EUROPEAN PRINCIPAL TRADERS ASSOCIATION

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FIA EPTA response to the legislative proposal for a Directive and Regulation on the prudential supervision and prudential requirements of investment firms

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Executive summary

FIA EPTA welcomes the European Commission's legislative proposals for a Directive[1] and a Regulation[2] on the prudential supervision, and the prudential requirements, of investment firms (the Investment Firm Review (**IFR**) Directive and Regulation or **IFRD** / **IFRR**).

We enthusiastically support the Commission's commitment to crafting a more simple prudential regime for non-systemic investment firms with more proportionate own funds requirements. However, we note that in spite of the concerns expressed by FIA EPTA as well as other stakeholders regarding some of the recommendations in the European Banking Authority's (**EBA**) September 2017 technical advice,[3] these recommendations have been reflected in the IFR proposals.

We believe that, if adopted in law, these elements of the proposals may undermine the Capital Markets Union (**CMU**) objectives of a simpler, more proportionate prudential regime for non-systemic investment firms and will diminish the quality and competitiveness of European capital markets. We also believe that some recommendations may need to be adjusted to fully meet key objectives of, and prevent conflict with, Directive 2014/65/EU on markets in financial instruments (**MiFID II**) and Regulation (EU) No 600/2014 on markets in financial instruments (**MiFIR**).[4]

In particular, we would like to draw attention to:

- **(a) Classification**: the de-facto permissions-based classification of non-systemic investment firms, including principal trading firms (**PTFs**), is arbitrary and may create barriers to entry to the detriment of the diversity and competitiveness of European capital markets;
- **(b) Risk to Market (RtM) K-factors**: the proposed formula for the calculation of RtM is suboptimal. The requirement to use the higher of the two K-factors would force market participants to calculate at least two different methods for setting own-funds requirements, thus raising compliance costs. Moreover, the "higher of" approach would effectively subordinate the K-factor on "clearing member guarantee" (**K-CMG**) to the K-factor on "net position risk" (**K-NPR**), thus undermining the proven accuracy and stability of clearing margin collateral models;
- **(c) Calculation of K-NPR:** the consequences of the full application of the Basel Committee on Banking Supervision's (**BCBS**) revised market risk standard (also known as the "Fundamental Review of the Trading Book" or **FRTB**) to non-systemic investment firms warrants close scrutiny. We note that the efficacy and impact of FRTB on systemic firms, those for whom it was developed, has yet to be determined;
- **(d) K-factor on "daily trading flow" (K-DTF):** As a proxy for operational risk, K-DTF is not fit for purpose; its procyclical nature risks conflicting with the objectives of both MiFID II and the CMU.

We believe that these problematic aspects of the proposals may be the result of some shortcomings in the data collection exercises undertaken by the EBA during its development of the technical advice. The data set used by the EBA in its impact assessment only represented a small cross-section of EU investment firms and excluded a significant number of principal trading firms.[5] FIA EPTA's own

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[1] Proposal for a Directive on the prudential supervision of investment firms (IFRD) [COM(2017) 791], 20 December 2017, [link]
[2] Proposal for a Regulation on the prudential requirements of investment firms (IFRR) [COM(2017) 790], 20 December 2017, [link]
[3] European Banking Authority, Opinion of the European Banking Authority in response to the European Commission's Call for Advice on Investment Firms [EBA/Op/2017/11], 29 September 2017, [link]
[4] Directive 2014/65/EU on markets in financial instruments (MiFID II), 15 May 2014, [link]
Regulation (EU) No 600/2014 on markets in financial instruments (MiFIR), 15 May 2014, [link]
[5] Annex to the EBA Opinion EBA-OP-2017-11 in response to the European Commission's Call For Advice of 13 June 2016, Section 13.3.3, Notes to Table 22 (page 124), 29 September 2017, [link]

comprehensive impact analysis amongst its members was not able to replicate the 13% decrease in Pillar 1 requirements for PTFs which the EBA suggested would be the result of its recommendations.[6] Rather, we found a significant average increase of 243%. In fact, some FIA EPTA members observe a seven to ten fold increase of capital requirements based on the EBA's recommendations.

We have outlined our concerns and recommendations in more detail below. We believe that over-all the Commission has provided a good basis for a new prudential regime for non-systemic investment firms. However, the calibration of the regime and alignment with the CMU objectives needs greater consideration to ensure that the proposals contribute to the competitiveness and quality of European capital markets. We would encourage the co-legislators to closely scrutinise the proposed regime from this perspective. FIA EPTA stands ready to engage throughout the legislative review and to provide further technical input as required.

FIA EPTA recommendations

(1) Classification

We broadly support the Commission's proposed three-fold classification of investment firms – commonly referred to as Class 1, 2 and 3 investment firms – whereby systemic investment firms (Class 1) are subject to the same prudential regime as credit institutions, whilst qualifying non-systemic investment firms are subject to a tailored regime for small and non-interconnected firms (Class 3). However, we question the de-facto permissions-based distinction between Class 2 and 3 non-systemic investment firms. The automatic exclusion from Class 3 of investment firms dealing on own account (set out in Article 12 IFRR), disregards the substantial increase in the number of investment firms with MiFID II Annex I Section A(3) permissions from 3 January 2018. Neither the EBA technical advice nor the Commission proposal seems to have provided justification for this exclusion, which risks creating significant barriers to entry to the detriment of the competitiveness and diversity of European capital markets. FIA EPTA members are of the view that Class 2 firms should be distinguished from Class 3 firms on the basis of a quantitative threshold, irrespective of the firms' MiFID-II permissions. We consider that firms with a fixed overheads requirement of EUR 5 million should be considered small and non-interconnected and should be deemed Class 3 firms.

(2) Own fund requirements

(a) Risk to Market (RtM)

We note that the Commission's proposal for the calculation of RtM in Articles 21-23 IFRR is closely aligned with the recommendations of the EBA. FIA EPTA members welcome the inclusion of K-CMG as a possible metric for calculating RtM. We have long championed an assessment of own funds based on the margin models applied by clearing firms. Section 5.6.5 of the Annex to the EBA's technical advice acknowledged the proven resilience of this methodology and its strong legal basis. The margin models are developed by our clearing firms, which are generally subject to the full scope of Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (**CRD IV**) and Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (**CRR**).[7] The models have undergone extensive testing to ensure their efficacy and accuracy and they are subject to stringent governance criteria. Nevertheless, the EBA recommended that firms should apply the "higher of" K-CMG and the K-NPR thus, in practice, subordinating K-CMG to the latter, as the K-CMG calculation is more acute and accurate and therefore inherently lower. Article 21 IFRR codifies the EBA's recommendation.

The approach to K-CMG in the Commission's proposal is somewhat ambiguous. Recitals 20 and 24 IFRR introduce K-CMG as a genuine alternative to K-NPR, subject to certain conditions and permission by the relevant national competent authority (**NCA**). Similarly, Article 23, detailing the conditions to be met and the calculation methodology for K-CMG, states that an NCA may permit a firm to calculate RtM on the basis of K-CMG as a "derogation" from K-NPR. These provisions suggest that the Commission recognises the merits of K-CMG and considers it as a suitable alternative to K-NPR. In contrast, the

[6] Annex to the EBA Opinion EBA-OP-2017-11 in response to the European Commission's Call For Advice of 13 June 2016, Section 13.3.3, paragraphs 391 and 395, 29 September 2017, [link]
[7] Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV), 26 June 2013, [link]
Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR), 26 June 2013, [link]

Article 21 "higher of" condition would subordinate K-CMG to K-NPR. According to our impact assessment undertaken among FIA EPTA members, the calculation of own funds based on the K-NPR methodology could be as much as ten times that calculated by K-CMG, with the average increase estimated at 243%.

In addition, we are concerned that the "higher of" approach would force market participants to undertake at least two calculations, using different methods for setting own-funds requirements, thus raising compliance costs. This contradicts the Commission's objectives to simplify the prudential requirements for non-systemic investment firms and to reduce compliance costs.

FIA EPTA believes that K-CMG should be recognised as a genuine alternative to K-NPR. Moreover, firms should not be forced to calculate two different methodologies in parallel on a continuous basis. Amendments to Article 21 IFRR to this effect would be consistent with the approach reflected throughout the rest of the text and with the CMU objectives, as detailed below in Section 5(a).

With regards to K-NPR, we believe that further consideration should be given to the impact of the calculation set out in Article 22 IFRR. Further assessment would be needed of the consequences of the full application of own-funds provisions derived from the BCBS's revised market risk standard (also known as the "Fundamental Review of the Trading Book" or **FRTB**) to non-systemic investment firms in Article 22(1)(b). The efficacy of this standard, which was developed for systemically-important institutions, has yet to be proven. While we see merit in various aspects of FRTB, notably the off-setting provisions, we fear that these may be outweighed by the prospective costs and substantially higher own funds required of non-systemic investment firms as a result of the provision for 'shocks' prescribed by the standard. We are of the view that such shocks should be phased-in and only applied when properly calibrated for non-systemic investment firms. The potential impact of FRTB is somewhat mitigated by the Commission's proposal to allow Class 2 firms to multiply the calculation of K-NPR by a factor of 65% as well as the Article 57 IFRR transitional provisions but evidence from the impact analysis amongst FIA EPTA members suggests further and more robust mitigating steps would need to be considered to ensure a more proportionate outcome.

(b) Risk to Firm (RtF)

K-DTF has been proposed as a proxy for operational risk,[8] however, we would question whether it possesses the necessary level of sensitivity to be an accurate measure of operational risk. In accordance with Article 32 IFRR, the K-DTF calculation will scale in a linear fashion with trading volume which does not correlate with an increase in operational risk. We are concerned that K-DTF as proposed may lead to unintended, procyclical outcomes which will potentially conflict with MiFID-II/MiFIR and the CMU objectives.

As it is linked to day-to-day trading volumes, K-DTF will be a variable measure that might severely hinder firms' internal capital planning and constrain their ability to maintain market making quotes in an efficient manner. This will have a negative effect on market quality and in turn raise trading costs for other market participants.

K-DTF does not take account of the inherent risk characteristics of the financial instrument being traded (e.g. whether the instrument is liquid or not) or of the presence of key risk mitigating mechanisms (e.g. whether the trade is being cleared and settled under the responsibility of a clearing firm). Moreover, the scalars for K-DTF have been calibrated for a period of uncharacteristically low volatility, which may create unrealistic outcomes when volatility in European markets returns to its typical average (which can easily be three times higher).

It should be noted that, in principle, PTFs' trading volumes are larger when volatility is high because of the greater demand for liquidity by other market participants under such conditions. Moreover, PTFs will undertake more offsetting trades when volatility is high, as such trades are needed for risk management purposes and in order to maintain market making quotes across markets and products. As a consequence, K-DTF as currently proposed may force market making firms to halt their trading during stressed market conditions in order to ensure compliance with their prudential requirements, in effect creating an artificial capital ceiling which conflicts with the Article 17 and 48 MiFID II and Article 15 MiFIR market making and quoting obligations for investment firms.

In order to address the above-mentioned concerns and to ensure greater alignment with MiFID II and the CMU objectives, we would advocate for the inclusion of a quantitative limit to ensure that the

[8] Recital 21 IFRR

resulting RtM requirements are not more onerous than the current operational risk regime. As noted above, we question whether the K-DTF possesses the necessary level of sensitivity to be an appropriate proxy for operational risk. With that in mind, it is important to ensure that NCAs will not have unlimited discretion to apply additional Pillar 2 requirements and that capital held under Pillar 1 in accordance with K-DTF must be duly taken into account and deducted from any Pillar 2 calculation.

With regards to the calculation of K-DTF, we are concerned by the use of the notional amount of the contract when calculating the value of derivative trading, in accordance with Article 32(2)(b) IFRR, as this distorts the true volume of trading flow. Adjustments could be made to the notional amount in line with those proposed for the calculation of the K-factor on "trading counter party default" (**K-TCD**) in Article 29(2) IFRR, whereby the notional amount is calculated on the basis of delta for option contracts and duration for short term interest rate calculations.

In the same vein, we would caution the use of a "rolling average" over a three month period for the calculation of K-DTF, and similarly for the calculation of K-CMG in Article 23(1), as exchange volumes can vary widely from month to month which would result in extreme fluctuations in the calculation of own funds. Such instability might hinder firms' ability to determine an appropriate internal capital strategy pursuant to Article 22 IFRD.

(3) Remuneration requirements

The proposed remuneration regime for non-systemic investment firms, introduced by Articles 28-32 IFRD, is a significant improvement on the current CRD IV rules.[9] In particular, we welcome the Commission's recognition that a maximum ratio rule (the "bonus cap") is not appropriate for Class 2 investment firms which use variable remuneration mechanisms as a means to be able to protect their capital base in times of economic stress or of reduced revenues.

We welcome the Commission's efforts to introduce greater proportionality to the remuneration regime, reflected especially in Article 23 IFRD which dis-applies the IFR remuneration regime for Class 3 firms. However, we believe that proportionality should be enshrined as an overarching principle of the remuneration regime, as it is in Recital 66 of CRD IV. Instead, the Article 30 IFRD variable remuneration rules are applied on the basis of the classification, discussed under Section 1 above, without taking due account of the firm's internal organisation or the nature, scope and complexity of its activities.

The Article 30(j) IFRD rule on pay-out in instruments is not appropriate for small employee-owned and/or owner-operated firms and other non-public companies which comprise the majority of the FIA EPTA membership. Observance of this rule would cause a considerable compliance cost for these firms which would not only need to create special instruments to meet this requirement, but would also have to bear the ongoing administration cost and other logistical challenges. These instruments would be very hard to value causing a further administrative burden as firms will need to justify the valuation techniques both to their employees and to their auditors.

The Article 30(k) IFRD rule on deferral of payment is also unnecessary for some FIA EPTA members whose balance sheets are short term in nature and which do not have long-dated trading assets or liabilities; trading and funding cycles of these firms allow profits, losses, and risks to be realised within a matter of days or weeks. Thus, the full impact of the decisions and behaviour of individual traders on the firms can be assessed very quickly as there are no longer-term trading risks that might materialise after a trader has left the firm or received a pay-out.

Whilst the Article 30(4) IFRD derogations from these rules are welcomed, we consider that the proposed thresholds are too low to be beneficial and would penalise small firms which have large (but off-set) balance sheets as a result of their market making strategies. In particular, we are concerned about the proposed threshold of EUR 100 million average total value in Article 30(4)(a) IFRD, which is just 2% of the equivalent threshold proposed for credit institutions in the proposed amendments to CRD IV.[10] We consider this contrary to the proportionality objective of the Investment Firm Review.

FIA EPTA would respectively recommend that the co-legislators build upon the approach of the Commission to enshrine the principle of proportionality into the provisions on remuneration and ensure

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[9] Articles 92 – 94 CRD IV

[10] Article 94(3)(a) of the Proposal for a Directive amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures [COM(2016) 854] (CRD V), 23 November 2016 [link]

that the application of the rules is appropriate to the size, internal governance and nature, scope, and complexity of the activities of the firm.

(4) Disclosure requirements

We would encourage the co-legislators to consider the proportionality of the proposed disclosure requirements. We would question the application to all Class 2 firms of the Article 47(b) IFRR requirement to disclose the diversity policy for the selection of the firm's management body. This requirement is not tailored for small sized investment firms which will have a limited pool of personnel from which to form a management body.

In respect of the Article 51 IFRR requirement to disclose remuneration policies and practices, Recital 29 states that this "serves the general interest of contributing to sound and stable financial markets". Whilst we agree with the necessity to establish and implement a prudent remuneration policy (in accordance with MiFID II requirements), we would challenge whether the publication of such information would make any meaningful contribution to stable financial markets and would question the proportionality of the requirement, given the nature, scale and activities of non-systemic investment firms.

(5) Consistency with objectives and existing legislation

(a) Consistency with CMU objectives

The objective of the Capital Markets Union is to facilitate alternative sources of market financing to reduce the over-reliance on bank financing in the EU. As evidenced by the impact assessment undertaken by FIA EPTA on its members, the IFR proposals risk generally increasing capital requirements for Class 2 investment firms, thereby hindering firms' ability to contribute to the liquidity and over-all quality of the market and undermining the success of the CMU. This impact would only worsen as Europe's capital markets increase in scale, as is the ambition of the CMU. We are concerned that the funding and investment costs for companies, investors, and citizens will unnecessarily increase, whilst high barriers to entry and undue compliance costs will reduce the level of competition and diversity of actors in the European markets. The consequence of such risks hindering both the competitiveness and robustness of European markets. We would encourage the co-legislators to closely scrutinise the calibration of the proposals to ensure that, in practice, they are aligned with the CMU objectives.

(b) Consistency with MIFID II / MIFIR

It should be borne in mind that upon the application of MiFID II on 3 January 2018, there has been a substantial increase in the number of firms with MiFID II Annex I Section A(3) permissions (for dealing on own-account).[11] A number of IFR proposals could potentially frustrate the objectives of the requirements of MiFID II and MIFIR. In particular, the objectives to bring more trading in financial instruments into a transparent and stable trading venue environment.

About FIA EPTA

*FIA EPTA is comprised of 28 principal trading firms (**PTFs**) which deal on own account in a wide range of financial instruments traded on trading venues across Europe. PTFs play a key role in the modern financial ecosystem, bridging gaps in supply and demand between market participants and facilitating price discovery, especially at times when markets are volatile. Collectively, FIA EPTA members are an important source of liquidity for trading venues and end-investors, allowing those who use the capital markets (whether to invest or to manage their business risks), to buy or sell financial instruments efficiently and at low cost. FIA EPTA's mission is to support transparent, robust and safe markets with a level playing field for all market participants.*

e-mail: epta@fia.org – web: epta.fia.org – twitter: @FIAEPTA

[11] The number of authorised persons in FIA EPTA's membership alone has increased by one-third.