EVIA European Venues & Intermediaries Association

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EVIA Response to FCA DP20_02
A new UK prudential regime for MiFID investment firms

European Venues and Intermediaries Association and the London Energy Brokers Association, together "EVIA" is pleased to have the opportunity to share feedback to the thorough and substantial discussion paper you have authored. We supported the objectives behind the European union approach to a tailored Prudential Regime for non-bank Investment Firms ["IFs"] after a long process of attempting to recalibrate Operational Risk metrics, and here we warmly welcome the suggestions that you have proposed to take that evolution towards even further proportional outcomes.

Clearly the core of the outcome for intermediaries such as limited licence and limited activity firms operating trading venues across borders beyond Europe, turns on two principal matters: firstly the balance between Pillar 1 quantitative metrics and Pillar 2 supervisory add-ons; and secondly the application of capital requirements across businesses within the same group structure that may operate in different subsidiaries and in different countries. Where simple and able to be standardised, we support the adoption of Pillar 1, not least because of the critical requirement for a level playing field where firms compete in offering a service rather than a balance sheet. Yet given the diversity of transaction methods, business models, and geographical spread even amongst the EVIA subset of the IFPR scope firms there remains a definite requirement for proportionality.

The discussion which this FCA paper elicits needs be held with the outcomes of preserving both market liquidity, the agility of operating models and the competitiveness of UK intermediary operators on the wholesale stage.

Answers to Questions.

Q1 What are your views on the instruments or funds used by non-joint stock investment firms that should count as CET1 capital? Please give specific examples (See paragraphs 4.18 to 4.21)

EVIA agrees that the principle of all forms of allowable CET1 capital should exhibit the same or equivalent forms of loss absorbing characteristics, and therefore that the direct read across from IFR into IFPR is appropriate. It would useful if FCA added similar additional guidance in current IFPRU handbook under 3.2.18 and 3.2.19 for Partnership capital CET1 eligibility.

Q2 What level of detail would you find helpful when calculating the fixed overheads requirement (FOR)? (See paragraphs 5.13 to 5.15)

EVIA would support the principle of all firm specific detailed matters to be reserved into Pillar II supervisory overlay, such that FOR requirements are broadly applied across all investment firms in a manner promoting a level playing field rather than taking account of firm by firm specific characteristics. The consequence of this approach would be a relatively lower level of FOR in relation to operational and other specific add-ons. Further clarification would be useful in relation to staff bonuses especially in the case of deferred payments when calculating FOR.

Q3 What are your views on how any negative values or liabilities an investment firm manages within a portfolio, for example from derivatives or leverage, should be treated when measuring AUM? (See paragraph 6.13)

This is not relevant to limited licence and limited activity firms operating trading venues.

Q4 Do you have any comments on delegation from or to another financial entity when calculating K-AUM? (See paragraphs 6.17 to 6.18)

This is not relevant to limited licence and limited activity firms operating trading venues.

Q5 Do you agree with our view on how to measure CMH and ASA? (See paragraphs 6.24 and 6.31)

As limited licence and limited activity firms operating trading venues, EVIA member firms do not receive client monies as a normal course of business or an operating model. They may receive such monies as a consequence of matched principal arrangements such as settlement fails, coupon payments or measures related to exchange block arrangements including failures of exchange members or clients to process margin payments. Consequent to such incidental operational matters, it is important that the K-CMH metrics average actual amounts held, and do not seek to measure maximum instances that would prove sporadic and episodic.

EVIA firms do not facilitate the safeguarding and administering of a client's financial instruments. Therefore, we make no comments on K-ASA.

Q6 Do you agree with our views on how to measure COH, and when it does not apply? (See paragraphs 6.39 to 6.40, and 6.43 to 6.44)

No, the FCA views do not clarify the use case scope for name give up arrangements sufficiently where the matching of interests is only sufficient to create alleges to be further formalised on a MiFIR trading venue.

In the case of Name Give-up Brokerage activities by a Limited Activity and Limited Licence Investment Firm, CoH would not apply in most cases as these interests ["IOIs"] are not treated by venue personnel as firm order passing because there is no underlying CLOB based on a designated contract or other fixed terms prior to the discovery of trading match.

- In this way we do not consider that contract law could apply to the matched IOIs because no execution has occurred, nor could be able to occur until the rulebook of the MiFID OTF or MTF trading venue is applied.
- Another way to view the activity occurring in the pre-arrangement of trading interests by brokerage systems is that the core economic terms ["CETs"] are the only ones captured at the point of sale or where brokerage is applied and an IF service may be deemed to be performed as arranging and bringing about. However, these CETs have no bearing on the either the treatment of lifecycle events for those contracts nor the complete information required for a contract such as standard credit modelling or the exchange of initial and variation margin between the counterparties.
- Therefore IOIs, in common with the general MiFIR application, do not constitute Order or AIOIs and the activities undertaken by the IF in bringing interests to the MiFID OTF or MTF trading venue would not be considered not counted as the Reception and Transmission of orders ["RTO"].

Furthermore, we would make the following request for specificity because as drafted the discussion text does not sufficiently clarify the appropriate categorisation of Exchange Give-Up trades under COH or DTF.

- Although the literal definition of COH from Article 4(30) of Level 1 text states that:
    - *'COH' means the value of orders that an investment firm handles for clients, through the reception and transmission of client orders and through the execution of orders on behalf of clients",*
- Whereas Article 20 sets out that:
    - *"COH shall exclude transactions executed by the investment firm in its own name either for itself or on behalf of a client."*
- Therefore, in accordance with Article 20, the IFRP Para 6.35 of the FCA DP states that:
    - *"Orders executed in the name of the investment firm, including on behalf of clients, are captured under a separate K-Factor, K-DTF"*

All this text is written from the standpoint of a pure agency broker or indeed the brokerage activities of a full scope bank itself. It does not capture the business models and activities of Limited Licence and Limited Activity firms such as EVIA and LEBA members ["IDBs"] who operate trading venues under Investment Firm permissions. It would be appreciated if the FCA could thus clarify, where Limited Activity and Limited Licence Investment Firms "Arrange Exchange Blocks" or "Execute Single Sided Futures", on behalf of their clients, under the rulebooks of the relevant RM/DCM and above the MiFIR LiS - is such activity part of K-COH or K-DTF?

- We note two broad models of exchange execution:
    - where a firm holds a direct membership of an exchange and places agency trades into that account at the exchange, and
    - where a bespoke arrangement permitting the submission of pre-arranged blocks occurs for execution of the designated contracts under the rules of the exchange.

We would appreciate an FCA clarification or affirmation of our view that:

With respect to K-COH:

i. the measurement of K-COH does not extend to third party buying and selling interests which come about due to the operation of a 'multilateral trading facility' (MTF) or when operating an 'organised trading facility' (OTF). Rather, the IFR does not initially include any K-factor requirement specific to these discrete MiFID activities (but see also K-NPR below in respect of an OTF). However, this is something that the EU has previously noted it may consider as part of any future review of the new prudential framework for investment firms.
ii. 'Name Give-Up' ("NGU") transactions that are arranged by an IF operating an OTF and subsequently concluded on its own OTF are out of scope for the purposes of calculating K-COH?
iii. the treatment of such transactions would be equally out of scope, should they not in whole or in component part, be concluded on a different venue not operated by the IF itself, for example a third country DCM, SEF or RMO or an EU or UK Regulated Market, MTF or SEF?
iv. Whether exchange give up trades form part of K-COH or K-DTF?

Where Limited Activity and Limited Licence Investment Firms arrange "Exchange Blocks" under the rulebooks of the relevant RM/DCM and above the MiFIR LiS EVIA does agree that these matched interests are complete under the exchange rules and constitute the reception and passing of orders as proposed by the FCA.

- We note two broad models of exchange execution: where a firm holds a direct membership of an exchange and places agency trades into that account at the exchange, and where a bespoke arrangement permitting the submission of pre-arranged blocks occurs for execution of the designated contracts under the rules of the exchange.
- It may be the case that the former model also involves trade execution by the clearing member in addition to the RTO capacity.

We would appreciate an FCA clarification or affirmation of our view that:

With respect to K-COH:

v. the measurement of K-COH does not extend to third party buying and selling interests which come about due to the operation of a 'multilateral trading facility' (MTF) or when operating an 'organised trading facility' (OTF). Rather, the IFR does not initially include any K-factor requirement specific to these discrete MiFID activities (but see also K-NPR below in respect of an OTF). However, this is something that the EU has previously noted it may consider as part of any future review of the new prudential framework for investment firms.
vi. 'Name Give-Up' ("NGU") transactions that are arranged by an IF operating an OTF and subsequently concluded on its own OTF are out of scope for the purposes of calculating K-COH?

vii. the treatment of such transactions would be equally out of scope, should they not in whole or in component part, be concluded on a different venue not operated by the IF itself, for example a third country DCM, SEF or RMO or an EU or UK Regulated Market, MTF or SEF?

With respect to K-DTF:

viii. If Matched principal trades concluded on the OTF are also considered out of scope as they fall with thin the definition of third party buy & selling interest that come about due to the operation of the OTF?

Q7 Do you agree with our views on the treatment of 'cash trades' for DTF and COH? (See paragraphs 6.49 to 6.50)

No, the FCA views do not sufficiently clarify the scope of the use case where personnel employed by an investment firm holding OTF permissions arrange matches in bonds and other cash instruments under the Matched Principal model.

We advocate a holistic approach across the IF activity in relation to the accounting of matched principal activity. This is because gross sum of notional face value amounts involved in the arrangement of markets in cash bonds are substantive in any quantitative analysis for the activities of an IF operating a matched principal broking model it is important to consider the scoping details under these licensed activities.

- Although it is clear that the activities inside the MiFID OTF or MTF trading venue are not counted towards K-DTF, it would be helpful for the FCA to expressly clarify that any related arranging activities carried out by personnel to introduce interests to venues, especially between component legs of packages should not be eligible for counting towards K-DTF.
- Scenarios are perhaps an easier source of examples as to where the perimeter of K-DTF should not apply to the introduction of trading interests to a MiFIR TV.
- We would also pose the hypothesis that if all NGU and MTCH becomes de-scoped from Pillar 1, then would this become a Pillar 2 matter? In which case, would firms still be expected to calculate this as part of the ICARA because in our estimates, such a method would only save three-quarters worth of regulatory reporting.

Q8 Do you agree with our views on how to calculate the notional value for derivatives for DTF and COH? (See paragraph 6.51)

No, EVIA does not entirely support the approach suggested, which would appear to create outcomes which are too high when the residual risk for intermediaries is considered relative to the notional size of packages of derivatives

- No access to life cycle events and associated data points required for notional calculation of certain derivatives– as arrangers capture data points and commissions at point of sale only
- Principal perspective versus an arranger perspective
- Does not apply NGU activities – should be already be clear

Q9 Do you have any comments on the use of K-CMG 'on a portfolio basis'? (See paragraph 6.61)

This is not relevant to limited licence and limited activity firms operating trading venues.

Q10 When calculating K-TCD for foreign exchange derivative contracts, do you agree with our view on what 'domestic currency' can mean? (See paragraph 6.92)

Yes, EVIA does agree with the view on what constitutes a 'domestic currency' both in general and in respect of Trading Counterparty Default.

Q11 Do you have any comments on the composition of an investment firm group including the concepts of 'control' and 'ancillary service undertaking'. (See paragraphs 7.14 and 7.15)

EVIA concurs that group service companies are a common utility within IF group structures and therefore should be treated as being consolidated at group level. The approach should focus more on achieving the correct and proportionate representation, rather than concerns over regulatory arbitrage. Such matters are idiosyncratic and more appropriate for Pillar II rather than a framework approach.

In respect of Prudential Consolidation and the consequent ICARA methodology, we would raise whether the FCA would agree with EVIA that the existing prudential consolidations per latest SREP reviews are expected to continue post IFR? If that is indeed the case, can such firms then apply a consolidated ICARA process as opposed to applying at a solo level?

Q12 Do you have any comments on how to calculate consolidated FOR, consolidated PMR, and consolidated KFR? (See paragraphs 7.22 to 7.46)

EVIA has no comments.

8 Group capital test

Q13 What are your views on the conditions, both of which must be met, before an investment firm group may be given permission to use the GCT? (See paragraph 8.5).

EVIA notes an array of questions across the membership around quite what constitutes a “sufficiently simple” group structure and whether any threshold measures could endure across models and more-so as a business operates and evolves over time. Therefore, this may be an overly complex approach for Pillar I.

9 Concentration risk

Q14 Do you have any comments on our views on the limits that apply for K-CON and our worked examples for calculating it? (See paragraphs 9.23 to 9.24, 9.26, and 9.33)

EVIA does not consider that concentration risk limits are applicable to Limited Licence and Limited Scope firms. For firms that hold proprietary positions (i.e. trading book positions) the approach seems suitable. Non trading book concentration risk is deemed to be a Pillar 2 consideration.

10 Liquidity

Q15 Do you have any comments on the list of assets that may count towards meeting an investment firm's minimum liquidity requirement? (See Figure 10.1)

EVIA concurs that the list of eligible assets in Figure 10.1 is sufficiently broad and fit for purpose. Clearly such a list should be formally subject to a periodic review, especially in light of some of the evolving asset classes starting with Central Bank Digital Currencies.

11 Risk management, governance, and review process

Q16 What are your views on the structure and content of the elements being covered in the proposed new 'Pillar 2' framework. (See Figure 11.3 - paragraph 11.68)

EVIA supports the move from a credit institution based ICAAP to a much more appropriate ICARA. In regard to the elements of ICARA process under IFD we would ask the FCA the following questions and comments:

i. Without a sufficiently granular Pillar I framework and underlying principles, it would be very challenging for firms to achieve the better prudential outcomes hoped for

    - Given the timeline of application in the EU is from 26 June 2021 onwards with a 5-year transition period, does this mean that Pillar II will not be made public until after the go-live date?
    - Given the prospective timeline from June 2021, should firms plan for their first ICARA from the end of 2022?

ii. Can the FCA set out a more contextual definition of potential harms to clients?

    - We consider that unless sufficiently generic and broadly defined, such harms to clients should generally reside in a Level 2 conduct issue
    - Would any financial loss to an investment firm without positions nor risk capital therefore constitute an "unexpected financial loss"?
    - Noting the examples given by the FCA, where is the principled boundary set for any failure to discharge responsibilities as any competent professional organisation?

iii. Will ICARA be required for all investment firms in scope of IFR/IFD, as well as Group? Firms note having previously just compiled ICAAP on consolidated basis. Can firms continue with consolidation applied per the previous SREP reviews and hence ICARA at that level?

iv. It has been suggested that the P2R/P2G will not apply at the consolidated level, only at solo level. Is this intention of FCA? Or will FCA expect to apply discretion to also apply on consolidation?

v. Given the new wind down plan requirements, have the FCA considered taking investment firms out of scope of the Recovery and Resolution Directive, which like CRR contains many requirements designed with banks in mind?

Q17 Do you agree with our proposal regarding additional own funds requirements and specific liquidity requirements? This includes the articulation of requirements and guidance, stacking order and the use of VREQs to set own funds and specific liquidity requirements. (See paragraphs 11.77 to 11.100)

EVIA has no comments.

12 Regulatory reporting requirements

18 What are your views on the proposed approach for the transition from existing IFPRU/BIPRU ICGs? (See paragraph 11.102)

We note that the FCA is suggesting that P2R will be same as current (Pillar I + ICG) as a minimum constraint. This raises two issues for EVIA:

i. For the transition, does not seem fair to take a point in time total capital requirement to compare against IFR Pillar 1 requirement to calculation P2R, as K-factors like K-COH/K-DTF look at average values over 3/6 months.

ii. Seems unfair that cannot possibly have benefit of lower requirements from IFR until next SREP (which could be many years away given how firms the FCA will need to review). Therefore, can the FCA provide an indication of timing of the next SREP review post IFR?

We would also ask the FCA whether a firm may appeal a decision and if so, then is it via a sufficiently simple process? Consequently, is it the case that the peer review process becomes important in respect of reporting requirements back to supervisors.

Q19 What are your views on the level of detail required to meet regulatory reporting requirements? (See Chapter 12)

The EBA has produced draft reporting templates as part of its L2 technical standards.

It would be appreciated if FCA can align UK Firms reporting content and format as close as possible to the EBA ones to avoid doubling of report generation effort for firms with EU27 entities in the group.

13 Remuneration

Q20 What are your views on the scope and application of a new remuneration code? see paragraphs 13.7 to 13.18)

EVIA agrees with the FCA approach in general, however, we underscore that the Remuneration Code as it has been developed in the UK has only been designed and built for banks and fails to address the diversity of business models across the firms in scope of IFPR. Therefore, we would urge a more principles led approach underpinned in the first instance by that of a level playing field between firms.

Consequently, we do not consider Q21 – Q24 applicable and EVIA has no comments.

Q21: Do you think it would be appropriate for us to include in a new remuneration code a general proportionality rule similar to that contained in the IFD? (See paragraphs 13.44 to 13.50)

Q22: Do you agree with our interpretation of gender-balanced remuneration committee? Do you think it would be appropriate for us to include it as a requirement in a new remuneration code? (See paragraphs 13.71 to 13.72)

Q23: Do you agree it would be appropriate for us to include in a new remuneration code rules and guidance on retention, deferral, and ex-post risk adjustment? (See paragraphs 13.95 to 13.116)

Q24: Do you agree with the list of existing CRR-based permissions that we have identified as continuing under a new regime? (See Figure 16.2 in paragraph 16.6)

17 Collective portfolio management investment firms

Q25: Do you agree with our intended future treatment of CPMIs? (See Chapter 17)

EVIA does not consider that CPMIs are applicable to those member Limited Licence and Limited Scope firms.

18 Competent authority discretions

Q26: What are your views on whether a MiFID investment firm should be able to 'opt-in' to a regime based on CRR? (See paragraphs 18.4 to 18.8)

EVIA does not envisage any member Limited Licence and Limited Scope firm opting into a CRR regime.

Q27: What would be most appropriate way for SNI investment firms to report on the results of their ICARA process? (See paragraphs 18.11 to 18.14)

EVIA supports the aspiration towards balance an increased allowance for proportionality with prudence and recalls that this is indeed the underlying objective of the proposal. Clearly the results of any ICARA process can form the basis of corporate and investor disclosures.

Q28: Do you agree that the group capital test should be made available as an alternative to prudential consolidation? (See paragraphs 18.26 to 18.27) And (if you are an investment firm) is it an option that you would be interested in?

EVIA supports both routes being made available for the UK approach.

We would also query the FCA as to whether having an US Futures Commission Merchant (regulated by CFTC) in a Group would constitute, "*significant risks to clients or to market stemming from the investment firm group as a whole*" and therefore automatically disqualify firms from Group capital test?

Q29: Do you agree with our intended approach to remuneration exemptions for smaller non-SNI investment firms and individuals? (See paragraphs 18.29 to 18.38)

Yes, EVIA supports the aspiration towards balance an increased allowance for proportionality.

Q30: Do you agree with our intended approach to replicating the effect of the discretions on instruments used and alternative arrangements for variable remuneration? (See paragraphs 18.39 to 18.42)

EVIA supports the aspiration towards flexibility and an increased allowance for proportionality in the instruments of remuneration.

Q31: Do you have any comments on the other competent authority options and discretions discussed in Chapter 18?

<u>19 IFR transitional provisions</u>

Q32: Do you agree that any transitional provisions for the PMR should also extend to the ICR? (See paragraphs 19.9 to 19.22)

We emphasise the repeatedly raised concerns about the speed to the transition and would urge the FCA to apply the maximum timeframe to the transitions, being mindful of the developing European context and the fact that all our member firms are essentially cross border business models.

Q33: Can you identify any other scenarios that are not covered by IFR transitional provisions? (See paragraph 19.23)

EVIA has no comments.

Q34: Do you have any other comments on the content of a new prudential regime for investment firms as described in this DP?

EVIA has no comments.

Q35: Are there any specific areas where you believe that the requirements could be made even more appropriate for investment firms?

EVIA has no comments.