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FIA EPTA: Position on a new prudential regime for investment firms

1. Introduction

The European Banking Authority (**EBA**) is expected to submit its technical advice on an appropriate prudential regime for investment firms by the end of Q2 2017. This advice will feed into the European Commission's completion of its report and legislative proposal on the same matter as is mandated under Articles 508(2) and (3) of Regulation (EU) No 575/20131 (**CRR**)("**508 CRR review**"). FIA EPTA members have continued to be engaged throughout this review process and have sought to be a source of information for all matters pertaining to the activities of investment firms and principal trading in particular.

This paper seeks to outline FIA EPTA members' views on the proposed future prudential regime for investment firms to inform the European Commission's considerations as it prepares for the forthcoming legislative proposals resulting from the 508 CRR review. Our position reflects our response to the EBA's proposed regime presented in its November 2016 Discussion Paper on designing a new prudential regime for investment firms [EBA/DP/2016/02].

2. About FIA EPTA

FIA EPTA is comprised of 28 principal trading firms (**PTFs**) that deal on own account in a wide range of financial instruments traded on trading venues across the Union. FIA EPTA members engage in manual, automated and hybrid methods of trading. Collectively, FIA EPTA members are an important source of liquidity for trading venues, 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, thus contributing to the overall quality of European capital markets. FIA EPTA members support liquid, stable and reliable markets that foster investor confidence and which efficiently allocate capital.

The majority of FIA EPTA members are investment firms authorised under Article 5 of Directive 2004/39/EC on markets in financial instruments (**MiFID**)("**MiFID investment firms**"). Those members that are not currently authorised as investment firms are expected to be authorised ahead of the 03 January 2018 application of recast Directive 2014/65/EU on markets in financial instruments (**MiFID II**). While FIA EPTA members differ in terms of the scale of their businesses and the financial instruments they trade, members share a number of common key characteristics, including:

- Members deal on own account, predominantly in financial instruments admitted to trading or executed on Regulated Markets (**RMs**) and Multilateral Trading Facilities (**MTFs**);
- Members transact with eligible counterparties and a limited number of professional clients only and do not generally have exposures to retail customers, hold client moneys or securities;
- Members' positions are margined and the great majority of member transactions are cleared by central counterparties (**CCPs**);
- Generally, members access clearing and settlement services through clearing firms and do not generally clear their own transactions in derivatives. Members do not undertake any 'bank-like' intermediation, maturity transformation or underwriting of financial instruments; and
- Members are not systemically important and can be wound down rapidly and in an orderly manner with minimal impact on markets and market participants.

3. Key considerations

a) Appropriate regime for PTFs

FIA EPTA members strongly believe that any future prudential regime for investment firms should simple and harmonised with an overarching objective of calculating regulatory capital which will ensure the orderly winding down of a failed investment firm. Whilst we agree that systemic and bank-like investment firms should remain 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 CRR, this regime is not appropriate for investment firms which do not meet those criteria. We believe that non-systemic and non-bank like investment firms should be subject to minimum capital requirements based on fixed overhead requirements (**FOR**) which is an established and proven practice with a basis in Union law.

b) Classification of investment firms

We broadly support the EBA's recommendation to propose a three-fold classification of investment firms: Class 1) systemic, bank-like firms; Class 2) non-systemic and non-bank like investment firms; and Class 3) small, non-interconnected investment firms.

Moreover, we support the EBA's recommendations in its Opinion on the first part of the Call for Advice on investment firms that the existing criteria remain appropriate for identifying Class 1 systemic investment firms, which we believe should remain subject to the full scope of CRD IV and CRR.

FIA EPTA members are not systemic. FIA EPTA members' operations ensure that systemic concerns and limited and contained. We operate in transparent, competitive and strictly regulated markets and generally trade highly-liquid instruments. Thus, if a member were to fail its business would quickly be taken on by a competitor and its positions would generally be settled or sold off within two working days. Moreover, our transactions are generally cleared and subject to margin requirements which would prevent the spread of risk to the wholesale markets in the event of failure. We believe that many of FIA EPTA members should therefore be considered Class 3 investment firms with the remaining firms falling into Class 2.

We would also challenge the EBA's assertion, in its Discussion Paper, that proprietary trading may be considered "bank-like". A substantial number of investment firms are authorised to deal on own account per Annex I Section A(3) of **MIFID**. The O-SII Guidelines do not refer to dealing on own account as a criterion for determining systemic importance. Moreover, proprietary trading as we understand the activity is not, and never has been, the preserve of credit institutions in the European Union or elsewhere.

With regard to the identification of Class 3 - small and non-interconnected investment firms - we believe that the exclusions proposed by the EBA need to be reconsidered. Class 3 exclusions should be, first and foremost, risk-based and for that reason we oppose the exclusion of firms dealing on own account, granting credit or loans to an investor, being a member of wider group or using a MiFID passport.

We consider that Class 3 firms should be distinguished from Class 2 firms by means of an appropriate quantitative threshold based on the three-month FOR. Given their small size and non-complexity, those firms falling below this threshold ought to be subject to a simple minimum own funds requirement based on FOR.

For those firms which ultimately fall into Class 2, we are broadly supportive of the EBA's proposal that minimum regulatory capital requirements should be the larger of FOR or the sum of applicable K-factors, provided they are appropriately calibrated as discussed in the section below.

We consider it to be crucial that the overarching purpose of the prudential regime for Class 2 and Class 3 investment firms should be to calculate the regulatory capital requirements to ensure the orderly winding down of a failed investment firm.

c) K-factors approach

As discussed above, we believe that Class 3 firms should be subject to simple minimum own fund requirements based on FOR. Nevertheless, we are broadly supportive of the EBA's proposed K-factor approach to the calculation of capital requirements for Class 2 investment firms. However, we consider that risk to customers (**RtC**) and risk to market (**RtM**) factors need some adjustment to properly address bilaterally executed trades as well as the clearing and settlement arrangements prevalent in European securities and derivatives markets. We are also doubtful as to the utility of the risk to firm (**RtF**) factor and how this measure may affect risk to customers and risk to market.

Further, we are concerned generally that the EBA's K-factor analysis does not seem to take into account the extensive conduct and market regulations that apply to investment firms, including the new regimes in MiFID II and Regulation (EU) No 600/2014 on markets in financial instruments **(MiFIR),** as well as Regulation (EU) No 596/2014 on market abuse (**MAR**). We consider that any K-factor analysis must consider the scope and primacy of these regulations.

On the basis of the abovementioned considerations, should the Commission decide to adopt the K-factor approach, we would propose the following adjustments to provide a more appropriate calibration of own funds requirements for Class 2 investment firms.

i. RtC

FIA EPTA members do not generally have "customers" as variously defined in CRD IV and CRR, thus the possible range of K-factors identified by the EBA as representing a risk to customers are generally not applicable to FIA EPTA members.

Some FIA EPTA members deal bilaterally in financial instruments with eligible counterparties as defined in Article 24(2) MIFID. Such transactions are not subject to MiFID requirements including the obligation to provide 'best execution'. Investment firm positions arising from such transactions, or any other transactions not subject to best execution requirements, should be excluded from the assessment of any RtC K-factor. Instead, such positions should be included in the assessment of RtM K-factors.

ii. RtM

The EBA understands RtM as the risk of a decline in market liquidity, a dislocation in market access or a loss of market confidence and integrity in the event of a firm failing. Based upon this definition, we are sceptical that FIA EPTA members pose a risk to market. FIA EPTA members, were one or more to fail, would not deny third parties access to markets in financial instruments. Such a failure or failures would not materially reduce liquidity and would not inordinately harm market confidence because FIA EPTA members operate in highly-liquid and competitive markets. Moreover their transactions and positions in financial instruments are generally cleared and subject to margining arrangements imposed by clearing firms. Additionally, FIA EPTA members are subject to real-time intraday monitoring and holistic initial and ongoing review by their clearing firms, who act as de-facto gatekeepers to the market and who effectively mitigate any risk to market posed by their clients' positions which they clear.

These considerations notwithstanding, were the Commission to include a revised 'proprietary trading activity' (**PTA**) K-factor in its proposal for a new prudential regime, we do not believe that the calculation should be based on balance sheet and off-balance sheet exposures as suggested by the EBA. These accounting measures fail to reflect the off-setting or hedged positions in financial instruments typically held by FIA EPTA members.

We believe a more appropriate measure of risk may be calculated on the basis of the aggregate margin applied by clearing firms to the investment firm's positions in financial instruments. Aggregate margin requirements provide an accurate picture of the risks of an investment firm's positions as they account for *inter alia* price volatility, liquidity, collateralisation, concentration and size of relevant positions and therefore, by extension, what may be considered any measure of RtM were that investment firm to fail. As credit institutions and systemic investment firms, clearing firms are subject to the own funds requirements in accordance with Article 92 CRR and must account for the positions they hold on behalf of their clearing clients. Consequently, these institutions devise clearing models reflecting their Part III CRR obligations and use these models to calculate the margin of their clearing clients, including FIA EPTA members.

In summary, we believe that calculating RtM on the basis of aggregate margin requirements offers policy makers the 'best of both worlds' – a new and simplified prudential regime for principal trading firms, which at the same time is firmly grounded in CRD IV and CRR.

iii. RtF

We do not support the EBA's proposed risk-to-firm uplift measure (**RFUM**) as methodology to reflect the potential for the risk to a firm itself to have an impact on others. We are doubtful that the EBA's analysis of RtF identifies any risk that would not already be accounted for by the revised RtM calculation as proposed by FIA EPTA. We would challenge the assertion that the risks described under the RtC and RtM K-factors would increase significantly in circumstances where the failure of an investment firm becomes more likely as this fails. This supposition fails to take into consideration the existing market and conduct regulation to which firms, including FIA EPTA members, are subject; the role of clearing firms and their monitoring and enforcement actions to restrict the trading activities and/or liquidate the trading positions of clearing clients; the ongoing supervision of investment firms by NCAs; and, the powers of NCAs to restrict the actions of investment firms or to order an investment firm to cease trading. Therefore, as currently defined, the RFUM would constitute the double counting of investment firm risk for the purposes of setting own funds requirements. To avoid duplication, we propose that the RFUM be set at 1 for all positions of a Class 2 investment firm that are cleared and/or margined. We do recognise that some investment firms may engage in more risky trading activity that is not subject to clearing or margining arrangements. In such cases, and within strict parameters, NCAs should be permitted to apply a RFUM greater than 1.

d) Liquidity

FIA EPTA members would welcome a liquidity regime that is both simple to understand and to implement, the principal objective of which would be to ensure that investment firms have sufficiently liquid funds to facilitate an orderly wind-down. We are of the opinion that all trading book assets as well as cash and cash-like assets should be eligible for liquidity purposes. It is worth noting that for clearing firm margin calls, cash and trading book assets (after adjusting for margin requirements) are considered equally as valuable in meeting liquidity needs.

With regard to discretionary supplementary requirements, whilst we agree that NCAs should retain an appropriate level of supervisory discretion, we believe that any new prudential regime should preclude NCAs from adding liquidity requirements for Class 3 investment firms and should include clear conditions to be satisfied before NCAs can direct a Class 2 investment firm to meet additional liquidity requirements. The application of additional liquidity requirements risks putting firms at a competitive disadvantage and distorting the level playing field within the EU market.

e) Consolidated supervision

We broadly agree with applying consolidated supervision as it serves to broaden and supplement supervision of a regulated person. However, consolidated supervision should not result in the capital requirements that exceed the sum of the requirements of each individual regulated person in the group. We believe that consolidation should extend only to affiliates established in a European Economic Area (**EEA**) jurisdiction and we are dubious of the merits of including very small and non-complex affiliates within the scope of consolidation given their negligent contribution to group risk.