FIA EPTA

EUROPEAN PRINCIPAL TRADERS ASSOCIATION

Response by the FIA European Principal Traders Association (FIA EPTA) to the FCA's second Consultation Paper on a new UK prudential regime for MiFID investment firms

28 May 2021

FCA CP21/7

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Introduction

The FIA European Principal Traders Association (FIA EPTA) appreciates the opportunity to provide feedback to the Financial Conduct Authority (FCA) on its second Consultation Paper regarding the implementation of the new UK prudential regime for MiFID investment firms.

FIA EPTA represents 30 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. Our members are independent market makers and providers of liquidity and risk transfer for exchanges and end-investors across Europe, including the UK. FIA EPTA's members are based in the Czech Republic, Germany, Ireland, The Netherlands and the UK (70% of our members having been licensed by the FCA).

Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

This document constitutes FIA EPTA's response to the FCA's Consultation Paper on a new UK prudential regime for MiFID investment firms (CP21/7). We very much welcome the FCA's approach as set out in the Consultation Paper and generally agree that the FCA's proposed rules are clear, proportionate and fit for purpose. In our response we focus on a number of key areas where we believe further improvements or clarifications could be made to enable a proportionate, effective and practicable prudential regime for investment firms. FIA EPTA members appreciate the FCA's consideration of our comments and suggested solutions and stand ready to provide any further input as required.

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Q1: Do you agree that CPMIs should apply MIFIDPRU requirements to their MiFID business? If not, please provide details of an appropriate prudential regime for the MiFID business of a CPMI.

N/a

Q2: Do you have any specific comments on our proposed approach to the calculation of the FOR and the specific items of expenditure that may be deducted from total expenses? If yes, what items would you suggest are/are not deducted, and why?

Yes. **FIA EPTA members would propose that fees and brokerage should be allowed to be deducted from total expenses regardless of whether these are directly passed onto customers**. We are of the view that otherwise, the inclusion of fees and brokerage in the FOR calculation would turn the FOR into more of a proxy for the risk associated with ongoing operations, rather than the risk associated with a wind-down, going against the intentions as stated in the FCA's consultation paper.

In calculating the own funds threshold requirement it is made clear the distinction between the risk of harm from ongoing operations and from wind-down. Each of these have their own assessment starting points, with additional own funds being necessary if the starting points are insufficient. For ongoing operations the starting point is the KFR. For wind-down the FOR. These address distinct areas of risk that occur due to different modes of operation of the firm.

In the calculation of the FOR if fees and brokerage cannot be deducted from total expenses unless these are passed onto customers, the FOR will no longer be a representation of the risk of harm from a wind-down but becomes much more a representation of the risk from ongoing operations, blurring the lines between these two concepts when calculating the own funds threshold requirement. Trading flow is not a representation of net position risk and vice versa, a distinction already drawn in the IFPR itself by the separate calculations of net position risk and daily trading flow.

We consider therefore, that fees and brokerage related to trading flow are a poor proxy for the fees and brokerage that would be incurred when liquidating a firm's net positions. We would therefore suggest that fees and brokerage may be deducted from total expenses, regardless of whether these are passed onto customers or not. For firms that have significant trading flow, but hold small positions, this should mean that when calculating their own funds threshold requirement the FOR remains a better starting point for the calculation of wind-down costs rather than a proxy for the cost of ongoing operations by effectively including a K-DTF style calculation within it.

We acknowledge that the fees and brokerage during a wind-down are unlikely to be zero but given the FOR is used as a starting point during the calculation of the own funds threshold requirement, rather than the calculation itself, we feel that this cost will still be adequately accounted for.

With fees and brokerage removed, FOR will remain an appropriate starting point for wind-down costs with the more detailed wind-down plan, a requirement as a part of the ICARA process, better able to represent the expected fees and brokerage that would be incurred during the liquidation of the firm's net positions.

Q3: Do you agree with our proposals for calculating K-ASA and that this should address the potential risk of harm from an FCA investment firm's direct safeguarding responsibilities, including where it is safeguarding assets delegated to it by another entity ASA? If you disagree, please explain why.

N/a

Q4: Are our proposals on the calculation of K-CMH, especially when amounts of CMH should be treated as being in a segregated account, sufficiently clear? If not, what specific suggestions do you have for improvement?

N/a

Q5: Do you agree with our proposals on how the value of assets should be calculated, and for when formal delegation takes place, when calculating K-AUM? If not, please explain any alternative suggestions you may have.

N/a

Q6: Do you agree with our proposals for calculating K-COH? Especially for measuring the value of cash trades, and for when certain transactions may be excluded from the measurement of COH? If not, please explain why and provide evidence to support any alternative suggested treatments.

N/a

Q7: Are our proposals that cover the interaction between K-AUM and K-COH clear and prudent? If not, what specific suggestions do you have to improve this?

N/a

Q8: Do you foresee any issues with our proposals for how to calculate an adjusted coefficient for use in times of stressed market conditions? If so, how might we address them, or what alternative practical suggestions do you have for achieving the desired outcome without unnecessary complexity?

FIA EPTA members welcome the inclusion of a method to adjust the coefficient used in times of market stress to calculate K-DTF. However, it is felt that the FCA's current proposals offer little relief in times of stressed market conditions whilst being operationally complex to implement. The most likely outcome for many firms being that they may choose to not implement these measures. FIA EPTA members see a number of issues with the proposed approach:

i. Exchanges would be disincentivised to call stressed markets, as this traditionally provides relief for market makers from providing liquidity, at the exact point that liquidity is needed.
ii. The markets are interconnected; stressed conditions in one market will ripple through into other connected markets. Whilst not being explicitly *stressed* it would be reasonable to expect price volatility and therefore on market risk to increase in those connected markets.
iii. Identifying the exact *time* that markets enter and exit stressed conditions will be difficult. The UK on-shored version of regulation (EU) 2017/578 states that 'Trading venues shall consider the resumption of trading after volatility interruptions as stressed market conditions'. Does this imply that stressed market conditions persist for the remainder of the trading session or for period of time?

In order to achieve a similar outcome, but avoiding the complications of the current proposal, **we would suggest that a statistical method, based on price volatility, as previously proposed by FIA EPTA is reconsidered**. We continue to strongly believe that this should practically allow firms to identify periods where price volatility is high in not just one but all connected markets. Providing relief for market makers during times of market stress, and therefore ensuring that the required liquidity remains in the market when it is most needed. We include a description of how the statistical method could work below:

Statistical method

1.1. FIA EPTA members believe that, rather than relying on trading venues, a simpler and more objective approach is to take a statistical view of stressed market conditions. This method removes volumes of transactions that are associated with statistically high price volatility. The great advantage of this method is that it is very simple, using generally available external market data and that the method can be used for every product on every exchange.

1.2. This approach is justified because during heightened volatility, end users of securities or derivatives increase their demands for liquidity. These periods tend to coincide with higher than average volume. The current drafting implies that following a period of heightened volatility, investment firms would be required to account for higher K-DTF. This creates a disincentive to provide liquidity at a point in time when end users most need it.

1.3. To ensure that liquidity providers are not disincentivised through higher K-DTF readings during this time, firms should be allowed to remove volume from the calculation which coincides with higher than average price volatility. Specifically, a threshold which defines higher than average price volatility is required in order to base this calculation.

1.4. The use of price volatility to statistically define 'stressed markets' is widely accepted practice. Delegated Regulation (EU) No. 2017/578 places this exact requirement onto trading venues who must set out parameters to identify stressed market conditions in terms of significant short-term changes of price and volume. Trading venues must then consider the resumption of trading after volatility interruptions as stressed market conditions.

1.5. The use of the same approach to identify stressed market conditions for the purposes of adjusting K-DTF seems entirely appropriate and aligns purposefully with the approach taken by exchanges, while ensuring an objective and consistent methodology across exchanges and financial instruments.

1.6. A percentile approach offers an elegant and scalable approach that should be simple to calculate. A percentile can be defined as the Nth percentile derived from a list of observations sorted from greatest to least. This can be determined as follows:

*Cadj = C * (DTFexcl / DTFincl)*
Where:
DTFexcl =the daily trading flow (DTF) of derivatives measured in accordance with Article 33 of Regulation (EU) 2019/2033, excluding the value of any trade that occurred during periods of ~~extreme volatility~~ ***stressed market conditions*** *as set out in Article 2**a**; and*
DTFincl =the DTF of derivatives measured in accordance with Article 33 of Regulation (EU) 2019/2033, including the value of any trade that occurs during periods of ~~extreme volatility~~ ***stressed market conditions*** *as set out in Article 2**a**.*

1.7. Article 2 would be deleted and a new Article 2a included to define 'period of stressed market conditions'.

1.8. We propose two different options, set out below, to define 'stressed market conditions', one based on historical volatility and another based on historical volume.

1.9. To ensure consistent outcomes from the calculation, we propose for the statistical method a longer look-back period than 6 months. This is to make sure the measurements can indeed empirically be assessed as substantive outliers over a longer time horizon; based on FIA EPTA members' quantitative analysis of market behaviour, we suggest to use a 3 year lookback period for this purpose.

1.10. Option 1 – historical volatility:

"Article 2a

Period of stressed market conditions

For the purposes of Article 1, periods of stressed market conditions shall be determined as the trading days where historic volatility is in the highest 10% of the last 3 years for a given market and product."

1.11. Historical volatility is measured by the difference between the high and low price of a product on a certain day. For derivatives, the price of the underlying product is used for the measurement. FIA EPTA members have analysed the proposed adjusted calculation, using this statistical method, based on Eurostoxx futures data. In doing so, we have used the year 2019 as the base data. When compared to this the calculated value for K-DTF, once March's volume begins to be included, increases by up to 51% compared to the same period for 2019.

1.12. Using this proposed statistical method, the increase in capital requirements would show an increase of only 5%, rather than the 51% increase. Without this statistical method the year on year changes for K-DTF range from -11% to 51%. With this statistical method the K-DTF value stabilises with the range tightening from -3% to 10% across 2019 and 2020. This achieves the desired effect of not disincentivising investment firms from providing liquidity during periods of market stress.

Q9: Do you agree with our proposed treatment of FCA investment firms when acting as clearing members and indirect clearing firms? If not, what alternatives could be used to calculate the own funds requirements for such activity? Are there any other circumstances in which FCA investment firms may have exposures to a CCP that should be captured by K-TCD?

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FIA EPTA members would like to highlight their view that the risk weighting used to calculate K-TCD for CCP default fund exposures would be disproportionate when compared to other K-TCD calculations and fails to take into account the risk mitigating functionality of the CCP. FIA EPTA members would like to highlight that the proposed risk factor does not align to other areas of prudential regulations:

- As set out in the proposal for MIFIDPRU 4.14.29, a risk weighting of 8% corresponds to that of 'other counterparties'. However, by nature of a CCP and the protections afforded by the default mechanisms, the risk factor of such an exposure should be at least more comparable to that of a Credit Institution.
- In other prudential regulations, there is a distinction made between QCCP and non-QCCP; whereby a QCCP receives a significant reduction in exposures by taking into account the fact that the loss on the default fund will be shared across other members. No such distinction is made within the currently proposed rules under IFPR.
- We note that within CRR the own funds requirements for the default fund contribution is calculated as 'K_i' as set out in Art. 308. This methodology takes into account the risk mitigation at the CCP and the ability to share losses amongst other clearing members; by doing so the risk factor applied to the exposure is significantly lower than the proposed 8% in IFPR.

FIA EPTA members would also like to highlight that by introducing a measure for clearing members within IFPR that is not reflective of the underlying risks, and is not aligned to methodologies found elsewhere, there may be a risk that investment firms will be dissuaded from entering into self-clearing or offering indirect clearing and potentially reduce the incentive of moving certain trading activities to the centrally cleared market. This could result in reduced competition in the clearing space, with more concentration amongst large banks and higher volumes of OTC derivative transactions.

In this regard, FIA EPTA members would strongly encourage the FCA to take into account the feedback it will receive from clearing firms. Client clearing services have been already restricted due to the impact of recent capital and liquidity rules, and this may exacerbate the current imbalance between supply and demand for client clearing services and impact indirectly liquidity in UK capital markets and affect end users of the UK markets.

Further, FIA EPTA members appreciate the simplicity of applying a prescribed risk factor but are of the opinion that the 8% is not reflective of the risk, and would request the FCA to reconsider this weighting.

By way of final comment, we would like to take this opportunity to reiterate our concern, expressed previously in our response to the FCA's CP1, that narrowing the scope of clearing members to UK based credit institutions or UK designated investment firms may have unintended consequences on liquidity, market stability and on the openness and competitiveness of UK financial markets. Consequently, we would again urge the FCA to ensure that the ability for clearing firms to enable the use of K-CMG by UK investment firms is not necessarily restricted.

Q10: Do you agree with our proposals for a basic liquid asset requirement, to be met by holding core liquid assets? If not, please explain what alternative proposal you would suggest and why.

FIA EPTA members welcome the FCA's guidance regarding the basic liquid asset requirement and holding core liquid assets. In this context, we would like to raise the comments below:

First of all, FIA EPTA members would request the FCA reassess the underlying rationale of this specific obligation. FIA EPTA member firms are Principal Trading Firms which means they are not trading or investing third party moneys or assets, but solely putting their own capital at risk. Consequently, their balance sheets are far less complex with little in the way of long-term assets or liabilities and with positions that can be closed out in a short period of time. As a result, in the event of the failure of a Principal Trading Firm, the extent to which external stakeholders are impacted is limited.

Secondly, we notice that there is a resemblance with existing regulatory requirements in other jurisdictions. However, we also see some notable differences in the FCA draft text. In par. 7.64, the FCA propose that investment firms will set their liquid assets threshold requirement as the sum of the basic liquid assets requirement ***and*** the higher of either (1) liquid assets to fund ongoing operations including financial stress, or (2) liquid assets to begin orderly wind down. This seems different from the existing EU regulation which sets only one criterion.

Furthermore, we have difficulties understanding the rationale for the second criterion. If we understand the draft rules correctly, the FCA sets the following standard when using the basic liquid assets requirement and option (1):

> [Liquid assets = basic liquid assets to begin wind down + liquid assets to begin orderly wind down]

With that, it seems that firms would have to hold liquidity twice for the same risk. We struggle to believe that this would be the intention of the FCA's draft rules.

Using the other combination, the basic liquid assets requirement and option (2), something is striking as well:

> [Liquid assets = basic liquid assets to begin wind down + liquid assets to fund ongoing operations]

In this case, an investment firm would have to take two sets of liquid assets for two risks/events which are mutually exclusive; either a firm winds down or it continues as a going concern. Again, we struggle to to believe this is the intention of the FCA's draft regulation.

In light of our comments above, **we would urge the FCA to reconsider its proposal as FIA EPTA members fail to see how there may exist an economic or regulatory rationale for these two, combined criteria.**

In addition, the main cost in these situations would be the margin. Margin is mostly collateralised (with assets/cash that are therefore "restricted", as set out in our comments above). If we understand correctly, the FCA proposes that an investment firm needs to hold liquid assets for its margin on top of the assets that are already excluded from the liquid assets pool and for a commitment (e.g., debt/net positions) which is already collateralised with liquid assets at the

clearing firm. In our view, this would be overly burdensome and would exceed the target level of market risk protection. **Consequently, FIA EPTA members would suggest to exclude any commitment arising from ongoing operations that is collateralized with liquid assets, because these will then be categorized as restricted.**

Lastly, we would also welcome if the FCA, as part of setting the specific core liquid assets requirements, would consider the following two aspects:

(i) For most firms, it will be allowed to include trade receivables as core liquid assets, taken into account the restriction from par. 6.14 and 6.15. However, firms that have permission to deal on own account are excluded. The FCA provides no reasoning for this exclusion in its consultation paper and we would argue it is also difficult to come up with an objective, economic rationale. Although to a lesser degree than with other types of investment firms or with banks, Principal Trading Firms will also have trade receivables on their balance sheet. By categorising this balance sheet item differently, an inequality is created that is unnecessarily burdensome. As elaborated above, the risk of insufficient liquid assets with a Principal Trading Firm in a wind-down scenario is very limited as well as the impact of such a wind-down on other stakeholders. **Therefore, we would suggest to amend the condition in par. 6.13, second bullet point:**

> ***"Non-SNI investment firms that ~~do not have permission to deal on own account, or~~ underwrite/place financial instruments on a firm commitment basis."***

(ii) In par. 6.19 it is proposed to exclude any asset that "is encumbered or subject to some restrictions that prevents it being realised". However, this condition does not contain a time indication for making these assets available. From a market practitioner perspective **we would suggest to use a timeframe of a couple of business days (2-4).** We would welcome further guidance on this. Especially because clearing firms may hold different types of assets for investment firms with different levels of restriction and/or shifting ownership. We would suggest it would be useful to allow for a degree of leeway in the applicable timeframe to adjust for these differences.

Q11: Are our expectations of firms regarding the ICARA and meeting the OFAR sufficiently clear? If not, which areas would benefit from further clarification?

FIA EPTA members welcome the FCA's approach. However, we note that local firms which are currently CAD-Exempt do not currently have an obligation to have the processes and arrangements in place which they would need to implement under IFPR ICARA process. Given the significant efforts which would need to go into establishing these processes and arrangements, **FIA EPTA members would welcome if the FCA could establish a 1-year transitional period which would allow current local firms to implement their ICARA process.** This would be based on the need to establish risk committees, assess harm to market and potentially source non-executive directors.

Q12: Is the rationale for and explanation of the own funds and liquid assets wind-down trigger sufficiently clear? If not, which areas would benefit from further clarification?

N/a

Q13: Do you agree with our proposal to use an early warning indicator?

FIA EPTA members welcome the clarity provided on the various intervention points from the FCA. However, we would like to highlight the additional burden that will be placed on firms by having a notification requirement for own funds falling below 110% of the threshold.

We feel that as a result of the notification requirement, and the possibility of regulatory intervention, the 110% will become an additional FCA-defined own fund requirement, with investment firms applying additional internal buffers above the 110% to reduce the likelihood of having to notify the FCA.

FIA EPTA members are of the opinion that the combination of the detailed recovery plans, ongoing SREP and the more extensive ICARA process should provide the FCA with sufficient reassurance that the investment firm has sufficient controls and recovery plans in place to effectively mitigate the risk of falling below the 100% threshold amount. The investment firm will also take a prudent approach to implement such internal buffers to avoid the use of their recovery plans.

Q14: Do you agree with our proposed approach to the ICARA for firms forming part of a group?

N/a

Q15: Do you have any comments on our proposals for high-level rules on internal governance and controls?

N/a

Q16: Do you agree with our proposals to require certain non-SNI firms to have a risk committee, remuneration committee and nomination committee?

N/a

Q17: Do you agree with our proposal for firms to apply the new MIFIDPRU Remuneration Code from the start of their next performance year beginning on or after 1 January 2022?

While FIA EPTA members expect many firms will be able to apply the new MIFIFPRU remuneration code from 1 January 2022, there are two areas which may be problematic for firms:

The first is the requirement to have a remuneration committee of which 50% or more of the members must be non-executive directors. While some firms may already have non-executive directors, many, particularly smaller firms that will become non-SNI firms (e.g., local firms), will need

to put in place the necessary process and governance structures to recruit non-executive directors. The recruitment of non-executive directors can take some considerable time. Having this in place by January 1st 2022 may mean firms rushing the process and not appointing the most suitable candidates to their management body. This is not a desirable outcome in our view.

The second is the requirement to have variable compensation paid out in kind. As per FG 17/6, most IFPRU firms will currently be in proportionality level 3 of the guidelines and therefore disapplying the rules on deferral and retained shares or other instruments. Therefore, firms which are in scope of the extended remuneration requirements will most likely need to put in place appropriate instruments in which variable remuneration may be paid and many of those firms will need to avail themselves of the ability to use alternative arrangements as per par. 12.9 to 12.11 of the Consultation Paper. Undertaking such a process is complex and time consuming. Firms will need to design appropriate instruments and assure themselves that they meet the requirements of the rules. They will then need to put in place the requisite legal arrangements as well as communicating the changes to employees and altering employment contracts. Firms should have time to ensure that the arrangements that they put in place meet the requirements of the regulations and are fair for employees. If firms are rushed because of the tight timescale then a sub-optimal arrangement may be put in place.

Taking both of these points into account, and the additional management time being devoted to a potential return to the office now that the worst of the Covid 19 pandemic appears to be over, **we believe it would be appropriate to delay the implementation of these aspects of the proposed remuneration code to allow firms sufficient time to ensure that their remuneration frameworks are implemented in an appropriate manner.**

Q18: Do you agree that SNI firms should be subject to the 'basic remuneration requirements'? If not, please explain why not.

As mentioned in our response to Question 17, the requirement to have a remuneration committee made of non executive members may be problematic. Most investment firms currently subject to CRR are not subject to the requirement to have a remuneration committee (as well as a risk committee). Indeed non significant firms are exempt from the requirement and those who exceeded these thresholds were usually granted a waiver (IFPRU 1.2.9) on the basis that governance requirements were disproportionate.

Taking into account that the threshold to have a remuneration committee has been significantly lowered in the new regime, it means that smaller firms will now be required to meet this requirement. This may be problematic and FIA EPTA members believe that for a number of firms these governance requirements would be disproportionate, as they are under the current regime.

We would therefore recommend to introduce a proportionality principle (applicable to all committees) in line with the FCA's past approach and with the EBA guidelines dated 17 December 2020 paragraph 51 (EBA/CP/2020/27) that provides that **"Where there are not a sufficient number of members within the management body in its supervisory function to ensure a sound composition of committees as set out in this section, the tasks of the committee may be delegated**

to one member of the management body in its supervisory function, who is supported as appropriate by staff"

We would suggest to the FCA to implement a rule to the same effect, noting that this will also ensure a level playing field with EU investment firms.

Q19: Do you agree that only certain non-SNI firms should be required to apply the remuneration rules on deferral, pay-out in instruments and discretionary pension benefits? Do you have any comments on the thresholds we propose?

FIA EPTA members agree that only certain non-SNI firms should be required to apply the remuneration rules on deferral, pay-out in instruments and discretionary pension benefits. However, we disagree with the propsed level of the threshold. As per par 9.22 of the FCA's Consultation Paper a non-SNI firm will be in scope if:

- The value of its on-and off-balance sheet assets over the preceding 4-year period is a rolling average of more than £300m, or
- The value of its on-and off-balance sheet assets over the preceding 4-year period is a rolling average of more than £100m (but less than £300m), and it has trading book business of over £150m, and/or derivatives business of over £100m.

By contrast, under the CRD Article 94 (and PRA 2020/27), credit institutions are not subject to the limits on variable remuneration if their average total assets are less than EUR5 billion regardless of the size of their trading book. Credit institutions, in addition to lending and deposit taking, often carry out some of the same activities as investment firms (e.g., dealing on own account, wealth management and advice). However, investment firms do not have depositors to protect from the financial consequences of any mismanagement of risk. FIA EPTA members are Principal Trading Firms which means they are not trading or investing third party moneys or assets, but only putting their own capital at risk. They are also not authorised to accept client moneys and their balance sheets are far less complex with little in the way of long-term assets or liabilities and with positions that can be closed out in a short time frame. As a result, in the event of the failure of a Principal Trading Firm, the extent to which external stakeholders are impacted is limited as compared to a traditional credit institution and the horizon in which the risk may materialise is also shorter.

We note further that investment firms and credit institutions (as well as other non-financial institutions) often compete for the same staff. If there is a significant mismatch in the terms of compensation then investment firms will be at a competitive disadvantage compared to banks when trying to recruit similar staff. In addition, firms are competing for staff in a global market and more stringent rules for UK investment firms will put them at a competitive disadvantage to investment firms in the other major global financial centres. Not only that, but Principal Trading Firms typically invest heavily in technology to make them more efficient and even more importantly, better protected against operational risks, and will therefore also be at a disadvantage in trying to recruit developers when compared to a non-financial technology firm (e.g., a Google or Facebook) and this will likely lead to investment firms being unable to attract the best talent.

Therefore, applying more stringent remuneration rules to investment firms, which have a far lower risk profile, will put investment firms at a significant disadvantage in recruiting staff that could prevent competition and put UK investment firms at a competitive disadvantage.

We also note that the new thresholds will lead to a considerable number of extra burdens for firms that are in scope (particularly in having the costs and logistical burden of operating schemes for instruments that pay out in kind since most investment firms are not quoted and do not issue shares as a matter of course). In addition, in the absence of a quoted price, there will be additional costs required to try and value such instruments possibly having to use external advisors to assure employees that they have been valued appropriately. Even then, the valuation of such securities remains uncertain with the potential poor alignment of remuneration to the firm's performance and risk. This combined with the deferral rules may mean an increase in costs for firms as employees will likely demand an increase in fixed remuneration to compensate for a large proportion of variable remuneration becoming uncertain and/or deferred. This would in turn increase the risk to firm as firms will not be able to reduce these fixed costs in case of economic downturn (other than by making employees redundant).

For the reasons discussed above, **we believe that it would be most appropriate if the relevant threshold was aligned with the CRR (EUR5 billion with no restriction on the size of the trading book) so that firms regulated under IFPR or CRR rules are operating under the same constraints.**

Q20: Do you have any comments on our proposed approach to identifying material risk takers?

FIA EPTA members note that the approach to identifying material risk takers is broadly in line with the Level 2 EBA text on this area. However there is one point to note that would be welcome from a clarification perspective:

- Under par. 9.56 the identification process looks at individuals managing any business unit that conducts a regulated activity such as dealing on your own account. However, there are a number of instances where firms are acting in an agency capacity such as trading that is booked into an affiliated entity and the trades and risks of that trade are given up to those entities. As such, the overall impact from a use of risk capital can be quite immaterial. Consequently, **we would recommend the FCA to allow firms the discretion, which we believe is in the spirit of SYSC 19G, to determine if a manager of a regulated activity should be considered 'material' and would recommend that SYSC 19G.5.3. be phrased as such:**

  For the purposes of SYSC 19G.5.1R, a staff member ~~is~~ could be deemed to have a material impact on a firm's risk profile or the assets the firm manages if one or more of the following criteria are met:

The above clarification would also be in line with SYSC 19G.5.6 (2) – (4) in allowing firms the ability to decide if an individual's authority and responsibility held would constitute 'material' in the context of a firm's risk profile.

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Q21: Do you agree with our proposals for exempting certain individuals from the rules on deferral, pay-out in instruments and discretionary pension benefits? Do you have any evidence that may assist us in defining the scope of the exemption?

FIA EPTA members note that the thresholds for exempting certain MRTs have been simplified under this Consultation Paper without materially changing the scope of individuals. Firms that trade on an own account (principal) basis have a model to keep fixed costs as low as possible given the volatility in profitability year on year. This makes it easier to manage a cost base and to allow for better capital planning. **We would welcome a higher total compensation threshold to accommodate such business models. As a way of doing this we would suggest using the GBP equivalent of EUR 750,000** (with that amount used as a reference point in a Level 2 draft consultation from the EBA when considering material total compensation). Any MRTS paid less than total compensation of EUR 750,000, with the fixed and variable split paid in accordance with firm policy being applied, should be excluded in our view.

Q22: Do you have any other comments on the proposed scope and application of the remuneration rules?

FIA EPTA members note that the metrics should be based (par. 9.32) on gross assets, gross trading book assets or gross market value of the derivative business.

Although we understand that it is reasonable to use gross assets for some assets, we believe that this metric is not justified when assessing a trading book or derivative business.

Indeed, the rationale for including a threshold related to the trading book or derivative business is to "reflect the greater level of harm to customers or to market" (par. 9.31). However the risk of a trading book or a derivative business which could give rise to risk to market is not related to its gross positions but rather to its net positions.

In addition, we note this approach would be inconsistent with the approach taken by the FCA on K-AuM that allows firms to "*offset any negative values or liabilities attributable to positions within the relevant portfolios*" (par. 4.57). This creates an inconsistency with no policy or economic justification and an unlevel playing field between investment firms subject to the same prudential regime.

We would recommend, therefore, that for trading book and derivatives business the <u>net</u> trading book assets and the <u>net</u> market value approach be taken as this would be aligned with the economic risk and consistent with the metrics used in other part of IFPR.

We further note that there seems to be a contradiction between section 9.41 and 9.43. Section 9.43 includes that UK remuneration rules will have to be applied on an individual and consolidated basis where the FCA has not granted the permission to apply the Group Capital Test while section 9.41 in-dicates to limit application of the UK remuneration rules to MRTs of group entities in third countries that oversee or are responsible for business activities that take place in the UK. We would appreciate if the FCA could clarify that our understanding is be correct in the following scenarios:

- *A U.S. headquartered group with with investment firms in US, UK, and APAC*: The group does not qualify as an FCA investment firm group; UK remuneration rules apply to investment firms in UK on an individual basis (par. 9.39).
- *A UK headquartered group with with investment firms in UK, US and APAC and GCT permission*: The group qualifies as an FCA investment firm group; UK remuneration rules apply to investment firms in UK and the UK HQ on an individual basis (par. 9.42) and not to any of the other investment firms in the group.
- *A UK headquartered group with investment firms in UK, US and APAC and no GCT permission*: The group qualifies as an FCA investment firm group; UK remuneration rules apply to investment firms in UK and the UK HQ on an individual basis and on a consolidated basis for MRTs of group entities in third countries that oversee or are responsible for activities in the UK (9.43 + 9.41) and not to any of the other UK investment firms in the group provided they do not oversee or are responsible of UK activities.

Q23: Do you have any comments on the specific remuneration rules which we propose to apply to all FCA investment firms ('basic remuneration requirements')?

N/a

Q24: Do you have any comments on the specific remuneration rules we are proposing to apply to all non-SNI firms ('standard remuneration rules')?

N/a

Q25: Do you agree with our proposal to extend the existing non-Handbook guidance on ex post risk adjustment to FCA investment firms?

N/a

Q26: Do you agree with our proposals for rules on paying out variable remuneration in shares, other instruments or using alternative arrangements?

N/a

Q27: Do you have any comments on our proposals on deferral, vesting and retention?

FIA EPTA members note that under par. 12.15, the FCA's Consultation Paper suggests that deferral of variable remuneration should be greater than three years for MRTs whose role and responsibilities can have a material impact on the risk profile of the firm. FIA EPTA members are Principal Trading Firms which means their balance sheets are simple with little in the way of long-term assets or liabilities and with positions that can, and are, closed out in a short time frame. In many cases, FIA EPTA members close out their positions the same day and carry little overnight risk. Any risks materialising from an employee's conduct will therefore be noticed in a relatively short

time frame (i.e., in a matter of days or potentially weeks but in any event well within the three year minimum deferral period).

Therefore, we believe that the length of the deferral period should also take into account the business model of the firm and the likelihood of risks materialising after the deferral period. A deferral period of three years is more than sufficient for MRTs who can have a material impact on the risk profile of the firm and we do not see the need to extend the period any further than three years.

We further note that par. 12.22 states that shares or alternative instruments cannot be sold or accessed by the MRT for an appropriate period of time after the date on which they vest. If an employee has already had their compensation deferred for at least three years, adding a small period thereafter simply complicates the process and has little benefit. We also note that this requirement does not appear in the EU Investment Firm Directive or in the EBA's consultation paper on the guidelines for sound remuneration. We therefore would suggest to the FCA that this requirement should be removed.

Q28: Do you have any feedback on our reporting proposals? Please particularly provide details of any areas where you consider additional guidance on how to complete them is needed.

N/a

Q29: Do you agree with our proposals for consequential changes to our other prudential sourcebooks? If not, please identify which specific provisions you believe are not consequential changes that are needed.

N/a

Q30: Do you agree with our proposal for a three-year transitional provision (set out in MIPRU TP 2) to give former exempt-CAD firms time to comply with any new requirements in MIPRU 3.2? If not, what alternative proposal would you suggest?

N/a

Q31: Have you identified any specific cross-references that we may have missed where a consequential amendment could be needed to ensure the relevant provision still operates once IFPR is implemented? If so, please provide details.

N/a

Q32: Do you have any feedback on the applications and notifications forms covered in this chapter, including our proposals for any supporting information or documentation? Please indicate the specific form or forms your feedback relates to.

N/a

Q33: If you think you might want to apply for any of the permissions that need to be determined before 1 January 2022, please indicate which ones.

N/a

Q34: Do you agree it is fair and appropriate that we charge fees for the applications in certain circumstances where we have deemed it justifiable to do so? Please suggest what you believe would be an appropriate charge for the applications we have listed in section 11.19. Please indicate which permissions from that list you might be applying for.

FIA EPTA members would like to point out our belief for the reference in Question 34 to section 11.19 to be incorrect, but would appreciate the FCA's clarification on this. We believe the question should refer to sections 15.14 – 15.18 and the corresponding *Table 7: MiFIDPRU Permissions*. Furthermore, as the fee proposals are not due to be published until Q3 in the FCA's third Consultation Paper (as noted in par. 15.23), it is difficult for us to determine what would be appropriate. We would appreciate when the FCA outlines its fee structure that it also includes service standards that will help provide accountability for the FCA for which firms can rely on when submitting applications, in line with the current authorisation process. Lastly, we would welcome the FCA's additional consideration to ensure the fee structure is not excessive in a manner that would encourage or discourage one business model over another.

Q35: Do you agree with our proposed approach to publishing MIFIDPRU permissions on the FS Register?

N/a