FIA response to second FCA Consultation Paper on a new UK prudential regime for MiFID investment firms (CP21/7)

(electronic submission to FCA via email - cp21-07@fca.org.uk)

London, 28 May 2021

FIA[1] welcomes the opportunity to respond to the second FCA consultation on a new UK prudential regime for MiFID investment firms (CP21/7).

In summary, our response focuses on the areas and issues that have been identified by FIA UK investment firm members as needing further clarity or amending, and so we are not responding to all questions in the consultation paper. In *Section 1*, we ask for clarity on (i) the proposed K-TCD calculation methodology for pre-funded default fund contributions to CCPs, (ii) avoiding of double counting with regard to K-DTF when an investment firm acts as a matched principal (execution to client v execution to exchange) and (iii) the treatment of subordinated loans, which we appreciate the FCA consulted on in the previous consultation paper. *Section 2* touches on the proposed ICARA process and highlights a significant uplift, especially for firms that are currently not subject to the ICAAP requirement. We ask the FCA to consider an implementation period for those firms to give them sufficient time to prepare for compliance. Finally, in *Section 3*, we raise a couple of general points on the proposed MIFIDPRU Remuneration Code and then provide a few substantive comments on the extended remuneration requirements. The response closes with a short list of specific questions/points relating to the proposed remuneration requirements that we respectfully seek FCA's clarity on.

We look forward to engaging further with the FCA on these important requirements for our members.

> ***Question 9***: *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?*

[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.
FIA's mission is to:

- support open, transparent and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

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1. **Chapter 5: Firms acting as clearing members and indirect clearing members**

FIA UK investment firm members welcome FCA's attention to investment firms that provide clearing services. We are supportive of the FCA's attempt to provide further clarity on the application of UK IFPR in the context of derivatives clearing, however we have some additional observations and comments that we hope the FCA can address and/or clarify in the final rules.

a. ***Own funds requirements for CCP default fund exposures***

The FCA proposal for the K-TCD calculation on pre-funded default fund contributions would benefit from additional clarity and a few hypothetical examples, which would provide UK investment firm clearing members with certainty as to how they should calculate K-TCD for pre-funded default fund exposures to CCPs.

The key uncertainty relates to the proposed 'risk factor' of 8% as it could be interpreted to mean different things (either a risk weight or a final capital charge), so we respectfully request that the FCA clarify it and provide a few practical examples of how firms are expected to calculate the capital requirement for CCP default fund exposures. We appreciate that the FCA likely intended to simplify the calculation methodology in UK IFPR, compared to CRR, where the formula for calculating capital requirement for (pre-funded) CCP default fund exposures is more complex, as CCPs are required to calculate the risk weight for the default funds that they maintain, and then circulate them to members (C-factors). In most cases, the C-factors are less than 2%, but this may change once the revised CRR (CRR II) comes into effect in June 2021.

In the absence of further guidance, it would appear that the prevailing interpretation of 'risk factor' leads to a significantly higher capital requirement when compared to the current CRR rules.

For the purposes of confirming the correct calculation methodology and to illustrate a significantly higher and punitive capital requirement under the proposed UK IFPR compared to CRR, we have prepared below an example, in which we assumed that a firm has a default fund exposure of GBP5,000,000. We then calculated the capital requirement under K-TCD and also under CRR (in the first example, we assumed a risk weight of 2% and in the second example, we used a risk weight of 20%).

	Proposed UK IFPR (K-TCD)	**CRR** (*Example 1 - (RF of 0.16% as for exposure for qualified CCP (risk weight 2%)*)	**CRR** (*Example 2 - (RF of 1.6% as for exposure to bank/investment institution (risk weight 20%)*)
Own Funds Charge	Own Funds Charge = 1.2 * £5m * 8% * 1 = **£480,000**	Own Funds Charge = 1.2 * £5m * 0.16% * 1 = **£9,600**	Own Funds Charge = 1.2 * £5m * 1.6% * 1 = **£96,000**
Notes:	Own Funds Charge = alpha * EV * RF * CVA CVA = 1 in this case Alpha = 1.2 Own Funds Charge = 1.2 * EV * RF * 1	If we assume C-factor 2%, then RF = 2% * 8% = 0.16%	If we assume C-factor 20%, then RF = 20% * 8% = 1.6%

If our understanding of the calculation methodology is correct, then the proposed risk factor of 8% is extremely concerning as it results in a punitive capital requirement, which would not only put UK investment firms that are clearing members at a competitive disadvantage compared to the institutions subject to bank capital requirements, but it would also create an unlevel playing field with the EU IFR regime, which does not explicitly provide for rules on capitalisation of CCP default fund exposures for EU investment firm clearing members.

To that end, we ask that the FCA clarify the calculation methodology to ensure its consistent application across the impacted firms, and provide a few hypothetical examples of how firms need to calculate the capital requirements for exposures to pre-funded default fund contributions to CCPs.

We would be happy to provide further feedback once the FCA provides the requested clarification and examples. If the calculation methodology set out above is correct, then we believe that the proposed 8% risk factor is disproportionate and punitive for the impacted firms, and not in line with the capital rules that their bank and EU investment firm competitors are subject to. A couple of possible solutions include:

- no specific charge for own funds requirements for CCP default fund exposures, which would be consistent with the EU IFR, and firms would then be expected to pick this up in their ICARA process; or
- introduce a 0.16% risk factor, which is a product of 2% risk weight for trade exposures to QCCPs under CRR and 8% capital charge.

b. <u>Avoiding of double counting</u>

While we welcome the clarification of how firms should apply K-COH and K-DTF when an investment firm both executes and the clears the same trade, we would also like to ask the FCA to clarify the treatment of volume with regard to K-DTF when a firm acts as a matched principal, so that the impacted firms are not required to double count each side of the trade. The current clarification of avoiding of double counting only extends to execution and clearing, however it is silent on execution to client and execution to exchange.

c. <u>Definition and composition of own funds (capital) – treatment of subordinated loans</u>

Some of our UK investment firm members would like to raise the issue of Tier 2 Capital as more fully described in CP20/24, but which forms part of the broader picture when discussing UK IFPR. Those firms will now be considering the arrangements they need to put in place well before the end of the year. A number of smaller firms are subject to the more specific rules found in Chapter 3 of IPRU-INV. In relation to the treatment of subordinated loans, there are two main points which these firms would like to raise:

- The current regime for these firms allows them to utilise, as part of their regulatory capital, subordinated loans with no fewer than three months to maturity (3-63(5)R IPRU-INV). This allows firms to use subordinated loans flexibly and as a key risk mitigation tool to provide buffers in times of market stress. The new rules on Tier 2 Capital (specifically paragraph 4.12 of CP20/24) use the Capital Requirements Regulation (CRR) and so subordinated loans need to have a maturity of no fewer than five years (CRR Art. 63(g)). That significantly increases the cost of capital and does not permit firms to take the same proportionate action to mitigate the effects or potential effects of market volatility. Can the FCA please confirm that if the intention is to make IFPR no less onerous than Chapter 3 of IPRU-INV, is there going to be any allowance made for smaller firms who currently utilise subordinated loans?

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- Somewhat incongruously from the first point given the potential for significant increases in the costs of borrowing: pursuant to 3-63(6)R IPRU-INV, the total amount of 'eligible capital substitutes' (which includes subordinated loans with more than three months to maturity) a firm may apply to its financial resources must not exceed four times tangible net worth. Is there any intention to apply such a restriction to Tier 2 Capital under IFPR as this condition does not appear to form part of CRR (Articles 63-71)?

Question 11: *Are our expectations of firms regarding the ICARA and meeting the OFAR sufficiently clear? If not, which areas would benefit from further clarification?*

2. Chapter 7: Risk Management, ICARA and SREP

FIA UK investment firm members note the FCA's focus on investment firm's risk management process and assessment, and that all FCA-supervised investment firms will have to undertake an ICARA through which the firms should (i) identify and monitor harms, (ii) undertake harm mitigation, (iii) undertake business model assessment, planning and forecasting, (iv) undertake recovery action planning, (v) undertake wind-down planning and (vi) assess the adequacy of own funds and liquidity requirements.

The ICARA process will replace the existing ICAAP process for investment firms that are currently subject to IFPRU and BIPRU. However, some investment firms are exempt from ICAAP today (e.g. commodity dealers) and so becoming subject to the ICARA process and compliance with it is a significant undertaking, which will require the establishment of new and/or reorganisation of existing internal processes, new build of systems, reporting and other implementation steps before full and effective compliance is achieved. We note that the ICARA requirement is due to come into effect on 1 January 2022, together with the rest of UK IFPR, and that no phase-in or implementation period is envisaged for firms, not even for those that are currently not subject to ICAAP. Given that the UK IFPR rules will be finalised in the next few months, this will give firms very little time for implementation and compliance on Day 1. We also note that compliance efforts will coincide with staff at the impacted firms going back to the office, which will add additional burden to meeting the requirements on time.

Against this backdrop, we respectfully request that the FCA introduce a 6 to 12 month implementation period to comply with the ICARA process for firms that are currently exempt from the ICAAP requirement.

Question 22: *Do you have any other comments on the proposed scope and application of the remuneration rules?*

3. Chapters 9 - 12: MIFIDPRU Remuneration Code

General comments/questions in relation to the three levels of remuneration requirements – relevant sources of data

FIA UK investment firm members respectfully ask the FCA to confirm whether it is asking for the balance sheet value as requested by the FCA on RegData or as on firm's published accounts on the Companies House? This may be a subtle point and may not change the categorisation of firms, but the FCA RegData balance sheet includes derivatives business whereas firm's company accounts may not (Annex 2, paragraph 35 of CP21/7 would suggest that firms should use the former but we ask the FCA to clarify).

We also ask the FCA to provide further clarity with regards to the calculations of **"total gross assets", "total gross trading book assets"** and "**total gross market value of their derivatives business"** in relation to the extended requirements for the MIFIDPRU remuneration code as set out in SYSC19G.1.4R(1) and in relation to governance and risk management (MIFIDPRU 7.1.7R(1)). The reference to 'total **gross** assets', 'total **gross** trading book' and 'total **gross** market value of derivatives business' is unclear and potentially concerning, because it suggests that firms cannot take into account netting, which they would ordinarily do when preparing their accounts in accordance with accounting offsetting rules. We suggest that the FCA clarify the approach such that the firms should follow the numbers that they include in their accounts, which also reflect a netting benefit, where the netting requirements have been met. This would be a more proportionate approach and would more accurately reflect the risk profile of individual firms.

We would also like to confirm whether the market value of the derivatives business only includes values from the trading book.

Furthermore, for the determination of the value of the on- and off-balance sheet assets under SYSC 19G1.1R, it would seem reasonable to exclude client money and client assets protected and held under the provisions of CASS 6 and CASS 7.

In addition, we note that firms need to calculate a rolling average of on- and off-balance sheet assets over the preceding 4-year period, however it is not clear whether the rolling average needs to be calculated on a daily, monthly, quarterly or some other rolling basis.

Question 26: *Do you agree with our proposals for rules on paying out variable remuneration in shares, other instruments or using alternative arrangements?*

MIFIDPRU Remuneration Code: extended remuneration requirements

FIA UK investment firm members generally disagree with the proposed rules on paying our variable remuneration in shares, other instruments or using alternative arrangements. This will create a competitive disadvantage for larger investment firms versus payment services firms, smaller investment firms and cryptocurrency firms. The proposals are therefore likely to result in increased fixed salary payments, with a reduced ability to incentivise for good conduct. Furthermore, unlike investment banks, most investment firms are not directly listed themselves, so the requirement to create special arrangements to make variable payouts in shares (or other instruments) will create a very large, and disproportionate, operational burden. Unlike investment banks, most wholesale brokers trade in vanilla listed derivatives or simple OTC derivatives, and are not involved in much riskier CDS and IR business.

We therefore respectfully request that the requirements for non-cash remuneration be removed on the basis that deferred cash remuneration is subject to ex-post risk adjustment if the firm or the relevant business unit suffers a material downturn in its financial performance. This would appear to meet the FCA objectives cited under paragraph 12.2: "By linking the value of variable remuneration to the credit quality of the firm, *the financial interests of the individual are aligned with those of the firm*. In particular, *the individual will participate in any losses that result in a deterioration of the credit quality*". Requiring smaller and/or privately owned firms to issue instruments specifically for remuneration purposes would be disproportionate and inefficient when the same outcome is achieved through the deferral rules applicable to variable remuneration in cash.

For firms that fall into the extended remuneration requirements (Chapter 12 of CP21/7), because of their balance sheet and derivatives business, the requirements under that section seem to relate more to publicly listed companies. While they understand that the basic and standard requirements should apply, small privately held companies would like to suggest having the extended remuneration requirements apply solely to publicly listed companies because the requirements under this chapter seem to be aimed at such institutions or at private limited companies of a larger size in terms of employees which would appear to be more proportionate to their business and risks posed. Paying out in instruments which would cause the employee to be more invested in the company (such as shares) is not possible for such firms.

In addition to the above, we would also like to clarify the requirement for committees for firms of a certain size. Most firms with a small amount of employees will not be siloed into completely separate departments and so remuneration, risk and nomination issues are discussed across the business and because employee numbers are low, such discussions will inevitably involve (but not necessarily be controlled) by those involved, even if tangentially, in those areas of the business as part of their day-to-day roles. The costs become punitive if they need to set up independent committees and be treated as significant IFPRU firms.

Finally, please see below a few specific requests for clarification in the final UK IFPR rules:

- **Paragraph 9.56 – Firms offering multiple services, e.g. payment services and unregulated business in precious metals as well as investment business**: Can the FCA confirm that the effect of paragraph 9.56 is that staff in such firms who are engaged in non-investment activities are outside scope of the MiFIDPRU requirements? This would appear to be the case, but a clarification would be welcome.

- **Paragraph 12.9 – Requirement to pay out at least 50% in shares or other instruments or using alternative methods approved by the FCA**: Could an investment firm create a scheme that uses securities issued by its non-UK listed group parent to fulfil this requirement? If not, why not?

- **Paragraph 12.1 – 'Must not vest faster than pro-rata':** Subject to retention policies, does this mean that MRTs could access/sell the vested portion before the end of the deferral period?

- **Paragraph 12.22 – Timing of applicability of retention policy requirements:** '*This means they cannot be sold or accessed by the MRT for an appropriate period of time after the date on which they vest*.' Does this mean that the FCA expects the retention provisions to apply after the entire amount of the deferred portion of variable remuneration has vested? Please could the FCA provide some examples of what an 'appropriate time' would be?

- **Paragraph 12.15 – Length of deferral period**: '*We would expect the variable remuneration of MRTs whose roles and responsibilities mean they have a considerable impact on the risk profile of the firm or the funds it manages (for example members of the management body or senior management), to be subject to a deferral period longer than the 3-year minimum*.' Our members have found this statement unclear. Please could the FCA provide some examples of how much longer they would expect deferral periods to be in the case of such individuals?

- **SYSC 19G.5.4** – The FCA considers individuals responsible for 'significant revenue' to be material risk takers (MRTs). We would welcome further guidance on the FCA interpretation of 'significant'. If firms are to determine this in-house, does the FCA expect firms to define significant in the context of the individual firm's total revenue?

- **SYSC 19G.5.10** – This requirement has been interpreted in different ways internally at some member firms. We would like confirmation that firms subject to the extended remuneration requirements are able to apply the exemption for individuals set out in SYSC 19G.5.9.

- **SYSC 19G.1.1R(3)(a)** and **MIFIDPRU 7.1.4.R(2)(a)** – Does the reference to '*the size of the firm's on- and off-balance sheet trading book business is equal to or less than £150 million*' include derivatives?

- The consultation paper includes 'employees of joint service companies, and secondees' under the definition of staff. How does the FCA propose to apply UK IFPR where off-payroll service companies provide staff and invoice the investment firm for services provided? In particular, how does the FCA propose that firms defer remuneration in this situation?

Thank you for consideration of these comments. We would be happy to discuss them in more detail with you as required. Please contact the undersigned at +44 (0)20 7519 1831 or msiraj@fia.org in case of any questions or to schedule a follow-up call.

Respectfully submitted,

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