Chapter 4

Own funds requirements

4.10 K-COH requirement

4.10.1 R The *K-COH requirement* of a *MIFIDPRU investment firm* is equal to the sum of:

(1) 0.1% of *average COH* attributable to *cash trades*; and

(2) 0.01% of *average COH* attributable to *derivatives trades*.

4.10.2 R When calculating its *K-COH requirement* in accordance with this section, a *MIFIDPRU investment firm* must include within its *COH* any amounts that relate to *MiFID business* of the *firm* that is carried on by any *tied agent* acting on its behalf.

4.10.3 G The definition of *COH* includes orders that a *firm* handles when carrying on either of the following types of *MiFID business*:

(1) reception and transmission of client orders; and

(2) execution of orders on behalf of a client.

4.10.4 R A *firm* is not required to include the following in its measurement of *COH*:

(1) an order executed by a *firm* in its own name (including where the *firm* executes an order in its own name on behalf of a *client*);

(2) an order that a *firm* handles when acting in the capacity of the operator of a *multilateral trading facility* or *organised trading facility*;

(3) a transaction that falls within the definition of reception and transmission of *client* orders only as a result of the situation described in recital 44 of *MiFID*; and

(4) orders that are not ultimately executed.

4.10.5 G MIFIDPRU 4.10.6G to MIFIDPRU 4.10.17G contain further *guidance* on whether particular arrangements are included within the measurement of *COH*.

Execution of orders in the firm's own name

4.10.6 G Where a *firm* executes an order in its own name (irrespective of whether the order is ultimately for the benefit of a *client*), the order is included within the *firm's* measurement of its *DTF* under MIFIDPRU 4.15 (K-DTF requirement) and not within its measurement of *COH* under this section.

The extended ("bringing together") definition of reception and transmission

4.10.7 G Recital 44 of *MiFID* describes transactions that result from a *firm* bringing together 2 or more investors (such as introducing an issuer to a potential source of funding), but where the *firm* does not otherwise interpose itself within the chain of execution of any resulting order. In practice, this is most likely to be relevant in the context of *corporate finance business* or private equity business. A *firm* may exclude these transactions from its measurement of *COH* provided that its role does not go beyond this "extended" definition of reception and transmission. This is further described in the *guidance* in PERG 13.3 (Investment Services and Activities).

Matched principal trading

4.10.8 G A *firm* that trades in a matched principal capacity will be placing orders in its own name. These orders must therefore be included in the measurement of the *firm's DTF* and are not included in the calculation of *COH*.

Name give-up activities

4.10.9 G

(1) The *FCA* understands that activities that are described as involving "name give-up" may take different forms.

(2) In certain cases, a *firm* may distribute indications of interest that indicate a willingness to enter into a transaction, but do not have fixed terms. The *firm* may then pass the names of the counterparties to each other following a match to allow them to facilitate the trade. These indications of interest and name-passing are not included within the measurement of *COH*. However, this does not mean that every transaction which begins with an indication of interest is outside the scope of *COH*. Where a *firm* is subsequently instructed to transmit an order on firm terms, or to execute an order, that transaction will be within scope of *COH*, even if the order results from a process that began with an initial indication of interest.

(3) In some circumstances, a *firm* may disseminate orders on firm terms that result in a transaction as soon as they are confirmed by the recipient, following which the *firm* will disclose the name of the relevant counterparty. This activity is included within the measurement of *COH* because it involves reception and transmission of an order on firm terms.

Exchange give-up activities

4.10.10 G

(1) A *firm* may facilitate trading by its *clients* on exchanges. Once a transaction has been executed, the relevant trade is then given up to the *client's* clearing firm.

(2) A *firm* should consider the exact capacity in which it is acting, and whether it incurs any liability as principal, when determining whether orders resulting from exchange give-up activities are included within the measurement of *COH*.

(3) If the *firm* enters into the transaction in its own name and therefore incurs principal liability, even for a short period, in relation to the trade before it is given up, the order should be included within the *firm's* measurement of *DTF* and not within its measurement of *COH*.

(4) If the *firm* does not incur liability as principal and merely acts as agent in the name of a third party in relation to the trade, the order should be included within the *firm's* measurement of *COH*.

Exchange block trades

4.10.11 G

(1) A *firm* may be involved in negotiating a bilateral trade in relation to an exchange-traded instrument between counterparties that takes place off-exchange because the size of the trade exceeds certain specified levels. In some cases, the exchange may provide communications functionality to facilitate the block trades, but the trades are not executed on the exchange's public market.

(2) A *firm* must determine the capacity in which the *firm* is acting in relation to the block trade to determine if the value of the trade should be included in the *firm's* measurement of *COH*.

(3) If the *firm* enters into the block trade in its own name and the trade is then given up to a *client*, the *firm* should include the value of that trade in its measurement of *DTF*.

(4) If the *firm* executes the block trade as agent by committing the *client* to the terms of the trade, the *firm* should include the value of that trade in its measurement of *COH*.

(5) If the *firm* receives firm terms of the block trade from the *client* and transmits the terms to the counterparty in order for the counterparty to confirm the terms to create a binding transaction, the *firm* should include the value of that trade in its measurement of *COH*.

Broker functionality

4.10.12 G

A *firm* may be a member of an exchange and may provide functionality whereby trades can be executed and booked directly into the account of the relevant *client*. In this case, the *FCA* considers that the trades should be included in the *firm's* measurement of *COH*, as the *firm* is still being used to execute the relevant trade.

Orders connected with the operation of trading venues

4.10.13 G

(1) A *firm* which is *operating a multilateral trading facility* or *operating an organised trading facility* does not need to include any orders it handles solely in that capacity in its measurement of *COH*. However, it should consider as part of its *ICARA process* whether that activity gives rise to the risk of material potential harm which may require it to hold additional *own funds* or *liquid assets* under ■ MIFIDPRU 7.

(2) However, if the operator of an *organised trading facility* is engaging in *matched principal trading*, as permitted by MAR 5A.3.5R, any matched principal trades are included in its measurement of *DTF* under MIFIDPRU 4.15 (K-DTF requirement).

4.10.14 G A *firm* that executes *client* orders on a *multilateral trading facility* or an *organised trading facility* when the *firm* is not acting in the capacity of the trading venue operator must include the orders in its measurement of *COH* (unless the *firm* executes the orders in its own name, in which case it must include the orders in its measurement of *DTF*).

4.10.15 G In certain circumstances, the same *firm* may both act as the operator of a *multilateral trading facility* or an *organised trading facility* and also submit an order on that *trading venue* on behalf of a *client*. In this case, although the *firm* is not required to measure *COH* in relation to its role as the operator of the *trading venue*, it must still measure *COH* (or *DTF* if it is possible to enter into transactions in its own name on the *trading venue* and it is executing in that capacity) in relation to the order that it executes for the *client*.

Orders that are never executed

4.10.16 G (1) The effect of MIFIDPRU 4.10.4R(4) is that where a *firm* receives a *client* order but that order is not ultimately executed, it does not have to include the value of that order in its measurement of *COH*. However, as part of its *ICARA process*, a *firm* should consider whether the fact that an order has not been executed gives rise to any material risks to the *firm* or to its *clients*. This may depend on the reasons why the *client* order has not been executed.

(2) If, for example, the order was not executed because market conditions did not allow the *firm* (or another entity to whom the order was ultimately transmitted) to achieve an appropriate outcome for the *client*, this may be consistent with the *firm's* contractual and regulatory duties. In that case, this may not give rise to any additional material risks.

(3) However, if the *firm* failed to transmit or execute an order because of an oversight or an internal systems failure, this may indicate that the *firm* has been failing in its duties to its *client* or in its regulatory obligations. Alternatively, the *firm* may have successfully transmitted an order, but failed to select an appropriate entity to receive and execute the order, and therefore may have failed to comply with its obligations to act in the best interests of the *client* when transmitting the order. In this case, the *firm* should consider as part of its *ICARA process* whether the failures may give rise to material risks and how these risks should be addressed.

4.10.17 G (1) Although failure to achieve the execution of an individual order does not necessarily indicate potential material harms, a series or pattern of failures may be evidence of potential material harms.

(2) A *firm's* analysis under its *ICARA process* is separate from the application of any individual regulatory or other legal duties owed to

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an individual *client*. Therefore, while a *firm* may conclude that an isolated oversight in relation to a *client* order does not give rise to the risk of material harm under the *ICARA process*, this does not affect any obligations that the *firm* owes to the *client*.

Calculating COH

4.10.18 R A *firm* must calculate its *K-COH requirement* on the first *business day* of each *month*.

4.10.19 R

(1) A *firm* must calculate the amount of its *average COH* by:

(a) taking the total *COH* measured throughout each *business day* over the previous 6 *months*;

(b) excluding the daily values for the most recent 3 *months*; and

(c) calculating the arithmetic mean of the daily values of the remaining 3 *months*.

(2) When measuring the value of *COH* for a particular *business day*, a *firm* must convert any amounts in foreign currencies on that date into the *firm's* functional currency.

(3) For the purposes of the currency conversion in (2), a *firm* must:

(a) determine the conversion rate by reference to an appropriate market rate; and

(b) record the rate used.

Measuring the value of orders for COH

4.10.20 R

(1) When measuring its *COH*, a *firm* must use the sum of the absolute value of each buy order and sell order, as determined in accordance with the remainder of this *rule*.

(2) For *cash trades* relating to *financial instruments*, the value of the order is the amount paid or received on the trade at the time at which it is executed, unless the firm has applied the approach in MIFIDPRU 4.10.23R.

(3) For *derivatives trades* other than orders relating to interest rate derivatives, the value of the order is the notional amount of the contract, determined in accordance with MIFIDPRU 4.14.20R(2).

(4) For orders relating to interest rate derivatives, the value of the order is the notional amount of the contract determined in accordance with MIFIDPRU 4.14.20R(2), adjusted in accordance with MIFIDPRU 4.10.25R.

(5) A *firm* may calculate the value of an order by deducting any transaction costs to reflect the consideration received or paid by the *client* for the relevant instruments, provided that the transaction costs are not paid separately to the *firm* by the *client*.

4.10.21 G

(1) Under the general approach in MIFIDPRU 4.10.20R(2), a *firm* determines the gross value of an order by multiplying the market price of the instrument by the quantity of the instrument being purchased or sold.

(2) However, MIFIDPRU 4.10.20R(5) permits (but does not require) a *firm* to calculate the value of an order by reference to the consideration paid or received by the *client* for the instruments (i.e. net of transaction costs), provided that the transaction costs are included in the gross value of the order and are not paid by the *client* to the *firm* separately.

(3) For example, Firm A executes an order for a *client* to buy 100 shares. The total cost of the order, including transaction costs, is £100. The *client* receives shares worth £88, after the *firm* uses £12 to cover transaction costs. Under the standard approach in MIFIDPRU 4.10.20R(2), the *firm* may record the value of the order in its *COH* as £100 (i.e. the gross cost of the order). The *firm* may, for example, choose this approach for reasons of simplicity and administrative convenience.

(4) Alternatively, in the example above, the *firm* may apply the approach under MIFIDPRU 4.10.20R(5) to record the value of the order in its *COH* as £88 (i.e. net of transaction costs paid by the *client* in relation to the transaction).

(5) However, a *firm* cannot rely on MIFIDPRU 4.10.20R(5) to reduce the value of an order by transaction costs that are paid separately by the *client* to the *firm*. For example, Firm B executes an order for a *client* to buy 100 shares. The total cost of the order is £100. The *client* additionally pays £12 to Firm B for transaction costs. In this case, the *firm* must record the net value of the order under MIFIDPRU 4.10.20R(5) in its *COH* as £100 (and not £88), as the transaction costs have been paid separately.

(6) The effect of MIFIDPRU 4.10.19R(2) is that when measuring the value of *COH* at the end of each *business day*, a *firm* must apply the relevant conversion rate on that date to any amounts in foreign currencies forming part of the *COH* attributable to that *business day*. The *COH* for each preceding *business day* should continue to be measured by reference to the conversion rate that was applicable on that preceding day.

(7) For the purposes of MIFIDPRU 4.10.19R(3), where a *firm* is carrying out a conversion that involves sterling, the *FCA* considers that an example of an appropriate market rate is the relevant daily spot exchange rate against sterling published by the Bank of England.

4.10.22 G

For *cash trades* relating to exchange-traded options, the amount paid or received under MIFIDPRU 4.10.20R(2) is the premium paid for the option.

4.10.23 R

(1) By way of derogation from MIFIDPRU 4.10.20R(2), a *firm* that receives and transmits an order that is a *cash trade* may apply the approach in this *rule* to determine the value of that order for the purposes of measuring *COH*.

(2) Where a *firm* applies the approach in this *rule*, the value of the order shall be determined by reference to:

(a) for an order which specifies a fixed price or limit price at which the order should be executed, that price; or

(b) for an order which does not specify a price, the market price of the relevant instrument at the end of the day on which the order is transmitted by the *firm*.

(3) A *firm* that applies the approach in this *rule* must apply it either:

(a) in relation to all *cash trades* that the *firm* receives and transmits; or

(b) only in relation to *cash trades* that the *firm* receives and transmits where it does not receive timely information from the executing entity about the terms on which the order was executed.

(4) A *firm* that applies the approach in this *rule* must document which basis in (3) applies.

4.10.24 G (1) The effect of ■ MIFIDPRU 4.10.23R is to permit a *firm* that receives and transmits orders that are *cash trades* to determine the *COH* attributable to the orders using an alternative approach. A *firm* may either:

(a) apply the standard approach in ■ MIFIDPRU 4.10.20R(2) and use the price at which the relevant order was ultimately executed, once this has been confirmed by the entity that executes the order; or

(b) apply the alternative approach in ■ MIFIDPRU 4.10.23R and use a deemed price that is determined by reference to the limit price of the order or, if there is no limit price, the end-of-day market price at the time at which the order is transmitted.

(2) However, a *firm* must not use the alternative approach in ■ MIFIDPRU 4.10.23R for regulatory arbitrage to reduce its *K-COH requirement*. To prevent this, a *firm* may only apply the alternative approach either:

(a) in relation to all *cash trades* that the *firm* receives and transmits; or

(b) in relation to *cash trades* that the *firm* receives and transmits where the *firm* does not receive timely information from the broker about the terms on which the order was executed. In this case, the *firm* must apply the standard approach in ■ MIFIDPRU 4.10.20R(2) in relation to all other *cash trades*. This is designed to ensure that the *firm* can record daily information for *COH* in circumstances where information about the ultimate execution of the order is otherwise missing or significantly delayed.

4.10.25 R (1) For the purposes of ■ MIFIDPRU 4.10.20R(4), a *firm* must adjust the notional amount of an interest rate derivative by multiplying the notional amount by the duration.

(2) The duration in (1) shall be determined in accordance with the following formula:

Duration = time to maturity (in years) / 10

Interaction between K-COH requirement and K-AUM requirement

4.10.26 G MIFIDPRU 4.10.27G to MIFIDPRU 4.10.32G and MIFIDPRU 4 Annex 12G explain the circumstances in which a *firm* must include orders that arise in connection with *portfolio management* or *investment advice* in, or may exclude orders from, its measurement of *COH*.

4.10.27 G (1) The basic definition of *COH* includes:

(a) orders that the *firm* executes when providing execution services for a *client*; and

(b) orders that the *firm* has received from a *client* and transmitted to another entity for execution.

(2) The *rules* and *guidance* in MIFIDPRU 4.10.28R to 4.10.32G explain how this definition applies in particular scenarios and certain exclusions or modifications that may apply.

4.10.28 R A *firm* may exclude from its calculation of *COH* any order that the *firm* generates in the course of providing either of the following in relation to a portfolio, if the portfolio is included in the *firm's* calculation of its *K-AUM requirement*:

(1) portfolio management; or

(2) investment advice of an ongoing nature.

4.10.29 R (1) This *rule* applies where:

(a) portfolio management has been delegated to a *firm* by a *financial entity*; and

(b) as a result of the delegation in (a), the *firm* has excluded the delegated portfolio from its calculation in *AUM* in accordance with MIFIDPRU 4.7.9R.

(2) The *firm* in (1) must include in its measurement of *COH* any orders that the *firm* executes in the course of providing *portfolio management* in relation to the delegated portfolio.

(3) The *firm* in (1) is not required to include in its measurement of *COH*:

(a) any order that the *firm* passes back to the delegating *financial entity* for execution (whether the order is executed by that *financial entity* or is transmitted by the *financial entity* to another entity for execution); or

(b) any order that the *firm* places with another entity for execution in the course of providing *portfolio management* in relation to the delegated portfolio.

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4.10.30 G The exclusions in MIFIDPRU 4.7.9R, MIFIDPRU 4.10.28R and MIFIDPRU 4.10.29R(3) may result in a *firm* that carries on delegated *portfolio management* having no *K-AUM requirement* or *K-COH requirement* in relation to all or part of a delegated portfolio. Where one or more exclusions apply, a *firm* should still assess as part of its *ICARA process* whether the activity of providing delegated *portfolio management* may give rise to potential material harms that may need to be covered by additional financial resources. *Firms* should refer to the *rules* and *guidance* in MIFIDPRU 7 for additional information on the *ICARA process*.

4.10.31 G

(1) MIFIDPRU 4.10.29R does not apply where a *financial entity* ("A") carries on *portfolio management* in relation to a portfolio and a *MIFIDPRU investment firm* ("B") provides *investment advice of an ongoing nature* to A in relation to that portfolio. In this situation, A has not delegated *portfolio management* to B. Instead, A provides the service of *portfolio management* to A's *client*, and B provides the separate service of *investment advice* to A. If A is a *MIFIDPRU investment firm*, A will include the value of the relevant portfolio when calculating its *K-AUM requirement*. B will calculate its own *K-AUM requirement* in relation to the same portfolio.

(2) Although MIFIDPRU 4.10.29R does not apply in this scenario, B may benefit from the separate exclusion in MIFIDPRU 4.10.28R(2) and therefore would not be required to include any orders that result from its ongoing *investment advice* within B's calculation of *COH*, because B will calculate a *K-AUM requirement* in relation to the relevant portfolio.

4.10.32 G When measuring *COH* for the purposes of MIFIDPRU 4.10.19R, a *firm* must include:

(1) an order that the *firm* executes, or receives and transmits, as a result of providing *investment advice* (other than *investment advice of an ongoing nature*, if the *firm* calculates a *K-AUM requirement* in relation to the advice) to a *client* and subsequently receiving instructions from the *client* to transmit or execute the relevant order; and

(2) an order that a *firm* receives from another *firm* ("X"), where:

(a) X provides *investment advice* (including *investment advice of an ongoing nature*) to a *client*;

(b) as a result of the advice in (a), the *client* instructs X to place an order with the *firm*; and

(c) the *firm* executes or receives and transmits the order received from X.

Firms with less than 6 months data on COH

4.10.33 R

(1) This *rule* applies where a *firm* has been handling *client* orders constituting *COH* for less than 6 *months*.

(2) For the purposes of its calculation of *average COH* under MIFIDPRU 4.10.19R, a *firm* must use the modified calculation in MIFIDPRU TP 4.11R(1) with the following adjustments:

(a) in MIFIDPRU TP 4.11R(1)(b), *n* is the relevant number of *months* for which the *firm* has been handling *client* orders constituting *COH* (with the *month* during which the firm begins that activity being counted as *month* zero); and

(b) during *month* zero of the calculation, the *firm* must:

  (i) generate a best efforts estimate of expected *COH* for that *month* based on the *firm's* projections when beginning the new activity; and

  (ii) use the estimate in (i) as its *average COH*;

(c) during *month* 1 of the calculation and each *month* thereafter, the *firm* must apply the approach in (a) using observed historical data from the preceding *months*; and

(d) the modified calculation ceases to apply on the date that falls 6 *months* after the date on which the *firm* began handling *client* orders constituting *COH*.