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EUROPEAN PRINCIPAL TRADERS ASSOCIATION

Lars Jul Overby
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Re: FIA EPTA response to the EBA Discussion Paper on designing a new prudential regime for investment firms

Dear Mr Overby,

I am writing to you on behalf of the FIA European Principal Traders Association (**FIA EPTA**) concerning the EBA's Discussion Paper on designing a new prudential regime for investment firms [EBA/DP/2016/02]. FIA EPTA members welcome the opportunity to provide comments on the EBA's proposals for a new prudential regime for investment firms. We are broadly supportive of the EBA's proposals, subject to appropriate calibrations outlined below.

1. About FIA EPTA

FIA EPTA is comprised of 29 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.

2. FIA EPTA position on the proposed new prudential regime

a) G-SIIs/O-SIIs

We support the EBA's recommendations in its Opinion on the first part of the Call for Advice on investment firms [EBA/Op/2016/16] and agree that the existing criteria remain appropriate for identifying systemic investment firms, which we believe 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 Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (**CRR**). We challenge the EBA's assertion that proprietary trading may be considered "bank-like". A substantial number of investment firms are authorised to deal on own account per MiFID Annex I Section A(3). 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.

b) Classification of investment firms

We support the proposed three-fold classification of investment firms and consider, generally, that Class 3 investment firms ought to be subject to a simple minimum own funds requirement based on fixed overhead requirements (**FOR**). However, we believe that the proposed Class 3 exclusions need to be reconsidered. Class 3 exclusions should be, first and foremost, risk-based and for that reason we oppose the exclusions on dealing on own account, granting credit or loans to an investor, being a member of wider group and 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.

c) K-factors approach

We are broadly supportive of the EBA's proposed approach and the focus on risk to customers (**RtC**) and risk to market (**RtM**), although we consider that both need some adjustment to properly address bilaterally executed trades as well as the clearing and settlement arrangements prevalent in European securities and derivatives markets. This said, we do not consider that FIA EPTA members pose risk-to-market (**RtM**) as described by the EBA. Also, we are 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 MiFID II and MiFIR regime, 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, we propose practical amendments to the K-factors approach in our response, which we believe would be 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 EBA's analysis on RtC and the proposed K-factors are not generally applicable to FIA EPTA members. We believe that bilateral transactions in financial instruments with eligible counterparties should not be considered as a risk to customers metric but rather as a risk to market metric.

ii. RtM

We are sceptical that FIA EPTA members pose risk to market as understood by the EBA. 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 and their transactions and positions in financial instruments are generally subject to clearing and margining arrangements. 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 that they clear.

These considerations notwithstanding, were the EBA to propose a revised 'proprietary trading activity' (**PTA**) K-factor we do not believe that balance sheet and off-balance sheet exposures are appropriate bases for any calculation as these accounting measures do not 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 or central counterparties 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 credit institutions and systemic investment firms subject to CRR, clearing firms must devise clearing models that reflect their Part III CRR obligations. We believe that calculating RtM on the basis of aggregate margin requirements offers EU 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 proposed risk-to-firm uplift measure (**RFUM**). 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 and as currently defined 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 should be eligible for liquidity purposes. We see merit in the EBA's proposal to link the liquidity requirement to the K-factors. Whilst we believe that NCAs should retain supervisory discretion, we believe that any new prudential regime should preclude NCAs from adding liquidity requirements for Class 3 investment firms and should include new conditions to be satisfied before NCAs can direct a Class 2 investment firm to meet additional liquidity requirements.

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.

f) Governance and remuneration

The objective of the new prudential regime should be to complement and not to duplicate existing market and conduct regulation. Therefore, the EBA should take account of the prescriptive and tailored governance requirements under MIFID II to which investment firms will be subject from 03 January 2018.

We believe that CRD IV remuneration rules remain appropriate for credit institutions and systemic investment firms but that they are disproportionate and overly burdensome for Class 2 and Class 3 investment firms under a new prudential regime. We support a new principles-based approach to remuneration. Such an approach should not include definitive limitations on variable remuneration similar to those in Article 94 CRD IV, which we believe compromise the risk management procedures of FIA EPTA members and which are not supported by any financial stability or public policy rationale.

FIA EPTA members and I look forward to discussing these issues further with you and your colleagues. We remain at your disposal to provide further information and ideas for the EBA's technical advice.

Yours sincerely,

Piebe Teeboom
Secretary General
FIA European Principal Traders Association