFD Directive and the IFR Regulation in the European Official Journal on 5 December 2019, (*and with the obligation to transpose and implement the provisions contained therein, in each individual member country*), it was later approved, and then implemented, in Italy the *legislative decree n.201*[249]. The main objective of the legislative decree in question[250], was aimed at adapting the national legislation to the provisions, established at European level, of Directive 2034/2019/EU (IFD)[251] and Regulation 2019/2033/EU (IFR)[252], both published in the European gazette on December 5, 2019. This two

[249] This decree concerns the: "*Rules for adapting national legislation to the provisions of Directive (EU) 2019/2034, [...], and to the provisions of Regulation (EU) 2019/2033*". (*For further information, please see: https://www.normattiva.it/uri-res/N2Ls?urn:nir:stato:decreto.legislativo:2021-11-05;201*)

[250] This decree incorporates the legislation (IFD) and adapts the Italian legal system to the legislation (IFR). (*For further information, please see: Dipartimento per le Politiche Europee, Direttiva (UE) 2019/2034 e Regolamento (UE) 2019/2033,* October 29, 2021, *Available at: https://www.politicheEuropee.gov.it/it/normativa/recepimento-atti-ue/20192034-e-20192033/, Decreto Legislativo 5 novembre 2021, n.201, Available at: https://www.normattiva.it/uri-res/N2Ls?urn:nir:stato:decreto.legislativo:2021-11-05;201,* Diritto Bancario, *IFD e IFR: approvato in esame preliminare il decreto di attuazione,* August 6, 2021, Available at: https://www.dirittobancario.it/art/ifd-e-ifr-approvato-esame-preliminare-il-decreto-di-attuazione/ and Diritto Bancario, *IFD e IFR: in GU il decreto di attuazione*, December 2, 2021, Available at: https://www.dirittobancario.it/art/ifd-e-ifr-in-gu-il-decreto-di-attuazione/)

[251] Relating to 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. (*For further information, please see: Senato – Camera dei Deputati, Vigilanza prudenziale sulle imprese di investimento Atto del Governo 287, Available at: https://www.senato.it/service/PDF/PDFServer/BGT/01309498.pdf and Decreto Legislativo 5 novembre 2021, n.201, Available at: https://www.normattiva.it/uri-res/N2Ls?urn:nir:stato:decreto.legislativo:2021-11-05;201*)

[252] Relating to the prudential requirements of investment firms and amending regulations (EU) no. 1093/2010, (EU) n. 575/2013, (EU) no. 600/2014 and (EU) no. 806/2014, TUF and TUB. (*For further information, please see: Senato – Camera dei Deputati, Vigilanza prudenziale sulle imprese di investimento Atto del Governo 287, Available at: https://www.senato.it/service/PDF/PDFServer/BGT/01309498.pdf and Decreto Legislativo 5 novembre 2021, n.201, Available at: https://www.normattiva.it/uri-res/N2Ls?urn:nir:stato:decreto.legislativo:2021-11-05;201*)

Measures in question, define a new prudential regime for investment firms, also providing for a differentiated discipline with respect to credit institutions, which takes into account the *size*, *activities carried out* and the *risks of the different types of investment firms*, providing in addition, the subdivision of the investment firms themselves into *three distinct categories*[253]. In order to pursue this objective and to apply the provisions of the latter, within the Italian framework, the aforementioned *legislative decree no. 201*, implements changes and amendments regarding the legislative decree 24 February 1998, n. 58, (*Also known as the "Testo Unico delle Disposizioni in Materia di Intermediazione Finanziaria" or "TUF"*), as well as the legislative decree no. 385, (*Also known as the "Testo Unico delle Leggi in Materia Bancaria e Creditizia" or "TUB"*) introducing into the Italian national law, *as mentioned above*, both a *specific discipline for all Class I investment companies*, and an *expansion of the definition of credit institution*. Such amendments aimed to *simplify the regime previously in force* and *clarify the functions and powers of the competent authorities*[254].

After the final approval of the draft decree by the Council of Ministers, (*on 29 October 2021*), and with its subsequent publication in the Official Gazette no. 286 of 1 December 2021, of *Legislative Decree no. 201*, we have the *effective application of the latter,* and therefore, the effective application of the European IFR and IFD discipline[255]. The innovations introduced on December 2 of the past

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[253] Which, as seen previously, are Class I, I-Minus, II and III .(*For further information, please see: Above in Chapter 3 and Dipartimento per le Politiche Europee, Direttiva (UE) 2019/2034 e Regolamento (UE) 2019/2033, October 29, 2021, Available at: https://www.politicheEuropee.gov.it/it/normativa/recepimento-atti-ue/20192034-e-20192033/*)

[254] (*For further information, please see:* Diritto Bancario*, IFD e IFR: approvato in esame preliminare il decreto di attuazione,* August 6, 2021, Available at: https://www.dirittobancario.it/art/ifd-e-ifr-approvato-esame-preliminare-il-decreto-di-attuazione/ and Diritto Bancario, *IFD e IFR: in GU il decreto di attuazione*, December 2, 2021, Available at: https://www.dirittobancario.it/art/ifd-e-ifr-in-gu-il-decreto-di-attuazione/)

[255] Therefore, the decree in question, (*which entered into force on December 2, 2021*), following the enactment of the Delegation Law n.53 of April 22, 2021, and after approval by the lower house, the senate and by the council of ministers, has therefore led to the implementation of all the aspects provided for in the IFD Directive and the IFR Regulation, in the Italian National Law. Such Delegation Law n.53: "*Delegation to the Government for the transposition of European directives and the implementation of other European Union acts*". (*For further information, please see: Dipartimento per le Politiche Europee, Direttiva (UE) 2019/2034 e Regolamento (UE) 2019/2033, October 29, 2021, Available at: https://www.politicheEuropee.gov.it/it/normativa/recepimento-atti-ue/20192034-e-20192033/, Gazzzetta Ufficiale, Legge 22 aprile 2021, n.53, Available at: https://www.gazzettaufficiale.it/eli/id/2021/04/23/21G00063/SG and https://www.normattiva.it/uri-res/N2Ls?urn:nir:stato:legge:2021-04-22;53*)

year have led to a general simplification of the previous regime in force, also strengthening the principle of proportionality for this type of intermediary. The multiple influences suffered by the previous regulation on SIMs, (*introduced thanks to decree no. 201*), can be divided into *Amendments provided for by the IFR Regulation* and *Amendments provided for by the IFD Directive*.

With reference to the first of these, (*in the context of Regulation 2019/2033/EU, through decree no. 201*), the prudential rules are established on the subject of *own funds requirements*, *requirements on concentration risk* and *liquidity risk* as well as the *reporting obligations* of the aforementioned requirements and *public disclosure obligations*. However, the regulation goes further, introducing a novelty, which, (*due to its effects and consequences*), certainly represents one of the most important measures, namely the modification and expansion of the *previous definition of credit institution*[256]. Currently, (*from 2 December 2021*), this new definition of Credit Institution, includes, in addition to banks, also all those *investment companies*[257] that are considered to be *systematically important* for the soundness and stability of the financial system itself. Typically, inside that category, fall all those SIMs that carry out an activity or offer a Trading Service on own account and / or placement with *guarantee*[258], whose total value of consolidated or individual assets, are at least equal to at least *€ 30 billion*[259].

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[256] As previously seen the amendments in question, was made by the IFR Regulation to Article 4 of Regulation 575/2013 / EU (CRR), and consisted in extending the definition of "*Credit institution*". It is important, because it introduces a new classification of SIMs that takes into account the *size*, the *activities carried out* and the *risks* of the activities carried out, (*which are divided into four different classes, as also seen previously in chapter 3 of the aforementioned thesis*). Hence the application of a new Prudential Regime, where the systematically most important SIM Class (*Class I and I-Minus*) are subject to the provisions of the CRR-CRD package, while for Class II and III SIMs they are subject to the new IFR / IFD prudential regime. Also introducing a new Authorization Regime, where the Class I SIMs, *considered as Credit Institutions*, continue to follow the process established by the old CRD-CRR package, while for the Class I-Minus, II and III SIMs, they follow the provisions of IFR / IFD package, with Class III SIMs following a simplified IFR / IFD regime.

[257] Excluding traders on own account of commodities or emission quotas, collective investment schemes for savings or insurance companies, as defined by Donato Varani, Il Nuovo Framework Regolamentare delle SIM, December 6, 2019, Available at: https://annunziataconso.eu/it/il-nuovo-framework-regolamentare-delle-sim/.

[258] As per Annex I, Section A, points 3 and 6 of Directive 2014/65 / EU (MiFiD II).

[259] Furthermore, it should be specified how the Supervisory Authority may decide to apply the provisions of the CRR / CRD package, (*also to all those investment firms that own at least €5 billion of assets*), if they are deemed to be of "*systemic importance*". This threshold represents a fundamental requirement to be able to distinguish a Class I investment firm from a Class I-Minus, *which will result in the application of a different authorization regime*. A fundamental

While with reference to the IFD Directive, it aims to regulate the initial capital level for SIMs[260], regulate the process of assessing the adequacy of internal capital, the *risk assessment process*[261] and the sanctioning regime, establishing a specific prudential regime for non-systemic SIMs, by virtue of their size and their interconnections with other financial and economic actors, leaving *systemic investment firms* to remain subject to the previous prudential framework[262]. The influences carried out by the latter on the SIM regulations, we have that it designates the Bank of Italy and CONSOB as the competent authorities to exercise the *functions* and *powers* provided for by European regulations, (*according to the current division of regulatory and supervision envisaged by the TUF with regard to SIMs*), and it provides that they can govern the detailed aspects of the new regime with secondary legislation[263].

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requirement, given that the former are considered in the same way as Banks. Therefore, in addition to apply for the "banking license", (*and be subject to the same regulation to which banks are subject, as outlined in the CRR II / CRD V package*), they will also fall within the scope of the Single Supervisory Mechanism (SSM), being supervised by the ECB if established in the Banking Union. This has meant that the authorization for the exercise of investment services and activities to Class I SIMs is issued by the European Central Bank (*no longer by CONSOB*), on the proposal of the Bank of Italy, (*after consultation with CONSOB*). However, it should be noted that currently any Italian SIM *does not exceed this threshold*. (*For further information, please see: Dipartimento per le Politiche Europee, Direttiva (UE) 2019/2034 e Regolamento (UE) 2019/2033, October 29, 2021, Available at:* https://www.politicheEuropee.gov.it/it/normativa/recepimento-atti-ue/20192034-e-20192033/, *Donato Varani, Il Nuovo Framework Regolamentare delle SIM, December 6, 2019, Available at:* https://annunziataconso.eu/it/il-nuovo-framework-regolamentare-delle-sim/, *Novità UE: Cambia la Vigilanza Prudenziale per le imprese d'Investimento, Dicembre 18, 2019 Available at:* https://www.riskcompliance.it/news/novita-ue-cambia-la-vigilanza-prudenziale-per-le-imprese-di-investimento/ *and Senato – Camera dei Deputati, Vigilanza prudenziale sulle imprese di investimento Atto del Governo 287, Available at:* https://www.senato.it/service/PDF/PDFServer/BGT/01309498.pdf)

[260] Which capital level required from the SIMs is variable and depends on the type of activity or service performed, on the authorization to hold or not the money and / or financial instruments of customers.

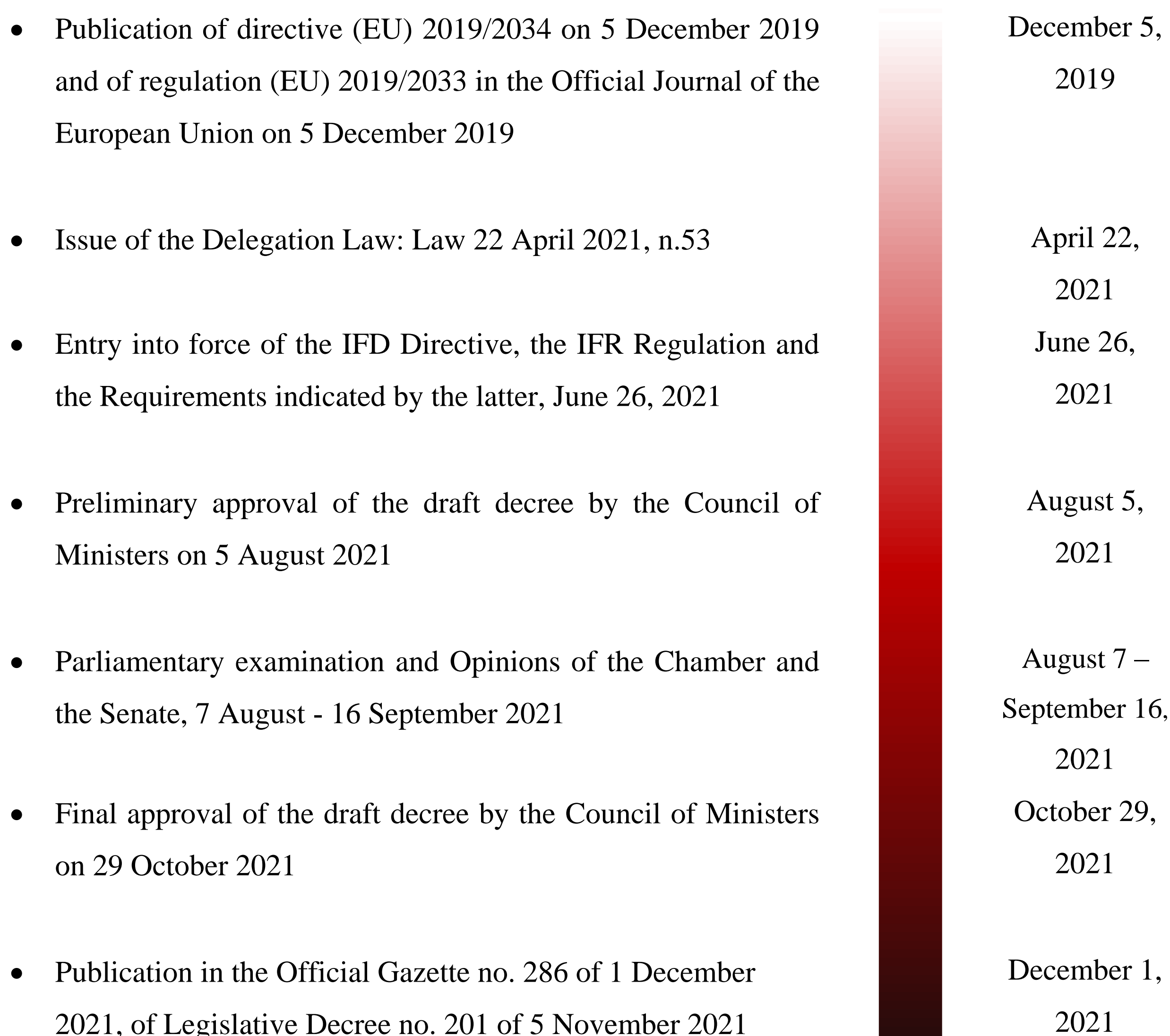
[261] Mandatory for Category II SIMs but Optional for Category III SIMs, for the latter the competent authorities are left with the option of being able to subject them or not to capital adequacy assessment processes and risk assessment processes.

[262] This is also due to the changes made by the IFR regulation, concerning the modification of the definition of *credit institution*.

[263] In this way, continuity with the current regulatory framework is ensured, considering that the Directive and the Regulation actually replace, simplifying such regulatory framework, the one currently applicable to SIMs. (*For further information, please see: Dipartimento per le Politiche Europee, Direttiva (UE) 2019/2034 e Regolamento (UE)*

The new regime that is emerging reveals how the current regulation on SIMs in Italy *is more simplified than the previous one*, (which was distinguished by a much more stringent regime)*, more articulated* and characterized by a *greater emphasis on proportionality*. In the Tables below, we can summarize the path regarding the implementation of the package IFD/IFR in the Italian Prudential Framework:

Timeline of the application of the *IFD* and *IFR* disciplines in Italy



Source:

2019/2033, October 29, 2021, Available at: *https://www.politicheEuropee.gov.it/it/normativa/recepimento-atti-ue/20192034-e-20192033/)*

Risk & Compliance - Platform Europe: *Novità UE: Cabia la Vigilanza Prudenziale per le Imprese di Investimento*, December 18, 2019, Available at: https://www.riskcompliance.it/news/novita-ue-cambia-la-vigilanza-prudenziale-per-le-imprese-di-investimento/

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Dipartimento per le Politiche Europee - Presidenza del Consiglio dei Ministri, *Direttiva (UE) 2019/2034 e Regolamento (UE) 2019/2033*, October 29, 2021, Available at: https://www.politicheEuropee.gov.it/it/normativa/recepimento-atti-ue/20192034-e-20192033/

Diritto Bancario, *IFD e IFR: in GU il decreto di attuazione*, December 2, 2021, Available at: https://www.dirittobancario.it/art/ifd-e-ifr-in-gu-il-decreto-di-attuazione/

In addition, we can summarize the *influences* and *changes* undergone by the regulations to which the SIMs are subject in Italy, carried out by the *Delegation Law 53*, *Legislative Decree November 5, 2021, n.201* and by the following *Government Act 287*:

Main Amendments brought forward by the *Delegation Law n.53*, Legislative Decree November 5, 2021, n.201 and by the *Government Act 287*

- Introduction in the TUF, of the new definitions of Class I and Class I-Minus, hence the amendments and expansion of the Definition of Credit Institutions, which from now on, includes all SIMs which have, at least, an amount of consolidated assets equal or greater than € 30.000.000.000,00[264], therefore classifiable as SIM belonging to Class I.

- Introduction in the TUF of the new definitions *Single Supervisory Mechanism* and *Single Resolution Mechanism*.

- Simplification of the Regime previously in force, with subsequent strengthening of the *proportionality principle* for SIMs.

[264] Hence the obligation for all investment firms belonging to this class to obtain authorization to operate exclusively from the ECB, and no longer from CONSOB, as cited by the Government Act 287. (*For further information, please see: Vigilanza prudenziale sulle imprese di investimento Atto del Governo 287, Page 1, Available at: https://www.senato.it/service/PDF/PDFServer/BGT/01309498.pdf*)

- Authorization for the exercise of investment services and activities only for Class I SIMs, issued by the ECB[265] on the proposal of the Bank of Italy, (*after consulting the CONSOB* [266]).

- Bank of Italy and CONSOB are designated as competent authorities to exercise the functions and powers provided for by European regulations in accordance with the current division of regulatory and supervisory responsibilities envisaged by the TUF with regard to SIMs and provides that they may regulate the detailed aspects of the new regime.

Source:

Senato – Camera dei Deputati, Vigilanza prudenziale sulle imprese di investimento Atto del Governo 287, Available at: https://www.senato.it/service/PDF/PDFServer/BGT/01309498.pdf

Donato Varani, Il Nuovo Framework Regolamentare delle SIM, December 6, 2019, Available at: https://annunziataconso.eu/it/il-nuovo-framework-regolamentare-delle-sim/

The fact that the Italian SIMs had already been subjected, *in terms of prudential treatment*, to the rules of the CRR, (*by direct effect of the same*), have made sure that the regulation of the SIM was therefore already imported to the criterion of proportionality; thus indicating the presence of no "*upheaval*" or significant change within it[267], with the exception of all those SIMs that fall within the definition of *Credit Entities*[268], and which would therefore be required to initiate the procedure for obtaining the *banking license*, with consequent entry into the banking sector.

[265] In replacement of CONSOB, for SIMs not belonging to the Class, the authorization process remains unchanged..

[266] It is good to specify that in Italy, currently, there are no SIMs belonging to this Class I, or SIMs with assets equal to or greater than €30 billion.

[267] (For further Information, please see: Brozzetti Antonella, La riforma apprestata con l'Investment firms regulation e directive (IFD/IFR): prime osservazioni ruotanti intorno al nuovo assetto bipolare della regolazione Europea e alla nuova definizione di "ente creditizio", 2020, I, Page. 424, Available at: https://www.dirittobancaemercatifinanziari.it/la-riforma-apprestata-linvestment-firms-regulation-directive-ifrifd-prime-osservazioni-ruotanti-intorno-al-assetto-bipolare-della-regolazione-Europea-alla-nuova-definizione/)

[268] In this case we refer to all systemic SIMs, *Class I investment companies*, which fall within the parameters set by the amended Article 4 of the CRR, and which will consequently be defined as Banks. Nonetheless, it is good to clarify how at the present time, in Italy, do not exists SIM of that range or size.

5 – Cost-Benefit analysis regarding the implementation of the new Prudential Framework IFD – IFR

Following the implementation of the previous disciplines, thanks to the reports and consultations carried out by the EBA, we can analyze the various costs and benefits that are brought about thanks to the entry into force of the IFR and IFD. In particular, the EBA has been mandated to develop a draft RTS to specify how to measure risks and elements of risks that are not covered or insufficiently covered by the own funds requirements set out in parts three and four of the regulation 2019/2033/EU IFR, and to analyze the potential costs and benefits of *draft implementing technical standards*.

Undoubtedly, one of the main benefits deriving from this regulatory package is the *separation of the discipline, which was previously applied*, *to both investment firms and banks*[269]. Indeed, until 25 June 2021 the prudential rules for investment firms were part of the broader EU prudential framework applied to banks, as established by the CRR regulation and the CRD Directive[270]. Previously, the minimum own funds requirements, for an investment firm, were based on a "*Prudential Classification*", which was mainly determined by the services and activities provided by MiFiD, *as well as by the ability of the firms themselves to hold money and securities belonging to its customers*. Subsequently, with the IFD and IFR, the pre-existing guidelines, as regards the procedures and methodologies envisaged by the SREP, (*together with the supervisory stress tests*), had become inadequate, which meant that *the EBA was in charge of developing new guidelines dedicated to investment firms on common procedures and methodologies for SREPs*.

The *Liquidity Requirements* represent another element of intervention. While in the previous discipline, (CRR/CRD), Liquidity Requirements were *not mandatory*, (for any kind of investment firms), *nor harmonised*, this changed drastically with the new regulatory framework. As a matter of

[269] As a matter of fact, before IFD & IFR, with the previous CRR-CRD Regime, the same discipline applied to banks, were also applied to investment firm, (*in other words, investment firms were required to comply with the prudential requirements and discipline set out in CRR and CRD*). Such discipline was based on the Basel standards, which were explicitly designed for banks, and hence focussed more on the lending and deposit activities rather than investment firm's activities. To make such regime working for them, a complex system of exceptions and modifications were required.

[270] So that, until the 25th of June, 2021, we applied, the same discipline to Credit Institutions, Banks and Investment firm, regardless of the Size, Systematic Importance, Activities in which they were involved and Risk of the Latter.

fact, (*thanks to the introduction and application of the IFD/IFR*), liquidity requirements became, (for the first time), *mandatory*[271] and fully *harmonised* for all investment firms across the EU. Moreover, the IFR, specify the composition and the *amount of liquid assets*[272], which investment firms should hold, mandating the EBA, (*in consultation with ESMA*), to issue guidelines, specifying further the criteria which the competent authorities may take into account, when exempting investment firms that meet the conditions for qualifying as *small* and *non-interconnected*[273]. The main consequence of the adoption of the IFD and IFR is the creation of Guidelines, which aim, *as said earlier*, at harmonise the liquidity requirements, set them mandatory for almost any investment firms[274], and contribute to create a sound financial market across the EU. So that, the *resulting guidelines* issued by the EBA, (*in line with what envisaged by the IFR at Article 43*), specify and address the elements regarding the criteria for the *exemption* and the *guidance* on a process for competent authorities when *granting the exemption*. Furthermore, in order to ensure that this exemption is applied uniformly across all European Investment Firms, it is important that these guidelines set common criteria, which competent authorities should take into account when considering granting such exemptions. They apply only investment firms on an individual basis[275], specifying that the exemption for the latter, occur only when qualify as a *small and non-interconnected investment firm*[276]. *Small and non-interconnected investment firms* do not hold clients' assets, thus liquidity requirements for such firms

[271] Unless the competent authority grants an exemption for the smallest investment firms (Class III). In fact, small and non-interconnected investment firms that meet the conditions set out in Article 12(1) IFR, *represent an exemption for the application of liquidity requirements*.

(*For further information, please see: Consultation Paper Draft Guidelines on liquidity requirements exemption for investment firms under Article 43(4) of Regulation (EU) 2019/2033, 10 December 2021, Available at: CP o draft Guidelines on liquidity requirements exemption for investment firms.pdf (Europa.eu)*)

[272] As set out in Article 43(1) IFR, investment firms shall hold an amount of liquid assets equivalent to at least one third of the fixed overhead requirement.

[273] As set out in Article 12 (1) from the liquidity requirement.

[274] The only exemption, (*as said above in 2.3 - Analysis of the Own Funds Requirements and Capital Requirements*), is made by Class III Investment Firms. (*For further information, please see: Donato Varani, Partner, Annunziata & Conso, Il Nuovo Framework Regolamentare delle SIM, December 16, 2021, Available at: https://annunziataconso.eu/it/il-nuovo-framework-regolamentare-delle-sim/, Art.6 Art. 12 and Art 43 Reg. 2019/2033/EU IFR*)

[275] As set out in Article 43 IFR.

[276] As set out in Article 12 (1) and Article 43(1) IFR.

do not intend to cover risks of potential losses of clients' assets. Liquidity requirements for investment firms intend to ensure that *the latter maintain a sufficient level of liquid assets for its orderly wind-down*. Based on this, the guidelines specify that the exemption should be based on the *assessment of financial resource needs for orderly liquidation of an investment firm*. The reasons and the rationale behind such GDLs, *regarding liquidity requirements*, is to ensure that an investment firm would be able to wind-down or restructure its activities in an orderly manner in a given period. These are the reasons why investment firms should hold *sufficient financial resources to withstand operational expenses over an appropriate period of time* during which an investment firm needs to be able to absorb losses. In addition to that, liquidity requirements cover a crucial role, for the financial and capital markets, because *Investment firms themselves cover an important role for the well functioning of capital markets*. So that, adequate liquidity requirements are therefore necessary to meet any *immediate* or *additional liquidity needs* that an investment firm might have. In this way, (*by setting mandatory liquidity requirements for all kind of investment firms*), we can actually contribute to *create a sound financial stability of the market*.

In addition to that, we should also consider the amendments bring in by the IFR Regulation, regarding the *own funds requirements*. Following what is outlined by the former, the EBA itself, has been mandated to *develop specific draft RTS*[277], specifying how to determine additional own funds requirements based on the outcomes of SREP[278]. The goal here is to create a *level playing field* by setting common requirements for the measurement of risks and elements of risks arising from the various businesses and activities in which an investment firm is involved. The methodology specified in *these draft RTS*[279], (*which are relevant for class II and class III investment firms*), aim to *promote* and *ensure* a consistent and proportionate application of supervisory practices across the Union and

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[277] The reason behind it, is to establish a harmonised methodology for the determination of adequate additional own funds requirements that investment firms should hold to cover any risks.

[278] (*For further informations, please see: Consultation Paper Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034, November 18, 2021, Available at: CP on RTS on Pillar 2 add-ons under IFD.pdf (Europa.eu)*).

[279] The approach specified in these RTS builds on the structure of own funds requirements set out in Article 11 of IFR, differentiating between class II and class III investment firms, and reflecting various objectives of the own funds requirements. (*For further informations, please see: Consultation Paper Draft Regulatory Technical Standards on Pillar 2 add-ons for investment firms under Article 40(6) of Directive (EU) 2019/2034, November 18, 2021, Available at: CP on RTS on Pillar 2 add-ons under IFD.pdf (Europa.eu)*)

supervisory requirements, better aligned with the *investment firm's size*, *complexity*, *business model* and *risk profiles*, that should help improve the efficiency and stability of financial markets, (*as well as the market confidence in the sector overall*).

The draft RTS should also have a positive impact on *investor protection* while strengthening capital requirements against a *disorderly failure* and therefore against the investment firm's inability to *restore client money and assets*, placing therefore less reliance on investor compensation schemes. Moreover, they also help in clarifying how competent authorities should measure risks that investment firms face, which are not covered or not sufficiently covered by the own funds requirements, as set out in the IFR. Here the EBA, (*through is cost-benefit analysis*), came to the conclusion that, *to determine the additional own funds requirements*, we should calculate them *separately*. On the one hand, we should determine *the capital considered adequate to cover all risks and elements of risks arising from the investment firm's ongoing activities*. On the other hand, we should determine *the capital considered adequate to cover the risk of disorderly wind up*, which could pose threats to their *clients*, *counterparties*, and the *wider markets* in which they operate in case of their failure.

4 – Conclusion

Starting from the beginning, from the introduction of the CRR and CRD, up to the current IFR and IFD, we were able to analyze not only the *evolutionary process* behind the current discipline, but we were also able to analyze the reasons that influenced the development of the latter and how this discipline intends to address the various challenges concerning the creation of adequate supervisory requirements, (*necessary to reduce the likelihood of failure of an investment firm*), and a financial system that is as resilient as possible to potential crises, but which can also favour market access to all companies as much as possible. In the First Chapter, I set out the reasons behind the creation of the previous discipline, describing and analysing the salient aspects of the CRR Regulation and the CRD IV Directive, including liquidity and capital requirements. Furthermore, I have placed a certain emphasis on how the 2008 financial crisis and subsequent Basel Accords, *especially Basel III Accord*, played an important role in the development and subsequent implementation of the CRR and CRD IV, in the European prudential framework. In the Second Chapter, I exposed the changes and innovations that follow the introduction of Reg. 2019/876/EU (CRR II) and Dir. 2019/878/EU (CRD V). Thanks to their introduction, we can appreciate the updating of some aspects, over the previous discipline, concerning in particular the *Capital* and *Own Funds Requirements*, the Liquidity Requirements, and the definitive introduction of the *Leverage Ratio* and the *Net Stable Funding Ratio*. In the Third and last Chapter, I introduced the new and current discipline presently in force in Europe, which supports and replaces, in some points, the previous regulatory framework. Within this chapter, particular attention and emphasis was first placed on the description of the two new disciplines, namely the *IFR regulation* and the *IFD directive*, analysing the most salient points, such as the introduction of K-Factors, the review of the definition of a *credit institution* and *investment company*, and the new requirements to which the latter are subject. With the implementation of this new discipline, it is possible to state that with the new regulatory framework, we wanted to place a greater emphasis on the *intrinsic risk* that each company possesses, thus focusing on the systemic risk that each company possesses, based on the size and quantity of managed capital and based on the activities covered. In this case, the goal that the legislator wanted to achieve is to place the emphasis on companies considered more risky, in such a way as to make the financial system considerably more resilient than with the previous disciplines, thus realizing, what established in the previous Basel Accords. In addition to this, with its implementation, the legislator is to make the discipline for investment firms much simpler than the previous regulatory package, (*also favouring access to these activities, present in Annex I of the Directive MiFid II*).

Therefore, in the light of what has been said so far, in my opinion, it is possible to state how, on the basis of the data currently available, the IFR/IFD package has laid the *basis* and *conditions* necessary to aim for an increasement in the number of investment firms present in Europe. This achievement was only possible through the concatenation of a series of various and different events and objectives, among which we can cite: the introduction of a new and articulated prudential discipline with connotations of *flexibility* and *proportionality*, (*which characterize the new regime so much*), suitable for *embracing different operational paradigms* and adequacy to the *risks deriving from the assumed commercial profile*, the "*lowering*" of the initial capital thresholds required of investment firms, (*following the application of the IFD directive*) and the simplification of the discipline itself by ceasing to apply the same CRR-CRD regime to both *investment firm* and *banks*.

In addition to these, great importance was also covered by the will of the legislator to align the *regulatory* and *supervisory framework* of large investment firms to that of credit institutions, (*thus subjecting certain investment firms to the supervision of the ECB*), the willingness of the same to pursue the general objective, to make the financial system itself *more solid* and *resilient* to possible shocks and / or economic crises, placing the companies, (*considered more dangerous*), under the "*spotlight*", equating them to credit institutions. Hence, the new prudential regime and the correlated *prudential surveillance*, by proposing themselves as more prudent to the various business models chosen by banks and investment firms, *in respect to the previous regime*, should ensure a reduction in compliance costs, thus also stimulating the entry of new operators and new businesses within the single financial market, incrementing in this way the total number of investment firms.

Moreover, regarding the Italian SIM and the influences brought-in by the current package IFR/IFD, we can state that: *From the one hand*, the package itself have the biggest merit to introduce, (*for the Italian Regulatory Framework*), important amendments like the *Expansion of the Credit Institutions definition*, and the willingness of re-setting the whole framework, *in order to be more focused on the Proportionality Criteria*. On the other hand, however, since the Italian Discipline and the SIMs themselves, were already subdue to the Proportionality Criteria, (*and since there are no Class-I Investments Firm*), then the very impact of the new package, was not so deep and upsetting for the prudential framework. Therefore, the IFR/IFD discipline, in my opinion, has certainly introduced important innovations, however, the level of influence, was in a sense, "*contained*" or "*limited*", for the simple fact that the previous discipline was already "*tuned*" to the same "*frequency*" of the discipline in question, (*since it was already subdue to the Proportionality Criteria*) .

Finally, as we have seen previously, the current regime has led to the termination of the application of a single discipline for both Banks and Investment Companies, (*to which they were traditionally subjected*). Nevertheless, it is natural and questionable whether this step was really necessary or not. In my opinion, this step is justified on the one hand from the need to find a solution to the many *shortcomings* and *problems* that arose with the previous regulations, concerning in particular the *lack of specific prudential regimes* (*referring to the vulnerability and risks inherent in investment firms*), the problems concerning the effectiveness of the previous discipline, towards large investment companies considered as systemic and with business models and risk profile similar to banks. (*Problems that have led to the emergence of adverse phenomena, such as misalignments of the laws of the various countries and distortions of competition with the same banks*). On the other hand, it can be explained by the will on the part of the European legislator to reorganize the past regulatory framework, introducing simplifications in response to a greater criterion of *proportionality* and *better harmonization* throughout the EU, building a prudential regime more articulated in terms of *capital* and *liquidity* for investment firms.

So in the end, *Why create a new prudential regime for investment firms*? *Why was it was decided to give autonomy to investment firms*? and *Why did the European legislator decide to unbundle investment firms from the same discipline to which banks are subject*? Before the implementation of the IFR/IFD Prudential Framework, investment firms were required to comply with the prudential requirements set in the CRR/CRD IV. These requirements were based on the Basel Accords, (*designed exclusively for banks active on an international stage, focussed on the lending, and deposit activity*), and the vast majority of the investment firms, have completely different business model. To make such framework work for the latter, the past approach consisted to adopt a complex system of *exceptions* and *amendments*. To overcome this flaws, a new framework, specifically designed for investment firms were needed. Therefore, (*in addition to the previous conclusions*), the new prudential framework has been devised, with the aim of *overcoming the previous shortcomings* and *providing the latter with a simpler system of prudential regulation appropriate to their business models*, with greater emphasis on the criterion of *proportionality*, *articulation* and *simplicity*.

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