

EBA/DP/2016/02

4 November 2016

Discussion Paper

Designing a new prudential regime for investment firms

Contents

1. Responding to this Discussion Paper	4
2. Executive Summary	5
3. Background and rationale	7
4. Discussion	9
4.1 Introduction	9
4.2 General principles governing the categorisation of investment firms	9
4.2.1 'Systemic and bank-like' investment firms	10
4.2.2 Investment firms that are not 'systemic and bank-like'	11
4.2.3 Very small, non-interconnected investment firms	13
4.3 Prudential regime for investment firms	16
4.3.1 Capital requirements	16
Rationale for investment firms' prudential standards	16
General Design considerations for capital requirements: the K-factor approach	17
Risk to Customers (RtC)	18
Risk to Market (RtM)	20
Specific design considerations for K-factors for RtC and RtM	21
Risk to Firm (RtF)	23
Methodology to assess the risk to firm: Up-lift factor	23
The capital adequacy framework for investment firms	26
Capital requirements for Class 3 investment firms	27
Fixed Overheads Requirement (FOR)	31
Mapping the capital requirement framework for investment firms against current requirements	31
Dealing with any investment firms for whom the new K-factor approach to capital requirements may be inappropriate	32
Investment firms trading financial instruments	32
Other considerations	32
4.3.2 Definition and quality of capital for investment firms	33
Overarching principles and need for simplification	33
Permanence and non-joint stock investment firms	34
Capital instruments and items (tiers of capital)	35
Deductions, filters and other elements	36
Options for way forward	37

4.3.3	Initial Capital requirements	37
4.3.4	Eligible Capital	40
4.3.5	Liquidity requirements for investment firms	40
	Purpose of liquidity	40
	Considerations on the appropriateness of LCR and NSFR for investment firms	41
	Designing a new liquidity regime for investment firms – policy options	41
	Qualitative requirements for liquidity management	46
4.4	Other prudential considerations	48
4.4.1	Concentration risk	48
4.4.2	Consolidated supervision	49
4.4.3	Additional requirements on an individual firm basis	53
4.4.4	A macro-prudential perspective for investment firms	54
4.4.5	Reporting and any other prudential tools	55
4.5	Corporate governance and remuneration	56
4.6	Alternative approach to a new regime	58
	Annexes	61
	Annex 1 – Stylised example (illustrative only) to show the calculation of the Risk to Firm Uplift Measure (RFUM) to capture the exposure risk of the investment firm	62
	Annex 2 – Stylised example (illustrative only) to show the application of the total minimum capital requirement formula	63
	Annex 3 – New capital requirements framework mapped to current regime	64
	Annex 4: Liquidity – Some considerations in determining what may be a liquid asset	65
	Summary of questions	68

1. Responding to this Discussion Paper

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions stated in the boxes below (and in the summary at the end of this paper).

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the view expressed;
- describe any alternatives the EBA should consider; and
- provide where possible data for a cost and benefit analysis.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 2 February 2017. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the [Legal notice section](#) of the EBA website.

Disclaimer

The views expressed in this discussion paper are preliminary and will not bind in any way the EBA in the future work. They are aimed at eliciting discussion and gathering the stakeholders' opinion at an early stage of the process.

2. Executive Summary

The EBA received a Call for Advice for the purposes of the report on the prudential requirements applicable to investment firms (hereafter 'CfA')¹ from the European Commission on 13 June 2016 to provide a technical advice on the new categorisation of investment firms and the design and calibration of a more appropriate prudential regime for investment firms. The CfA is based on the EBA Report on Investment Firms ('the EBA Report') published on 15 December 2015, where the EBA provided its assessment of the current prudential requirements applicable to investment firms. The report included three recommendations that could be summarised as follows:

- 1) The necessity to make a distinction between investment firms for which prudential requirements equivalent to the ones held of credit institutions are applicable and those for which those requirements are not appropriate;
- 2) For the latter firms, a specific prudential regime should be designed;
- 3) The extension of the exemption for commodity dealers.

The CfA follows up on the first two recommendations in the EBA Report and has two different deadlines. The first part (henceforth 'Part 1 of the CfA') had a 30 September 2016 deadline and required the EBA to further specify the criteria for the identification of investment firms that should remain subject to the full CRD/CRR framework. This was submitted to the Commission on 19 October 2016 and has also been published on the EBA website.²

The second part (henceforth 'Part 2 of the CfA') should be submitted to the European Commission by 30 June 2017. The EBA is required to further specify the criteria on the first two recommendations of the Report, namely:

- 1) The exact criteria or indicators and thresholds for allocating firms in each of the proposed classes (new categorisation); and
- 2) The appropriate design and calibration of all aspects of a new prudential regime specifically tailored to the needs of different business models of firms and the risks that their operations present.

Against this background, the EBA is presenting a discussion paper (DP) on the design of new prudential requirements for investment firms with the aim to give respondents the possibility to provide input into the EBA considerations at an early stage. In view of the scope of the CfA, this DP focuses on MiFID investment firms (and potentially MiFID II firms). This notwithstanding, the

¹ Can be found at <https://www.eba.europa.eu/about-us/missions-and-tasks/calls-for-advice>

² Can be found at <https://www.eba.europa.eu/regulation-and-policy/investment-firms>

DP will also be relevant for UCITS management companies or AIF managers authorised to conduct certain MiFID investment services or activities.

The approach is presented in the DP aims to better capture the risks for investment firms that are not deemed to be systemic **and** bank-like. As was concluded in the EBA Report, there is a clear need to develop a single, harmonised set of requirements that are reasonably simple, proportionate, and more relevant to the nature of investment business, to cover the broad range of all types of investment firms. The framework proposed in this DP places particular focus on the **risks that investment firms pose to customers and to market integrity and liquidity**. Therefore the ongoing capital requirements shall be calculated based on capital factors (K-Factors) that are attributed to one of these two broad types of risks, which are then amplified by a measure of the risk to which firms themselves are exposed. As a result, firms that pose more risk to customers and markets should get higher requirements than those who pose less risk, and firms that pose similar risk to customers and markets but with more own risk should hold more capital than those with less own risk.

In addition to capital requirements, considerations on other parts of an overall framework, such as the definition of capital, liquidity requirements and other prudential requirements is presented with a view to develop a completely separate regime covering all risks for investments firms.

The proposals presented in this DP are developed with a view of designing a tailored regime for investment firms. While this remains the EBA preferred approach at this stage – as it captures the risks faced by investment firms more appropriately – the option of applying the CRR, albeit in a more proportionate and targeted manner, also remains an option, at least for some investment firms. The DP therefore also seeks the view of respondents on this possibility.

Next steps

The EBA launched a data collection exercise on 15 July 2016. The data collection ran until mid-October and the subsequent analysis of this data collection shall be used to calibrate the proposal in the final report. Therefore, this DP does not yet include a detailed calibration of a new prudential regime for investment firms.

The public consultation of this DP will last three months – until 2 February 2017. By that time, the analysis of the data collected should be advanced enough to support the final report. Following the feedback from the industry and stakeholders, the EBA will submit the Opinion supported by a report to the European Commission by 30 June 2017.

The EBA Opinion and the Report will be published on the EBA's website.

3. Background and rationale

According to Articles 493(2), 498(2) and 508(2) and (3) of Regulation (EU) No 575/2013 (CRR), the European Commission (EC) is mandated to submit three reports to the European Parliament and Council on investment firms. In preparing these reports the Commission is required to consult with the EBA and ESMA. In order to fulfil these mandates, the EC sought technical advice from the EBA's in December 2014, which led to the EBA Report of 15 December 2015. In this report the EBA analysed the current framework and gave three recommendations:

- 1) New categorisation of investment firms distinguishing between systemic and 'bank-like', investment firms that are not systemic and 'bank-like', and very small firms with 'non-interconnected' services;
- 2) Development of a prudential regime for investment firms that are not systemic and 'bank-like';
- 3) Extend the waiver for commodities dealers until 31 December 2020.

Following the EBA report, the Commission issued a second Call for Advice in June 2016, where the EBA should report on:

- 1) Whether systemic and bank-like investment firms should be subjected to same rules as banks or if there should be any derogations;
- 2) Appropriate design and calibration of all relevant aspects of a new prudential regime specifically tailored to the needs of the business models of 'non-systemic' investment firms; including whether they should be subject to liquidity requirements.

The EBA followed up by a separate response to the first part of the Call for Advice on 19 October 2016. The EBA Response includes recommendations on which criteria should be applied for the identification of investment firms for which the CRD and CRR constitute appropriate prudential requirements.

This discussion paper (DP) focusses on the prudential regime for investment firms and proposes a new framework where the focus is on risks to customers and markets and risks to the firm itself. This framework includes *de minimis* requirements aimed at taking into account the proportionality and different business models.

The calculation of the capital requirements, based on a risk (K-factor) approach, is the most innovative aspect of this DP. Therefore, this so-called K-factor approach is explained in detail and the proposal is accompanied with a clear description of relevant risk drivers, the proposed calculation methods and the description of the relevant proxies.

The DP covers all the most important aspects related to the prudential requirements for investment firms. Overall, the DP remains open to all the alternatives as at this juncture the main target is to gather as much information as possible from industry stakeholders.

The methodologies related to capital requirements, including the so-called K-factor approach, are discussed in detail. The potential need for specific requirements to cover certain exposures as well as the treatment of investment firms for which the K-factor approach may be not appropriate is discussed in detail.

The DP envisages the role of fixed overheads requirements and initial capital as ‘floors’ to the aforementioned K-factor approaches to the calculation of capital requirements. The DP illustrates the articulation of such approach with these other components and the impact that this might have to the smallest and non-interconnected investment firms.

There is also a section on the quality of capital, however no immediate change is proposed in the DP, rather to seek the views if it is possible to simplify it for investment firms in any way.

Furthermore, the EBA consults on the possibility of introducing **liquidity requirements** and the appropriateness of approaches such as the LCR. Alternative approaches are also presented as valid alternatives, which are also still open to contributions.

Although less detailed, other aspects that will be subject to the prudential regime are discussed. These include the need for **consolidated supervision**, the opportunity to monitor **large exposures** for investment firms, the consequences the introduction of a new prudential regime would have on the **reporting requirements**, the importance of **internal risk management** arrangements and the need for competent authority to have the power to address firm-specific issues, in case, with capital add-ons. Finally, this discussion paper includes a dedicated section on remuneration, as explicitly requested in the CfA.

All the industry stakeholders’ inputs, including quantitative and qualitative information, will be used to draft a second and final report that will accompany the EBA response to the second part of the Commission’s Call for Advice. This final report shall be submitted by the end of June 2017.

Recommendation 3 of the EBA Report on the exemptions for commodity dealers referred to in Articles 493 and 498 of the CRR has been catered for with the extension of both exemptions, until 31 December 2020.³

³ [Regulation \(EU\) 2016/1014 of the European Parliament and of the Council of 8 June 2016 amending Regulation \(EU\) No 575/2013 as regards exemptions for commodity dealers.](#)

4. Discussion

4.1 Introduction

1. The purpose of this Discussion Paper is to seek the industry's views on the EBA's considerations on a new prudential regulatory framework for investment firms that are not deemed **to be both systemic and bank-like**. This new framework aims to simplify the existing categorisation of investment firms and propose a single, more coherent approach to their prudential requirements. The proposed framework aims to be more proportionate and reduce the complexity compared to the existing framework while at the same time increasing the risk sensitivity.
2. In approaching this subject, it is to be remembered that the overall population of investment firms covered by this review is both large and extremely diverse. It covers MiFID investment firms with various different prudential treatments currently set out in the CRD/CRR including those for whom capital requirements are currently minimal, and those firms for whom there are currently no common EU requirements applied. The latter subset includes firms that will be brought into scope for the first time by virtue of the extension of the scope of MiFID II. Hereafter all of these firms are referred to as "investment firms". Due to the diverse range of investment firms covered by this review, consideration has been given throughout to proportionality, together with the need to find a common, minimum framework that is appropriate to address the relevant risks. These considerations will also apply to subsequent calibration and impact assessment of the proposal.
3. Regardless of the content of the future framework, the starting point of the EBA and this DP is that investment firms would benefit from having a consolidated single rulebook, separate from the one applied to credit institutions, even if this single rulebook were to borrow some relevant concepts and requirements from the CRD/CRR.

4.2 General principles governing the categorisation of investment firms

4. The EBA published its Report on investment firms (hereafter the 'EBA Report'), where it was concluded that a new prudential framework for investment firms should be based on a new categorisation of these undertakings into three categories. In the second stage of the work, the EBA is called, inter alia, to specifically identify the criteria according to which investment firms could be categorised between **systemic and 'bank-like'** investment firms, also called Class 1 firms, other investment firms (Class 2 firms) and very small investment firms with 'non-interconnected' services (Class 3 firms). The EBA Report suggested that the determination of which investment firms would be considered systemic and 'bank-like' should be mainly made by quantitative indicators, while the identification of the very

smallest, non-interconnected firms could be determined by a combination of both qualitative, such as legal factors, and quantitative indicators.

4.2.1 ‘Systemic and bank-like’ investment firms

5. According to Recommendation 1 of the EBA Report, a distinction should be made between ‘systemic and bank-like’ investment firms “to which the full CRD/CRR requirements should be applied” (henceforth ‘systemic and bank-like investment firms’), other investment firms with a more limited set of prudential requirements, and very small firms with ‘non-interconnected’ services. In particular, the recommendation highlights that such systemic and bank-like investment firms are exposed “to credit risk, primarily in the form of counterparty risk, and market risk for positions taken on own account, be it for the purpose of external clients or not”. For these undertakings, the capital requirements should be set in order to avoid contagion to other institutions and the system as a whole.
6. The EBA recently make public its considerations about systemic and bank-like investment firms, which details the EBA’s recommendations with respect to the identification of these systemic and bank-like investment firms. In summary it is recommended that existing EBA criteria used for the purpose of identifying Global Systemically Important Institutions (G-SIIs⁴) and Other Systemically Important Institutions (O-SIIs⁵) are also used to identify systemic investment firms. For the purpose of ensuring stability, integrity and sound competition in the EU financial market and to avoid regulatory arbitrages, it is important to ensure consistency between the criteria for identifying systemic credit institutions and systemic investment firms.
7. The EBA technical standards on G-SIIs and the EBA guidelines on O-SIIs set out five main indicators of systemic importance: size, interconnectedness, substitutability, complexity and cross-border activities. When assessing the systemic importance of investment firms it is important that all of these broad indicators are considered. There is also guidance in relation to assessing the systemic importance of investment firms in the EBA guidelines on O-SIIs. In particular, paragraph 12 of the EBA guidelines on O-SIIs establishes that relevant competent authority could use a different sample or an amended set of indicators, if considered more appropriate. Thus a broad range of factors is taken into account in assessing the systemic importance of investment firms.

⁴ Commission Delegated Regulation (EU) No 1222/2014 of 8 October 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards for the specification of the methodology for the identification of global systemically important institutions and for the definition of subcategories of global systemically important institutions (OJ L 330 of 15.11.2014).

⁵ Guidelines on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs) – EBA/GL/2014/10 of 16 December 2014.

8. In addition to the criteria for identifying G-SIIs and O-SIIs, there is also the consideration of what constitutes banking-type activities. It is considered that ‘bank-like’ activities of investment firms possibly include underwriting and/or placing of financial instruments on a firm commitment basis, provided it exposes the firm to a significant amount of market- and/or counterparty credit risk. Also, proprietary trading may be considered ‘bank-like’, if carried out at a very large scale.
9. In its Opinion on Part 1 of the Call for Advice on Investment Firms of 19 October 2016 the EBA recommends that investment firms that can be considered systemic and that engage in ‘bank-like’ activities should remain under the full CRD/CRR. It is the view of the EBA that only a very small sub-set of investment firms in the EU qualify as both systemic and ‘bank-like’, being very large ‘investment banking’ and proprietary trading firms, that can be identified by using the G-SII and O-SII criteria, as developed by the EBA. Only these extremely large investment firms should therefore remain subject to full CRD/CRR requirements.⁶

Questions

Question 1. What are your views on the application of the same criteria, as provided for G-SIIs and O-SIIs, for the identification of ‘systemic and bank-like’ investment firms? What are your views on both qualitative and quantitative indicators or thresholds for ‘bank-like’ activities, being underwriting on a firm commitment basis and proprietary trading at a very large scale? What aspects in the identification of ‘systemic and bank-like’ investment firms could be improved?

4.2.2 Investment firms that are not ‘systemic and bank-like’

10. For investment firms that are not considered ‘systemic and bank-like’, a less complex prudential regime seems appropriate to address the specific risks that these firms pose to investors and to other market participants. In addition, the EBA Report also recommended a proportionate solution for very small investment firms with ‘non-interconnected’ services. Hereafter this DP uses the term “investment firms” or simply “firms” to refer to all investment firms that are not ‘systemic and bank-like’, except where it explicitly refers to very small investment firms with ‘non-interconnected’ services.
11. Recommendation 2 of the EBA Report further elaborated on the specific prudential regime that could be developed for investment firms. In particular, specific rules could be developed with regards to investment business risks, such as credit, market, operational and liquidity risks taking particular account of the holding of client money and securities (client assets). In

⁶ Note: By ‘full’ it is meant the same set of requirements that apply to large credit institutions, subject to the possible need for any differences for such investment firms that might be identified in the future, for example in the development of the NSFR.

addition, Recommendation 2 noted that the development of this regime needs to pursue the aim of improving harmonisation for investment firms across the EU. It noted that the modified prudential regime should represent a solid basis for supervision, ensuring an appropriate and uniform level of minimum requirements in a 'Pillar 1' context.

12. Taking these recommendations into account, as well as subsequent analysis, the following set of overarching principles for a new prudential regime for investment firms is proposed:

- a) It is recognized that investment firms are *not* 'systemic and bank-like' and therefore, in general, the purpose of a prudential regime for investment firms is not to provide the same level of assurance as is provided for firms that are systemic and bank-like. It is, however, recognised that it is possible that an investment firm may be categorised as systemic, while not being 'bank-like'; the design of an appropriate, prudential regime for investment firms will need to provide sufficiently for any such *entities*. Furthermore, it is also recognised that there may be some large 'bank-like' investment firms which, although not categorized as systemic, are nevertheless deemed 'significant' in terms of their trading activity and the potential for their failure to create an adverse impact upon market confidence; the subsequent new prudential regime for investment firms may need to include a different approach, for example some form of simplified rules to capture exposure risks, but tailored for such investment firms.⁷
- b) It is recognized that the failure of investment firms may impact on customers and markets and therefore appropriate prudential requirements should be set for investment firms in order to minimize risk of harm and/or disruption to customers and markets. These capital requirements should ensure the continuity of the provision of services by ensuring that investment firms:
 - i) can absorb a degree of loss, including in respect of correcting any harm caused to customers and markets, and continue in business;
 - ii) have appropriate liquidity measures; and
 - iii) have enough own funds and liquid assets to wind down⁸ in an orderly fashion in the event of failure.
- c) In addition to the organisational rules applicable further to MiFID I and MiFID II⁹, the prudential regime applicable to investment firms should address the specific risks associated with holding client money and securities.

⁷ Please refer to Section 4.3.2 for further discussion.

⁸ E.g. Transferring customer assets to another investment firm.

⁹ Article 13 (7) and (8) of MiFID I, Article 16 (8), (9), (10) and (11) of MiFID II

- d) The prudential regime applicable to investment firms should ensure a harmonised set of requirements for these firms across the EU.
- e) The prudential regime for investment firms should ensure that firms that pose more risk to customers or markets hold more capital than those that pose less risk, as it is more important that these firms address any harm on an on-going basis.
- f) Among firms that pose similar risk to customers or markets, firms with more risky balance sheet or off-balance sheet exposures should hold more capital than those with less risky positions, as they present more of a risk of disruption to customers and/or markets.

Questions

Question 2. What are your views on the principles for the proposed prudential regime for investment firms?

4.2.3 Very small, non-interconnected investment firms

- 13. Recommendation 1 of the EBA Report established that consideration should also be given to “very small and ‘non-interconnected’” or Class 3 investment firms which may warrant a different prudential treatment.
- 14. Recommendation 1 of the EBA Report noted that these firms warrant a very simple regime to wind them down in an orderly manner. It further elaborated on the prudential regime that could meet this objective of proportionality and established that such a regime could be based mainly on fixed overhead requirements (FOR) and initial capital that fulfil the objective of setting aside sufficient capital for ensuring safe and sound management of their risks. These firms could also be subject to simplified reporting obligations. This could be achieved through a ‘stand-alone’ set of requirements for Class 3 firms.
- 15. Alternatively, the objective of proportionality may also be achieved through being ‘built-in’ into the design of the proposed new prudential regime for investment firms, as consideration has been given to proportionality and to ensuring that the smallest investment firms that pose low risk to customers and markets have simpler requirements (such as the FOR, subject to a ‘floor’ of an on-going initial capital requirement). This proportionate treatment, which is explained in paragraphs 68 to 71 below (and illustrated in Figure 1), means that new start-ups and firms that show no desire to expand in size beyond their existing local or niche business (and could therefore include sole-traders and partnerships) and that pose low risk to customers and markets, will have simple capital requirements when they meet the criteria for being classified as Class 3 firms.
- 16. Regardless of how a proportionate treatment is applied to Class 3 investment firms, it is necessary to identify a number of criteria that, if met, would preclude an investment firm

from applying the simpler capital treatment. These criteria would reflect higher risk activities and for instance could include holding client money or securities belonging to clients, the ancillary service of safekeeping and administration (B1)¹⁰, dealing on own account (A3), underwriting or placing with a firm commitment (A6) and the granting of credits or loans to an investor (B2).

17. Operating a multi-lateral trading facility (or MTF) (A8) and the MiFID II activity of operating a trading facility (or OTF) may also warrant consideration. Such activities in themselves do not generally have customers that are not financial institutions but can have an important role in the market (and under certain circumstances an OTF will be able to hold positions to facilitate trading).
18. There is then the question of whether firms that are part of a wider (inter)national banking or investment firm group should be considered interconnected and so precluded from applying a simpler capital treatment. However, where an investment firm is part of a 'banking' group then the application of consolidated supervision may help address any concerns. The remaining issue to address then is the situation where an investment firm might seek to separate itself into many, very small legal entities for regulatory arbitrage purposes – this possibility can be prevented by applying consolidated supervision to the investment firm-only group for capital requirements purposes.
19. There is also the question as to whether it should matter prudentially if a firm uses a MiFID passport. Even though such a firm would then be operating in more than one Member State, it is considered that the nature of the underlying MiFID investment services and activities, and the risk to customers that they present, would be no different than where a firm operates in a single Member State and therefore no different requirements should apply. This would reflect the fact that it is the firm as a whole that must fulfil its prudential requirements, which give the required level of protection no matter which Member State or States the investment business is being conducted in.
20. A further possible criterion to consider is the extent to which a firm makes use of tied agents¹¹. Both natural persons and legal persons may act as tied agents; the legal person itself may have employees. Using tied agents as a criterion for precluding the application of the proposed simpler capital treatment could risk biasing a firm's choice between business models (e.g. use of direct employees versus tied agents). On balance, it is suggested that the design of the prudential regime should address risks created through the use of tied agents

¹⁰ Please refer to the Annex I and II of MiFID for a list of all the MiFID investment services and activities.

¹¹ Tied agents are natural or legal persons who, under the full and unconditional responsibility of only one investment firm on whose behalf they act, promote investment and/or ancillary services to clients or prospective clients, receive and transmit instructions or orders from the client in respect of investment services or financial instruments, place financial instruments or provides advice to clients or prospective clients in respect of those financial instruments or services.

for all investment firms. Tied agents could be compared to employees and therefore addressed as an expense in calculating any FOR-like requirement. Therefore, any additional control risks associated with the use of tied agents should be captured through other requirements.

21. As well as the qualitative criteria discussed above, a range of indicators and quantitative thresholds may need to be set to distinguish the very smallest, lowest risk investment firms from larger firms (whilst ensuring that larger firms that do present material risk to customers and markets do not benefit from any simpler treatment). These quantitative indicators would include balance sheet size, income/turnover and assets under management (AuM). For instance the same thresholds that currently define an entity as “Nano” under the EU SME criteria (a balance sheet of up to [EUR 2m], and income/turnover of up to [EUR 2m]¹²) could be used.
22. However, some adjustments could also be developed. For example, a smaller firm should not be penalized for – e.g. – investing in infrastructure for the future (including say IT which could help provide a better service to customers) and there could be other factors that determine the size of a firm’s balance sheet that are not necessarily directly related to the size of its customer business and the risks that the firm poses to its customers.
23. Income/turnover from regulated activities could be said to be related to the amount of investment business conducted for customers, but by the same token it might make more sense to use a threshold that more directly reflects the potential risk to customers generated from that investment business.
24. Indeed taking the above argument further would suggest that the indicators or proxies to use for quantitative thresholds should be consistent with those used for how such risks are identified under the new capital adequacy framework¹³. The solution set out in paragraphs 68 to 71 adopts this approach¹⁴ and in so doing provides a smooth transition as a firm grows, whilst avoiding the need to specify any other quantitative thresholds – an exercise which is difficult, particularly when trying to set levels that would be appropriate across different Member States. However, such approach might add complexity for investment firms currently subject to the sole FOR.
25. In terms of other (non-capital) requirements, consideration is given in each area to ensure that proportionality works for very small firms. For example, it is considered that the new liquidity requirements identified below are appropriate and proportionate for all investment

¹² Note: If the EU SME definition of “Small” is ‘borrowed’ instead, then the thresholds for balance sheet and income/turnover would be EUR 10m each.

¹³ See Section 4.3.1 of this Discussion Paper for details on new capital requirements framework.

¹⁴ It uses the calculated total risk to customers measured against initial capital to identify the very smallest, low risk firms who may then avail of less onerous capital requirements.

firms, including the very smallest and non-interconnected investment firms. Another example is concentration risk, where limits might be justified for some investment firms, while a simple reporting might suffice for others.

Questions

Question 3. What are your views on the identification and prudential treatment of very small and non-interconnected investment firms ('Class 3')? If, for example, such class was subject to fixed overheads requirements only, what advantages and drawbacks would have introducing such a Class 3? Conversely, what advantages and drawbacks could merging Class 3 with other investment firms under one single prudential regime with 'built-in' proportionality have?

Question 4. What are your views on the criteria discussed above for identifying 'Class 3' investment firms?

For the above question, it would be useful to receive detailed comments on each of the following items, which would preclude an investment firm from being in 'Class 3':

- a) holding client money or securities,
- b) ancillary service of safekeeping and administration (B1),
- c) dealing on own account (A3),
- d) underwriting or placing with a firm commitment (A6),
- e) the granting of credits or loans to an investor (B2),
- f) operating a multilateral trading facility (or MTF) (A8),
- g) the MiFID II activity of operating an organised trading facility (or OTF),
- h) being member of a wider group,
- i) using a MiFID passport, and
- j) using tied agents.

4.3 Prudential regime for investment firms

4.3.1 Capital requirements

Rationale for investment firms' prudential standards

26. In the EBA Report it was suggested that a prudential regime can help to (i) avoid the failure of investment firms resulting in a material impact on the stability of the financial system, (ii) prevent harming investors' rights and assets, (iii) deal with the impact of failure, and/or (iv) ensure there is enough time to wind down a firm in an orderly fashion.
27. It noted that customers may suffer losses, for example where an investment firm provides unreliable investment advice or manages investments poorly; prudential requirements help to ensure that the firm has financial resources, on an on-going basis, to help pay for

correcting any harm that the customer may have suffered. It also noted that in the event of the failure of the firm, consumers may encounter loss of continuity of service, for example due to investments having to be transferred to an alternative investment firm; prudential requirements may enhance the ability of the investment firm to achieve a more 'orderly wind-down' and thereby most efficiently transfer customer investments.

28. And it further noted that market integrity may be compromised – and hence market counterparties and ultimately their underlying customers may suffer, for example through less market access or liquidity – where investment firms run into problems and/or fail, leading to erosion of confidence in the market and the firms participating in it. The footprint of a firm in the market, whether as a provider of investment products or as a provider of services relating to market infrastructure, should obviously be reflected in the adequacy of its risk management practices and the level of its available financial resources.
29. It was also observed that perhaps the greatest source of potential risk for investment firms overall was 'operational risk', in the sense of when something goes wrong with the business operations or investment services and activities of the firm. Here operational risk should be seen as the accumulation of risk that can arise to customers and markets through the operation of the various investment business conducted by a firm. Many investment firms are not currently required to calculate a 'Pillar 1' operational risk capital requirement, which in any event can be a basic percentage of income or other expenditure based metric. But where operational risk is assessed and reviewed under current 'Pillar 2' following the CRD/CRR approach it can be quite a complex exercise.

General Design considerations for capital requirements: the K-factor approach

30. With the rationale above in mind, there is a clear need to develop a single, harmonised set of requirements that are reasonably simple, proportionate, and more relevant to the nature of investment business, to cover the broad range of all types of investment firms.
31. The focus is therefore on designing on-going capital requirements that help to address the potential for impact that an investment firm can have on others – customers and market integrity. Overall, the harm an investment firm might cause to others may, in general, be expected to arise from some combination of the "size, internal organisation, nature, scope and complexity" of its business, and so to capture this on an on-going basis requires both the identification of a set of observable 'proxies' or factors to represent those risks and a set of scalars or percentages to reflect size and so to turn each individual factor into an actual amount of capital required. The extent to which such risks are then amplified by the risk to the firm itself (RtF) is dealt with subsequently (see paragraphs 47-49).
32. Such capital proxies or factors (hereafter called 'K-factors') as may be identified can be attributed to one of two broad types: as risk to customers ('RtC') and risk to market access, liquidity or integrity ('RtM'). This concept may be illustrated simply thus:

$$\text{Capital requirement} = aK_1 + bK_2 + cK_3 + dK_4 \dots nK_N$$

and where:

- a, b, c, d ... n are constants, scalars or percentages; and
- $K_1, K_2, K_3, K_4 \dots K_N$, are the 'K-factors' or proxies for risk.

33. The K-factors need to be based upon readily observable metrics, preferably the sort of information a firm might generally wish to know and hold about its business (rather than capture something that only has a meaning for the purpose of calculating its regulatory capital requirements). Furthermore, the scalars do not necessarily have to be measured in a linear way, but can be tailored according to the profile of an individual K-factor, if appropriate.
34. The K-factor approach is risk-based and would capture the on-going impact an investment firm can have on others. However, this should also be 'underpinned' by some form of expenditure-based metric – for example, a fixed overheads requirement (FOR) type measure – as a 'floor'; this would provide a minimum amount of capital to also help address the aim of ensuring that there is time to help wind down an investment firm in a more orderly manner should it get into difficulty.
35. This approach leads to utilizing the **two design principles** (compatible with the general principles laid out above) for setting the overall capital requirements for investment firms:
- a) Firms that pose more risk to customers or markets should have a higher capital requirement than those that pose less risk to customers or markets, as it is more important that these firms can address any problems whilst still in business; and
 - b) Among firms that pose similar risk to customers or markets, firms with more own (balance sheet and off-balance sheet exposure) risk should hold more capital than those with less own risk, as they present more of a potential risk of subsequent disruption to customers or markets.

Risk to Customers (RtC)

36. For the vast majority of investment firms, especially those which operate on an agency basis, the most important element of risk will be the potential for harm they may pose to their customers (for example, where they do not carry out the relevant investment services correctly). Therefore a range of observable K-factors for the 'risk to customer' (RtC) are required, taking into account the need for full coverage of the wide range of investment firms and different ways in which they can service, and act for or on behalf of, customers.
37. The possible range of K-factors for RtC identified thus far, is:

a) Assets under management (AUM)

This recognizes the potential risk of customer harm from incorrect discretionary management of customer portfolios, or poor execution etc. as well as any benefit the customer may derive from continuity of service. The metric would be the amount of customer assets under management (AUM).

b) Assets under advice (AUA)

This recognizes the potential for unsuitable advice, as well as the customer benefit of continuity of service, where that investment advice is provided on an on-going basis (e.g. where a firm has contracted to periodically review and advice on a customer's investment portfolio). For many consumers advice being given will simply be accepted, without question, which therefore is similar as if the firm had discretionary power. It would not, however, capture the customer taking 'one-off' advice on a transaction. The metric would be the amount of customer assets under advice (AUA).

c) Assets safeguarded and administered (ASA)

This recognizes the risk of safeguarding and administering customer assets. This includes where a firm might do this and provide the customer with access to information on, and the ability to request transactions be made in their investments through, an electronic platform Direct Electronic Access (DEA). The metric would be the amount of customer assets being safeguarded and administered (ASA).

d) Client money held (CMH)

This recognizes the risk of potential for harm where an investment firm holds the money of its customers. The EBA Report identified the holding of client money as an area of risk requiring particular attention and where it was desirable to seek to somehow cover this risk with (specific) prudential requirements. This K-factor could cover not just client money but also securities belonging to clients, but the latter asset class is kept separate for now pending subsequent analysis and calibration, as the quantum of risks need not be the same. Safeguarding of financial instruments belonging to clients would therefore initially be captured under the separate K-factor for ASA. The metric would be the amount of client money held (CMH).

The setting of the holding of client assets as specific K-factors (ASA and CMH) recognises the importance of this function, in terms of ensuring that the investment firm holds some capital, in direct proportion to such balances, for additional protection. Furthermore, it does so in a way that achieves equal treatment across jurisdictions and firms. This is because it no longer matters whether the investment firm treats client money and securities as its own liability on the balance sheet, or as completely separate from the accounts of the firm itself, or how asset segregation may work in practice at national or individual firm level, as the K-factor would treat all situations the same.

e) Liabilities to customers (LTC)

This recognizes the risk that a firm can have particular liabilities to customers¹⁵ that it may need to cover if something goes wrong. Such an example is where the firm may give a guarantee or indemnity to a customer, when the customer's asset is used for security-lending purposes. Another is where the customer may hold an 'in the money' contract written by the firm, such as a contract for difference (cfd). Even though the firm itself may have made a provision for, or may hold a hedge against, a (mark-to-market) loss, there is still the risk that the firm may not have the funds to pay out to the customer. The metric would be the amount of relevant liabilities to customers (LTC). It is not, however, intended to include cash trades which are settled according to common market practices.

If appropriate, a liability to a customer for which a firm holds a hedge could attract a lower calibration, or could simply be stripped out through adjustments to the exposure measure in calculating any uplift for the firm's own risk (as is explained further in paragraphs [50 to 56]).

It should be noted that client money or securities, regardless of whether such client assets are held on the balance sheet of the firm itself, would already be addressed via the separate K-factors for CMH (K_{CMH}) and ASA (K_{ASA}). Therefore, these client monies or assets held would not (also) need to be included under the factor for liabilities to customers (K_{LTC}).

f) Customer orders handled (COH)

This recognizes that whenever a firm is part of the chain or process for a customer order – reception & transmission, execution and/or dealing in order to give effect to the customer order – there is a risk that the customer can lose out. The firm should be able to afford to pay to put things right. If a broad view of 'customer' is taken here – i.e. to include banks and other institutions – then this K-factor may also be applied for orders conducted via multilateral and organised trading facilities (MTFs/OTFs). The metric would be the number (or similar measure of frequency) of orders handled (COH).

Risk to Market (RtM)

38. The second element of risk to consider is the impact an investment firm can have on the markets in which it operates. For example, should the firm fail or otherwise need to exit that market, particularly if this occurs suddenly, a temporary dislocation in market access or market liquidity may be observed and market confidence or integrity could be questioned. This can be addressed through specific K-factors that address such potential risks to the

¹⁵ On the trading markets, it can be difficult to attribute the quality of a client to one of the counterparties; therefore a clearer definition would help in application. This one might exclude eligible counterparties.

market or RtM. Although there will be other types of firm that may require K-factors for RtM, they will be particularly important to deal with (the minority of) firms that do not have any obvious external customers (and hence if/where no RtC K-factors might apply). One such type of firm that may have no external customers and RtC is one that trades derivatives only on a proprietary basis, and in so doing, provides liquidity to the market (and hence to firms that do operate on behalf of customers).

39. One K-factor for RtM may be identified in:

g) Proprietary Trading Activity (PTA)

This recognizes that although a firm's own proprietary trading (i.e. where dealing for its own gain and not on behalf of clients) primarily impacts the firm's own finances, it is possible to still have an impact on others, including via disruption to market access or liquidity etc.

This K-factor would certainly cover derivatives in addition to all other forms of proprietary trading (including derivatives trading firms that otherwise have no external customers as such). The metric could be the number (or similar measure for frequency of activity) of proprietary trades (PTA), albeit particular attention will need to be paid to ensure this is appropriate for derivatives.¹⁶

40. Operators of a multilateral or an organised trading facility (MTF/OTF) can be treated as investment firms under MiFID and therefore represent another type of firm that may not have any obvious direct risk to customers. Any positions taken by an OTF would be captured via this PTA K-factor. But if the transactions that they facilitate for others were not treated under the RtC for COH (under point f in paragraph 37) then there would be a need to provide for an alternative simple K-factor as a basic 'proxy' for RtM, especially where this may be the only MiFID investment activity for which an MTF operator firm is authorized. As an initial starting point, a simple, observable metric could be based upon trading facility income generated from this activity.

Specific design considerations for K-factors for RtC and RtM

41. When scalars are applied to each specific K-factor, the amount of any capital requirement should then increase in proportion to the scale of business undertaken (e.g. the higher the amount of assets under management, the higher the requirement should be in absolute numbers). Individual scalars would be identified as part of the overall calibration and impact assessment process. A scalar could be linear, which would be simple, or could be non-linear for example if the potential impact of the firm on others is felt to be increasingly more important the larger the firm's 'footprint' is in the relevant area. There is also the possibility

¹⁶ Please also see Section 4.6.

to subsequently drill down and provide sub-factors under any given K-factor should additional granularity be deemed appropriate (and does not unduly compromise simplicity).

42. In conclusion, there are initially seven identified K-factors, which act as simple proxies to help address various risks to customers (RtC) and to markets (RtM).
43. The overall capital requirement arising from risk to customers and markets would therefore be:

$$\text{Sum of RtCs and RtMs} = a * K_{AUM} + b * K_{AUA} + c * K_{ASA} + d * K_{CMH} + e * K_{LTC} + f * K_{COH} + g * K_{PTA}$$

where a, ..., g are scalars, and where the amount from a K-factor is simply zero if a firm does not undertake the relevant activity.

44. The above list is not necessarily exhaustive or definitive. For example, another possible K-factor for RtM could be any economic risk-retention ('skin in the game') that an investment firm might hold in respect of a securitization where it is acting as either sponsor or originator. Note this would be contingent upon investment firms (continuing to be) allowed by CRR to hold the economic retention (e.g. minimum first loss piece) for a securitization even if they were to be under a future, separate prudential regime. This risk retention may not only be a regulatory requirement on the firm itself, but other parties to the securitization (including investors) may take comfort from the alignment of incentives that such retention brings. Therefore the retention piece may reflect the impact the firm can have on others (including where its own customers are investors) in the securitization market. However, it may be that any economic risk retention for securitizations would be captured sufficiently under the proposed treatment of balance sheet risk to the firm itself, so as not to warrant any further consideration as a risk to customers. This would appear to be consistent with the overall EU financial services policy to increase confidence and activity in securitization markets.
45. Some competent authorities also have experience of the use of tied agents giving rise to additional risk in the operation of investment business; however, the use of tied agents (which could be individuals or a single legal entity that itself employs many individuals) is not necessarily an easy issue to immediately capture by way of its own K-factor. So, what has to be borne in mind in identifying any K-factor is whether there is a simple, readily identifiable metric that can be measured for use as a proxy for the additional risks tied agents may pose. However, it should be ensured that the extent to which a tied agent does any investment business then such amounts should be included by the investment firm when calculating the relevant RtC K-factors (e.g. AUA).
46. Given the prime importance of protecting customers and ensuring that firms have adequate capital to absorb the cost of putting right any problems should harm occur, the actual K-factors serving to address potential risk to customers would continue to be kept under review and adjusted as necessary.

Risk to Firm (RtF)

47. The third element to consider in the design of any new overall capital requirements regime for investment firms is how to deal with any risk to the firm itself (RtF), for example from its balance sheet assets and off balance sheet exposures (and where this is not already captured by an RtC or an RtM K-factor so as to minimize any possible ‘double counting’). These are the sorts of exposure risks that might give rise to a firm suffering the potential for loss arising from market price movements, counterparty defaults and credit deterioration etc.
48. There is also the possibility of not requiring the capture of any RtF itself (i.e. no K-factors nor any “uplift measure” required for RtF). This is because the risks to others will have already been adequately captured (i.e. through RtC and RtM K-factors), because any credit institution (or systemic and bank-like investment firm) counterparties would have CRD/CRR protections in place against failure of the investment firm, and because the capital of the investment firm would be underpinned by an expenditure / fixed overheads (FOR) type requirement to assist in wind-down. In such circumstances, **it could therefore legitimately be asked why any (residual) risk to the firm itself actually matters.**
49. Central to this question is the recognition that, whilst there may not necessarily be any direct impact on others (beyond shareholders/proprietors, who in any event should have an interest in good risk management to protect their own franchise), there could, nevertheless, be **an indirect impact on customers and/or markets.** This is because (and as acknowledged in the EBA Report), a firm that is financially weak or in trouble itself can be more susceptible to poor behaviour, weaker controls and greater risk-taking as it seeks to correct its fortunes. This in turn suggests that any RtF could increase the probability that RtC occurs, and/or amplify its impact if it does occur, and so should not be overlooked.

Methodology to assess the risk to firm: Up-lift factor

50. Taking the principles set out in paragraph 35 above into account, together with the analysis above, suggests that a viable alternative to creating specific K-factors for RtF is to find a simple way to reflect the potential for (direct) risk to a firm itself to have a subsequent (indirect) impact upon others. In other words, to provide an ‘up-lift’ to the total of capital requirements derived from RtC and RtM, so as to represent the relatively higher risk an investment firm could now pose (indirectly or subsequently) to its customers or to markets, by virtue of its own balance sheet and off balance sheet exposures (i.e. RtF).
51. This may be represented as follows:

$$\text{Capital requirement} = \text{Uplift factor} * \text{Sum (K-factors)}$$

where the purpose of the uplift factor is to reflect the riskiness of the firm and act as a multiplier that allows risk to be taken into account, either as a result of the business model or firm-specific characteristics.

52. One way to achieve this is to consider the leverage of the firm as a simple ‘proxy’ for risk arising from balance sheet and off-balance sheet exposures of the firm. Indeed the CRR actually specifies a measure for this, the Leverage Ratio (LR), where both the capital measure (numerator) and the exposure measure (denominator) are defined and for which any unnecessary complications identified could always be removed as part of simplification¹⁷. As Section 2.3.5 of the EBA Report on the Leverage Ratio under Article 511 of the CRR recognises, differences in accounting treatments under IFRS can have an impact upon the calculation of the leverage ratio for banks and this would also be true for investment firms, particularly for pending cash transactions which may be accounted for on the trade date by some firms or on the settlement date by others.
53. It should be stressed that ‘borrowing’ the concept behind the LR for the purposes of calculating an ‘up-lift’ (to RtC and RtM) for a new capital framework for investment firms is not the same as applying the LR as a binding measure upon investment firms. And so appropriate solutions can be found to issues such as the accounting treatment of pending cash transactions noted above when finalising the details of how the ‘uplift’ measure might operate in practice.
54. The use of the concept of leverage for a different purpose is not inconsistent with what is said in section 3.2.6 of the EBA Report under Leverage Risk:
- a) The sentence on the ‘concept’, “excessive leverage can be said to occur when a firm over extends the amount of business it conducts (on or off balance sheet) relative to the amount of capital it holds” must surely hold true for any type of firm.
 - b) The Report then talks about the ‘current framework’, but this review is not bound by either scope of application or detail of any existing CRD/CRR provision.
 - c) Under ‘main issues’ it says “initial experience with reporting on leverage suggests that the calculation of a leverage ratio may be rather volatile for (non-systemic) investment firms, where the ‘deleveraging’ of the majority of trading assets could be achieved in a fairly short time.” Whilst this is fair enough if using the LR as intended, it is not proposed here to use a LR as a binding minimum measure; the CRR ‘risk-weighted’ capital requirements can also be volatile for trading book items; the vast majority of investment firms do not have a trading book; and any volatility can fairly easily be smoothed through an adjustment.
55. Considering point c) about ‘adjustment’ to smooth potential for volatility in a leverage measure, it would in any event be unreasonable to use the LR itself in a ‘raw’ form, because

¹⁷ Please refer to Part Seven of the CRR for further details of how the LR is currently calculated for institutions within its scope and for the terms that are used for this.

of its range, albeit it will generally be banded to somewhere between (more than) 0 and 100%. Furthermore, the LR itself is not necessarily the most intuitive way to express leverage risk, but rather lends itself better to monitoring a bank being above a minimum ratio (which is not our purpose here).

56. In summary, the approach to RtF would deal with its potential, indirect, impact through increasing the capital held against risk to customers and markets, whilst keeping the prime focus on the RtC and RtM that investment firms can pose to others. This would meet the second of the two principles set out in paragraph 35. If anything, this leverage based approach could even be too prudent for firms with larger amounts of lower risk exposures, and so further risk-sensitivity can be added to the detailed design of the ‘uplift’, for example some basic ‘risk-weights’ for broad types of assets or exposures provided that this is kept fairly simple.

Illustrative example of the application of the up-lift factor

As an example, consider at one extreme a firm that only just meets the suggested minimum for banks of 3% – i.e. it is highly levered at 33 times, compared to a firm with a LR of say 80% which is lowly levered at just 1.25 times. Hence for the purposes of introducing a capital ‘up-lift’ – i.e. the higher the leverage (lower the LR), the higher the capital ‘up-lift’ should be – it would be necessary, simply for mathematical reasons, to use the inverse of a LR measure.

So, the simplest way to capture this is to ‘flip’ the underlying concept, and use the Total Exposure Measure (TEM) as the numerator divided by the Capital Measure (CM) as the denominator, or TEM/CM – and also not to express this as a percentage – to arrive at an RtF Uplift Measure (RFUM). Example: For a firm with a LR of 3% or capital/exposure of 3/100, the exposure/capital or RFUM would be $100/3 = 33.3$. And a firm with a LR of 80% or capital/exposure of 80/100, the RFUM would be $100/80$ or 1.25.

One way to then achieve smoothing, and to narrow the range for up-lift/multiplication purposes, would be not to use the actual figure for RFUM, but rather to allocate it to one of a few simple ‘bands’ [e.g. [1x], 1.1x, 1.25x, 1.5x etc. ‘up-lift’] depending upon the size of the actual RFUM measure – i.e. the higher the RFUM, the higher is the leverage of a firm and so the more likely it will fall within a higher band with a higher ‘up-lift’. The actual bands would need to be determined through calibration.

However, a major downside with any ‘banding’ is that it creates ‘cliff effects’ as a firm moves between bands. A mathematical alternative to this, to create a smooth, continuous path – albeit with curvature rather than linear – is to use some basic mathematical function, such as, say, the square root (of the RFUM).

Example, using the square root of, a firm with an RFUM of 33.3 [33.3 times leveraged] would require an ‘up-lift’ (on total RtC and RtM) of $\sqrt{33.3} = 5.77x$, compared to a firm with an RFUM of 1.25 [or 1.25 times leveraged] which would require an ‘up-lift’ of only 1.12x.

This type of approach to smoothing then provides a much more manageable range of ‘up-lifts’ [ranging from 1x for a firm with zero leverage (i.e. all exposures are funded by capital) through to 7x for a firm with 50x leverage (i.e. capital is only 2% of exposures)]. Firms with higher leverage would receive a higher ‘up-lift’ but at a more proportionate rate, to reflect the fact that overall leverage can be determined by different factors (e.g. exposure classes).

Whilst a square root is used initially as it is a simple way to provide an ‘up-lift’ within a reasonably bounded range, the precise mathematical function used is open to evaluation (e.g. we could use the ‘log’ of the RFUM) and of course subject to results of subsequent calibration.

Finally, the figure for the total exposure measure (TEM) can be easily ‘adjusted’. First to remove any types of exposures for which there is already a relevant RtC or RtM, in order to avoid double counting (for example, with an RtC K-factor for client assets held (K_{CAH}), any firm that also records client money and securities on its balance sheet can exclude it for the purposes of the TEM). And second to remove any types of exposures deemed inappropriate (for example, the firm’s own deposits at bank; and certain other types of exposures held for the purposes of meeting any new liquidity requirements for investment firms).

A worked example for applying the RFUM is given in Annex 1, which suggests that both the principles set out in paragraph 35 above are met.

The capital adequacy framework for investment firms

57. There are two strands to determining a firm’s minimum capital requirements under the new capital adequacy framework. First there is the on-going strand of the sum of capital requirements derived from the RtC and RtM K-factors, which may then also be subject to an up-lift for RtF (the RFUM). Second there is the wind-down element of expenditure/FOR.
58. The second of these strands (FOR) should effectively operate as a floor to the more ‘risk-based’ requirements of the first. In achieving this outcome, a number of implementation possibilities were considered.
59. Firstly a two-step process was considered with step one entailing a comparison of (1) the RtC and RtM calculation before the application of the RFUM and (2) the FOR such that whichever of these two strands is the highest (at any point in time) determines the minimum amount of regulatory capital required for that firm. Then a second step, the application of the RFUM, would take place where the first strand – the sum of capital requirements derived from RtC – is higher than the FOR. It was also considered that there may be some instances where a firm would automatically have to apply the RFUM, even if the sum of RtC and RtM (before the application of the RFUM) is less than the FOR, e.g. where a firm holds client money or securities.
60. In summary, the new minimum capital adequacy framework for investment firms would then be represented as:

- a) FOR, if the FOR is higher than the sum of RtC and RtM K-factors; or
 - b) The sum of RtC K-factors times the 'up-lift', if the sum of RtC and RtM K-factors (before any up-lift) is higher than the FOR.
61. Under the above suggested framework proportionality would be 'built-in' to the design of this new minimum capital adequacy standard for investment firms. Only where a firm undertakes the relevant business would the corresponding K-factor (for RtC or RtM) apply (i.e. not be zero); the scalar would see capital requirement derived from a K-factor increase only as firms' business grows; and the 'up-lift' measure would address the relative degree of inherent risk arising from the firm's own balance (and off-balance) sheet exposure. The overall framework should therefore be commensurate with the size, nature, scope and/or complexity of the investment firm as measured by the risks that it could pose to its customers and to others through markets.
62. However when working through the implications of the above formula, a number of weaknesses were noted and are discussed in more detail in this section. Firstly, the RFUM is important because it is the only way that certain risks to a firm or 'RtF' are captured. The presence or absence of these risks makes a firm more or less risky (to itself) and therefore more or less likely to run into difficulty and thereby pose a threat of harm, disruption or discontinuation of services to customers or markets. The above formula poses the risk that a large firm that would have an 'uplifted RtC and RtM' greater than the FOR, would have the (smaller) FOR as a 'biting' requirement because the FOR is higher than the pre-uplift sum of RtC and RtM K-factors. This is particularly an issue when the level of RtF of the firm is relatively high. It is the "uplift times the sum of RtC and RtM K-factors" that measures the total risk a firm presents – not just the RtC and RtM calculation by itself. By not applying the RtF uplift factor to such a firm, an inherent part of the measure of risk that the firm represents would not be captured.

Capital requirements for Class 3 investment firms

63. Recommendation 1 of the EBA Report noted that Class 3 firms warrant a very simple regime to wind them down in an orderly manner. It further elaborated on the prudential regime that could meet this objective of proportionality and established that such a regime could be based mainly on fixed overhead requirements (FORs) that fulfil the objective of setting aside sufficient capital for ensuring safe and sound management of their risks.
64. This could be achieved through setting both qualitative and quantitative criteria in order to determine which investment firms could be categorized as Class 3 investment firms (see section 4.2.3 on very small non-interconnected firms) and then apply to these firms a simple fixed overhead requirement (FOR).
65. Another way forward would be for all investment firms to be within the potential scope of the K-factor calculation. However, it is expected that, in practice by virtue of being 'very

small', many Class 3 firms should have very low amounts of business under any applicable K-factors and so be able to fairly easily determine where the simpler FOR (or initial capital 'floor') will instead apply.

66. The K-factor formula could result in the very smallest firms, that represent a very low level of risk to customers, having to apply the uplift factor due to a low sum of the RtC and RtM K-factors being higher than an 'also small' FOR (although whether this situation exists will ultimately depend on calibration). This is not an ideal situation as it is these very smallest firms that represent low risk to customers that should be able to avail themselves of a simpler, proportionate capital requirement.
67. Therefore it is clear that using the above approach would still necessitate the development of a range of accompanying quantitative threshold(s)¹⁸ to ensure that, whilst firm risks are appropriately and proportionately reflected in capital requirements, Class 3 firms are not unduly impacted.
68. To solve this it is instead proposed to determine how the total minimum capital requirement for firms is calculated by using initial capital as a reference point. This is because competent authorities shall not grant authorisation unless the investment firm has sufficient initial capital. Hence minimum initial capital is required for all start-up firms and also serves as an on-going floor to capital requirements (including those which meet the criteria for being classified as Class 3 firms). It could be determined that there is a period of growth, in terms of capital requirements, up to γ -times initial capital (where " γ " could, for example, be somewhere between 1 and 2), where a firm would be allowed to have proportionately more borrowing until reserves etc. are built up. This would result in the following simple formula:

If **FOR** $\leq \gamma$ **ICR**

and if $\sum_{i=1}^p a_i K_i \leq \gamma$ **ICR**

then the capital requirement = **MAX**(**ICR**, **FOR**, $\sum_{i=1}^p a_i K_i$)

Where:

- **FOR** is the fixed overheads requirement
- **ICR** is a firm's initial capital requirement
- γ is a constant between 1 and 2, with the precise value of γ depending on whether levels of initial capital are increased
- **a, b, ...** are constants or scalars or percentages
- **K** represents the various observable K-factors for RtC and RtM

¹⁸ See paragraphs 21 to 24.

69. For that start-up period, the RFUM would not be applied. After that period, i.e. when a firm has reached a certain level either in terms of size (FOR) or risk to customers (RtC) and risk to markets (RtM), the RFUM would be applied. Respecting in any case the qualitative criteria proposed for Class 3 firms, an existing firm (rather than a start-up firm) that may simply be content not to grow beyond the same measure of being “very small”, would also continue not to have to apply the RFUM.

If any of the two conditions above are not verified,

then the capital requirement = $\text{MAX}[\text{ICR}, \text{FOR}, (\sum_{i=1}^p a_i K_i) * f(\text{RFUM})]$

Where:

- **RFUM** (or Risk to Firm Up-lift Measure) represents a leverage measure
- **f** is a function of the RFUM, initially proposed as a square root ($\sqrt{\cdot}$).
-

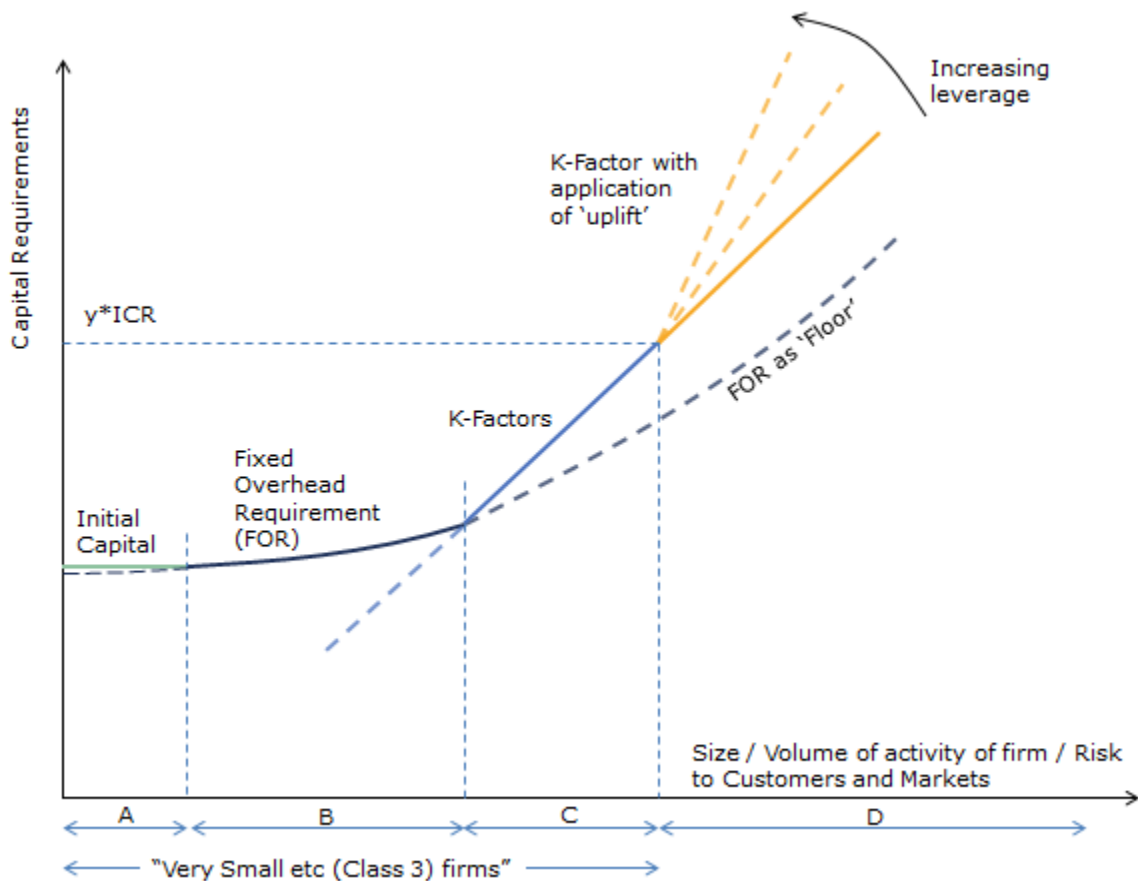
70. Conversely firms that engage in certain higher risk activities (such as holding client assets) could always be required to apply the RFUM to reflect the high risk of the particular activity – potential higher risk activities are discussed in Section 4.2.3 above. This approach results in the same formula as in the previous case but it would apply regardless of size:

For firms engaging in higher risk activities, regardless of size,

the capital requirement = $\text{MAX}[\text{ICR}, \text{FOR}, (\sum_{i=1}^p a_i K_i) * f(\text{RFUM})]$

71. This proposed approach avoids the need to set any other quantitative thresholds for distinguishing Class 3 firms (from other investment firms) whilst also ensuring that only the very smallest, low risk firms are allowed the advantage of a simpler capital requirement. This appears to be a proportionate solution that delivers proportionate capital requirements, for all investment firms, within one single prudential regime, including for Class 3 firms, and is in line with the EBA’s recommendations in the EBA Report. A simple worked example of this approach for a range of firms is given in Annex 2.
72. The following chart provides a stylised illustration of the expected outcome under the above approach where, subject to appropriate calibration, for the vast majority of Class 3 firms the minimum regulatory capital requirement would be the FOR, subject to the ‘floor’ of the flat, on-going, initial capital requirement. There is also the possibility of providing relief when a smaller firm transitions to the K-factors, by not applying the ‘uplift’ factor.

Figure 1. Transition between FOR requirements and K-factor.



This figure illustrates the simpler requirements that would expect to apply to Class 3 firms, which are those investment firms that fall within the range of both A and B, and potentially also C. The precise shape or gradient of each part of the chart above is for illustrative purposes and in practice would be determined by the exact pattern of a firm's expenditure on fixed overheads and as a result of subsequent calibration of the scalars.

73. However, should it be found not to be the case that it delivers simpler, proportionate requirements for Class 3 firms, such as via the FOR, then an alternative approach would be to set explicit thresholds (as discussed in paragraphs 21 to 23, and in 63 to 64) for Class 3 firms and to then apply the FOR separately.

Fixed Overheads Requirement (FOR)

74. The current fixed overhead requirement (FOR)¹⁹ might be said to have been intended to help cover risk of an unexpected failure and disorderly wind down. Having identified that the fixed overhead regime is still an appropriate requirement for investment firms, it is worth considering whether the current regime needs revising in any way (particularly given that one of the possible approaches to setting minimum liquidity requirements has the potential to use (a percentage of) FOR as a reference point.)²⁰ Using the FOR as a floor (to a method which takes into account RtC, RtM and RtF), the current methodology for calculating the FOR may have to be reviewed to cater for the diverse profit & loss structures of trading firms. Also, the question of which expenditures should be deemed “fixed” may need to be revisited.
75. The current minimum percentage for the FOR is 25% (one quarter) of annual fixed overheads. As there will be situations where the winding-down period could last longer than three months, a higher minimum percentage than 25% might be preferable (possibly via a national discretion). On the other hand, proportionality might suggest keeping the minimum standard at 25% for all firms, and using a revised ‘pillar 2’ type approach to apply higher requirements to any individual firms where it is assessed that a wind-down might cost more and/or take longer to achieve (than the minimum FOR would provide for).
76. There is a risk that, as legally separate entities, tied agents (especially where owned by the investment firm) could be used to incur overheads that otherwise might fall to the investment firm itself (and so arbitrage the requirement). Although the investment firm might take over if the tied agent were to fail, as it is likely that the tied agent will have the relationship with the customer (and may be more local), and there may thus be a need to consider additional expenditure required by the investment firm in such a situation. The current RTS on the FOR does include some coverage of tied agents²¹, but the detail of this may benefit from fresh consideration as to what is the most appropriate treatment for expenditure incurred by tied agents in respect of regulated investment business.

Mapping the capital requirement framework for investment firms against current requirements

77. Although the new approach would be different from that currently applied, to help understand the difference in how prudential risks are captured, a simplified visual illustration of the overall capital requirements framework for investment firms is provided in Annex 3,

¹⁹ Commission Delegated Act (EU) 2015/488

²⁰ See Section 4.3.3 for further details on liquidity.

²¹ According to Commission Delegated Regulation (EU) 2015/488 amending Delegated Regulation (EU) No 241/2014, Art 34b(4) requires the firm to add an amount equal to 35% of all the fees related to the tied agents.

which includes a mapping from the new framework back to the current framework, for firms that are currently subject to requirements in, or derived from, the CRR²².

Dealing with any investment firms for whom the new K-factor approach to capital requirements may be inappropriate

78. The overall objective is to ensure that the prudential regime for any given investment firm is appropriate. The new regime that focuses on risk to customers, risk to markets and risk to firm aims to achieve that. However, recognizing that the investment firm population is extremely diverse, there may be some cases where this would not so; if this is found to be the case then alternatives will be required. This might prove to be necessary with firms for whom risks to the firm itself (RtF) is significant, such that capturing exposure risk (e.g. of net positions held) in a different yet simple, way could be appropriate. The example of investment firms that trade financial instruments, including derivatives, is explored below.

Investment firms trading financial instruments

79. As noted in Paragraph 37, particular attention may also be required for larger firms that trade financial instruments, e.g. derivatives, especially those that have no external customers. One possibility here would be to develop an approach around the use of the amount of initial margin (IM) payments for centrally cleared trades, as set by either the investment firm's general clearing member (GCM) or by the relevant central counterparty (CCP). Margin requirements for non-centrally cleared OTC-derivatives could also be incorporated into the calculation.
80. Another possibility for firms that trade financial instruments such as derivatives is to explore whether it may be appropriate to make use of internal calculation methods by which firms might determine economic capital (for example, emissions trading firms without a clearing obligation)²³ in some way, but which for these firms may not be as sophisticated as permission to use internal models under the CRR .

Other considerations

81. Point (a) of Paragraph 12 also notes that the possibility exists that there may be some investment firms that, although not 'bank-like', could nevertheless be considered systemic, for example an extremely large portfolio manager. Bearing in mind that the proposed K-factor approach focuses on risk to customers (RtC), risk to markets (RtM) and risk to firm (via

²² This includes firms under CRR Art 95(2), but not those firms currently only subject to initial capital in the CRD or otherwise exempt from own funds requirements.

²³ Because of the difficulty to clearly distinguish between different forms of proprietary and customer-driven principal trading, which may just be dependent on the technical set-up of trading venues, the ultimate design of such a model (i.e. margin based) would try not to introduce a different treatment of trading firms with respect to their eligible counterparts contingent on their sending orders or quote requests or not – as far as measuring risks to markets are concerned.

the risk to firm ‘uplift’ measure, or RFUM) and includes specific K-factors for business such as portfolio management (K_{AUM} and K_{AUA}) and client assets held (K_{CMH} and K_{ASA}), the basic assumption is that this approach provides for an appropriate prudential regime for such systemic firms. Furthermore, subject to calibration, it should not be assumed that the K-factor approach would deliver lower minimum capital requirements for these firms than at present. In addition, the thresholds for systemic importance could differ between different Member States and might therefore be subject to national (supervisory) discretion.

Questions

Question 5. Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?

Question 6. What are your views on the initial K-factors identified? For example, should there be separate K-factors for client money and financial instruments belonging to clients? And should there be an RtM for securitisation risk-retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?

Question 7. Is the proposed risk to firm ‘up-lift’ measure an appropriate way to address the indirect impact of the exposure risk a firm poses to customers and markets? If not, what alternative approach to addressing risk to firm (RtF) would you suggest?

Question 8. What are your views on the ‘built-in’ approach to delivering simpler, proportionate capital requirements for Class 3 investment firms, (compared to having a separate regime for such firms)?

Question 9. Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how could it be improved?

Question 10. What are your views on the appropriate capital requirements required for larger firms that trade financial instruments (including derivatives)?

Question 11. Do you think the K-factor approach is appropriate for any investment firms that may be systemic but are not ‘bank-like’?

4.3.2 Definition and quality of capital for investment firms

Overarching principles and need for simplification

82. A question identified in the EBA Report was whether or not the quality and definition of capital introduced under the CRR should be equally relevant for investment firms that are not systemic and bank-like. The EBA Report also noted that it may be necessary to consider

the provisions on deductions, prudential filters, and conditions for capital items, to determine if they were justified within a new framework for investment firms.

83. To answer this, there is a need to also consider the approach this review is taking towards appropriate prudential requirements for investment firms. In particular, it would be worth considering the role both capital adequacy and liquidity play in mitigating the potential harm to customers and markets, including during wind-down and including the costs of liquidation.

Permanence and non-joint stock investment firms

84. Some investment firms operate in other legal forms, such as partnerships, limited liability partnerships (LLPs), or even as a single natural person. This is permitted under MiFID, and it is not uncommon in practice. Some of these forms can include unlimited personal liability of the owners or that pay-outs can be reclaimed by creditors of the firm; subject to affordability, this can lead to more distinct willingness of owners to bring additional funding to avoid a default situation (and protect their livelihood), a stabilising feature not inherent in shares of joint stock companies.
85. Therefore, any provision relating to the definition and quality of capital also needs to be capable of being applied to investment firms that do not have one of the legal forms specified in the relevant accounting directives that apply to limited companies.
86. Difficulties may occur when trying to apply the concept of permanence to partners that have a civil right to leave the firm and take a pay-out of the value of their participation, whereas sole traders have the right to liquidate their businesses at any time. Similar concerns could arise on proprietors' or participators' civil rights to withdraw certain parts of the funds in order to secure their costs of living or to receive pay-outs of profit within the year. At the same time it seems worth discussing, to which extent the permanence of capital is needed to ensure prudential concerns are met given that the EBA Report states that the concept of ensuring going concern is not essential for the majority of investment firms, as opposed to caring for the impacts of the withdrawal of the firm from the market. Lowering the administrative burdens for investors to decrease the levels of capital in the wake of decreasing levels of risk may even have the effect of an intensified willingness of investors to put up more capital in the first place.
87. Investment firms may also be parts of wider groups, which are not financial groups. In certain MS, mainly for reasons of local tax law, investment firms enter into profit and loss transfer agreements with their parent company²⁴.

²⁴ Read literally (EBA Q & A No 408) this would conflict with Article 28 of the CRR, although it regularly limits the risk of decreasing levels of capital.

Questions

Question 12. Does the definition of capital in the CRR appropriately cater for all the cases of investment firms that are not joint stock companies (such as partnerships, LLPs and sole-traders)?

Question 13. Are the cases described above a real concern for the investment firms? How can those aspects be addressed while properly safeguarding applicable objectives of the permanence principle?

Capital instruments and items (tiers of capital)

88. The strengthening of the quality of capital and the focus on CET 1 under CRD/CRR reflects the lessons of a banking crisis, where the overriding objective is to try to keep firms solvent (and keep trading), such that capital can absorb losses on an on-going basis. To the extent that a firm might need to absorb losses and keep in business long enough so as to discharge its obligations to customers and prevent risks to markets crystallising, CET 1 can be said to have the same importance for investment firms.
89. The CRR also allows the use of a whole range of capital instruments and items, which are permitted to count as: CET 1, Additional Tier 1 (AT1), or Tier 2 capital. However, many investment firms are funded by equity, whether shares or partnership capital, supplemented by subordinated debt where required. It is therefore possible that simplification could be achieved through streamlining the instruments and items of capital, including any 'tiering', that may be used to meet their minimum capital requirements.
90. The CRR contains a whole set of very detailed conditions for what can count as own funds, to give effect to the Basel III agreement for banks. However, some of these conditions may still appear overly prescriptive when applied to investment firms. This is especially the case when these conditions do not refer to the quality of the tiers as such, but require scrutinizing procedures by the competent authorities²⁵.

Questions

Question 14. What are your views on whether or not simplification in the range of items that qualify as regulatory capital and how the different 'tiers' of capital operate for investment firms would be appropriate? If so, how could this be achieved?

²⁵ While it is common in supervisory practice to closer investigate the case of a capital increase, when it is needed to meet regulatory requirements, the assessment can be postponed until the next regular auditing if the increase is only made to enhance the level of comfort.

Deductions, filters and other elements

91. The CRR contains detailed prescription on a whole range of deductions that need to be made to own funds, including items such as intangible assets (notably goodwill), deferred tax assets, holdings in capital instruments of financial sector entities and current year losses. Some of these deductions are clearly still relevant for investment firms.
92. Goodwill is a good example because, especially in a wind-down scenario, it is the first to go. Therefore, goodwill and other intangible assets that have no loss absorbing capacity should be deducted at all times from available own funds. However, it will be a matter of regulatory technique to achieve this result by introducing binding investment principles (such as the third approach to liquidity requirements as shown in Figure 3 in paragraph [135]) instead of a deduction.
93. Other aspects may be less straightforward. On the one hand, holdings of capital instruments in other financial institutions by investment firms regularly occur in the course of normal investment business where these firms act as intermediaries providing valuable market liquidity. From a business perspective, there is no difference between e.g. a trading firm warehousing shares of banks for a client and shares of other issuers. On the other hand, this deduction does not address a bank specific (or CRR-specific) issue but concerns the general issue of avoiding double gearing in own funds of financial intermediaries. Given the restricted possibilities of the average investment firm to raise debt capital, there is little evidence that the investment services sector significantly contributes to the funding of the banking sector. To ensure banks' compliance with CRR provisions it could be sufficient to impose notification requirements on investment firms bound to certain thresholds.
94. The CRR is firmly based upon accounting values, and as such for the most part²⁶ removed the ability of the competent authority to allow the use of 'prudential filters' where the accounting value of certain items may be adjusted for the purpose of prudential regulation.
95. Prior the introduction of the CRR, for example, one filter utilised in some jurisdictions was to make an actuarial adjustment in respect of a defined benefit pension scheme deficit. Accounting standards require full IFRS market value of any total projected deficit in a defined benefit pension scheme to be reflected in the firm's accounts (in effect, reducing available capital as if the full amount had been deducted from own funds) and yet, should the firm fail, this amount would not necessarily represent the actual amount of the liability of the firm to the scheme at that point. Thus, before the CRR it was possible to agree with firms the use of an actuarial adjustment to reflect this. Another example may be where the business activities of investment firms are more project-type meaning that profits are only made at certain

²⁶ Article 32 of the CRR does contain the ability to exclude from own fund any increase in equity under the accounting framework that results from securitised assets.

points in time while expenditures are constant; it may be warranted to grant the possibility of levelling these out over a period of time, thereby eliminating the incentive given by the current stipulation of an automatic and immediate loss deduction to avoid the accounting of losses as long as a firm can.

Questions

Question 15. In the context of deductions and prudential filters, in which areas is it possible to simplify the current CRR approach, whilst maintaining the same level of quality in the capital definition?

96. In the interests of both the simplification of the overall regime, and in light of the particular discussion above concerning the definition and quality of capital for capital adequacy purposes, it is relevant to consider whether it might be appropriate to consider identifying only one, single, definition of regulatory capital to work with for investment firms, that would then apply for any prudential purpose.

Options for way forward

97. The first option is to use exactly the same own funds provisions as per the CRR. This has the benefit of consistency with credit institutions and the systemic and bank-like investment firms. Given the need for assurance that regulatory capital can fulfil its purpose, this would be the default option unless there are convincing arguments otherwise.

98. The second option is to introduce new standards on what is regulatory capital specifically for investment firms. This would aim at simplifying the area of definition and quality of capital consistent with a new framework for determining regulatory capital. It could be possible to simplify down to essentials only (and remove anything that is not strictly necessary) given the simpler nature of most investment firms.

Questions

Question 16. What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?

4.3.3 Initial Capital requirements

99. As noted in the EBA Report, Article 28 of the CRD contains the separate concept of 'initial capital', which represents one of the conditions for authorisation of an investment firm under MiFID. And Article 93 of the CRR then states that the own funds of an institution may not fall below the amount of initial capital required at the time of time authorisation.

100. Given the importance of a firm meeting minimum authorisation conditions at all times, it is recommended that an on-going obligation is retained and clarified as such, so that the minimum level(s) for authorisation in effect act as a further 'floor' to the minimum level of capital an investment firm must continue to hold in order to keep its authorisation to conduct MiFID investment services.
101. Alongside this, it is also recommended that, in the interests of simplification (for both firms and supervisors), the definition of capital used for the purposes of meeting the minimum level(s) required as a condition for (on-going) authorisation of an investment firm under MiFID should also be aligned with whatever definition of capital (i.e. own funds) is decided to be used for the purposes of meeting the capital adequacy requirements of investment firms.
102. Consideration should also be given to the actual levels of initial capital currently required of investment firms for MiFID authorisation purposes, which have remain unchanged for over twenty years (since they were set in the original CAD), and whether they should, therefore, be increased proportionately. It should also be considered that the scope of application of any different amounts of initial capital to different types of investment firms may need to be updated, to reflect the new classification system proposed under this review.
103. Currently the CRD IV sets the level of initial capital for investment firms as either 730 000 EUR, 125 000 EUR or 50 000 EUR, the last of which is a national discretion that has not been implemented by all Member States and so 125 000 EUR is applied instead. So some investment firms authorised for the same investment business are currently operating in the EU on the basis of different levels of initial capital. To avoid this, an option could be that all Member States implement the same amount(s) of initial capital. As a compromise, a possible harmonized initial capital could be 100 000 EUR.
104. If the discretion to use 50 000 EUR was simply removed then the current default situation under the current CRD would automatically be an initial capital of 125 000 EUR instead. This would be an increase of 75 000 EUR (or 150%).
105. However, if the option of allowing for a reduction of the initial capital (below 125 000 EUR) is kept, then an increase from the current 50 000 EUR up to 100 000 should be considered. This would, very roughly, take into account the effect of inflation since the original lower figure was first set under the original CAD.
106. As some Member States currently require 125 000 EUR as initial capital for firms that do not hold client money and securities, it is also thinkable to increase that amount for those that do hold client assets. An increase in the same relative order of magnitude as for other firms as mentioned above would suggest that 250 000 EUR might be considered.
107. Finally there are firms (e.g. those that deal on own account and operators of multi-lateral trading facilities) for whom the current level of initial capital is 730 000 EUR. A similar relative increase here would put the amount at approximately 1.5 million EUR.

108. As any material increases in the amount of initial capital could prove a problem for firms to meet in one go a transitional period would be sensible. For example, a graduated annual increase over a certain period, in combination with the requirement that capital may not fall below the average level over the preceding six months, which shall be calculated every six months.
109. In any event there is merit in clarifying the level of initial capital that applies to any individual investment firm, because as the EBA Report²⁷ noted there are some MiFID services and activities that are not explicitly covered by Article 29 of the CRD, and so as a result a firm conducting those may currently have to hold the higher amount of initial capital of 730 000 EUR without necessarily any clearly articulated reasoning for this.
110. Point (b) of Article 31(1) of the CRD currently offers the possibility (for the relevant investment firms that fall under this article²⁸) to replace the initial capital requirement with a given amount of professional indemnity insurance (or some combination of both). Given that insurance relies on a third-party who is incentivised to try to reduce the circumstances in which they will pay out, or only after delay, it is suggested that such insurance (being more suited as a risk mitigant a firm may choose to hold itself) should not be regarded as a 'substitute' for regulatory capital. Accordingly, the option to use insurance may be deleted.
111. According to point (a) of Article 31(2) of CRD, investment firms that are also insurance intermediaries are currently required only 25 000 EUR as initial capital. According to Article 4 of Directive 2002/92/EC (IMD) the insurance intermediary does not need any initial capital but only an insurance policy with respect to the insurance business against liability arising from professional negligence. But as initial capital and the insurance required by the IMD are two different tools and are intended to cover different things, the insurance required by the IMD is no reason for a reduced capital. Therefore this possibility may be deleted.²⁹

Questions

Question 17. What are your views on the definition of initial capital and the potential for simplification? To what extent should the definition of initial capital be aligned with that of regulatory capital used for meeting capital requirements?

Question 18. What aspects should be taken into account when requiring different levels of initial capital for different firms? Is there any undesirable consequence or incentive that should be considered?

²⁷ See page 66 of the EBA Report.

²⁸ Essentially MiFID investment firms that can only conduct the core MiFID investment services of reception and transmission of orders (A1) and investment advice (A5).

²⁹ The IMD is to be replaced by the Insurance Distribution Directive, but the same point remains.

4.3.4 Eligible Capital

112. The CRR also contains another separate definition of capital, namely “*eligible capital*” in point (71) of Article 4(1). The term eligible capital is used for meeting three specific types of requirement: the fixed overheads requirement in Article 97 of the CRR, the large exposures regime in Part Four of the CRR, and for qualifying holdings outside the financial sector in Title III or Part Two of the CRR.

113. Eligible capital is different in that Tier 2 capital is limited to no more than one third of Tier 1 capital³⁰ (and furthermore there is also a slight variation in terms of deductions when it comes to qualifying holdings). The use of eligible capital for the fixed overheads requirement is of particular relevance to a large number of investment firms.

114. Both in the interest of simplification of the overall regime, and in light of the particular discussion above concerning the definition and quality of capital for capital adequacy purposes, it is relevant to consider whether the concept of eligible capital should also be aligned, such that there is only one, single, definition of regulatory capital (i.e. own funds) to work with for investment firms, for whatever prudential purpose.

Questions

Question 19. What are your views on whether there is a need to have a separate concept of eligible capital, or whether there is potential for simplification through aligning this concept with the definition of regulatory capital used for meeting capital requirements?

4.3.5 Liquidity requirements for investment firms

Purpose of liquidity

115. Liquidity management aims to ensure that an investment firm is able to meet its liabilities as they fall due, for a given time horizon. This generally involves a firm monitoring its cash in-flows and out-flows, supplemented by holding an adequate stock of assets, unencumbered for other purposes, that consists of cash or assets that can be readily converted into cash at little or no loss of market value in markets. Managing liquidity should be in the interests of all investment firms, irrespective of their type of business, but a simple, common minimum set of regulatory standards should help to reinforce this, as well as providing a basis on which to build for any individual firms that may require more than the minimum.

³⁰ This is compared to own funds requirements under Article 92 of the CRR, where there is in effect no limit to the amount of Tier 2 capital a firm can include for the purpose of showing its total capital ratio (even if there are also requirements to meet both minimum Common Equity Tier 1 and Tier 1 ratios..

Considerations on the appropriateness of LCR and NSFR for investment firms

116. The EBA Report indicated that the Delegated Regulation on the Liquidity Coverage Requirement (LCR) is not an appropriate liquidity standard for investment firms that undertake MiFID activities (A3) and/or (A6), and nor would it be appropriate for the vast majority of other types of investment firms.³¹ The Delegated Regulation focuses on credit institution business model issues with little or no relevance for investment firms. For example, out-flows on deposits, in-flows on loans to retail, wholesale and financial customers and the interplay with central bank funding. The same observation prevails for the Additional Liquidity Monitoring Metrics (ALMM) templates and the Net Stable Funding Ratio (NSFR).
117. For the vast majority of investment firms it is important to note that their main out-flows (liabilities) needing some form of liquidity coverage stem from operational expenses, which are not calculated as out-flows in the LCR for banks. Whilst the liquid assets of many investment firms are, in the main, held in the form of bank deposits; in order to avoid contagion risk the LCR does not permit such interbank receivables within the definition of liquid assets, but not doing could have a massive adverse impact for investment firms, who would typically view such deposits as available liquid assets.³² Holdings of shares may also be important as a source of liquidity for some specialized investment firms.³³ Such features help confirm that the LCR and NSFR are inappropriate for investment firms.

Designing a new liquidity regime for investment firms – policy options

118. As an alternative to the LCR and NSFR requirements, three broad possible approaches to setting a minimum liquidity standard for investment firms are identified. Regardless of whichever approach is used, there are various details that would need to be agreed for example, what is allowable as a 'liquid asset'?³⁴
119. The first approach would be to adopt a "counterbalancing capacity" perspective, i.e. where the total receivables and liquid, marketable assets that an institution could use to fulfil its obligations – no matter their liquidity value or certainty in times of stress – could be measured against payables.
120. This counterbalancing capacity approach may be illustrated as in the following figure:

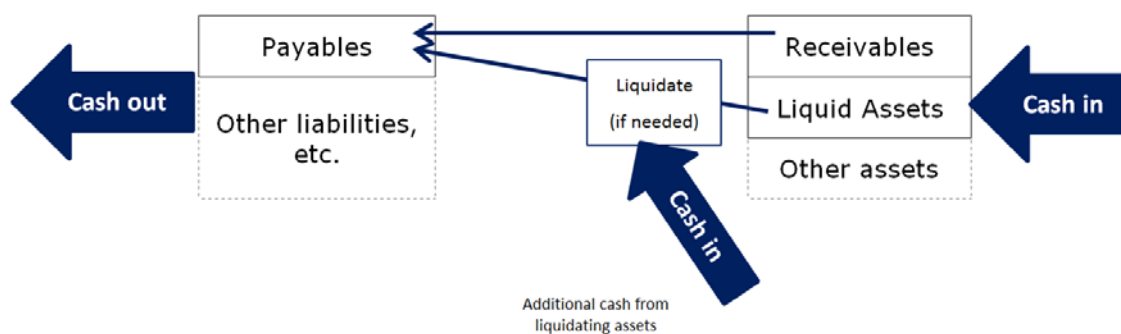
³¹ See pages 45 to 49 of the EBA Report.

³² Under the LCR if they meet certain criteria they are eligible as inflows subject to the general cap on inflows.

³³ EBA Report page 45; in the LCR such sources of liquidity have only a capped (15%) significance for the calculation.

³⁴ See Annex 4 for an initial analysis of the sorts of issues to consider when determining what may be a 'liquid asset'.

Figure 2. Counterbalancing capacity approach.



The total payables over a given time period are balanced by the total receivables over the same period, with liquid assets making up any projected shortfall.

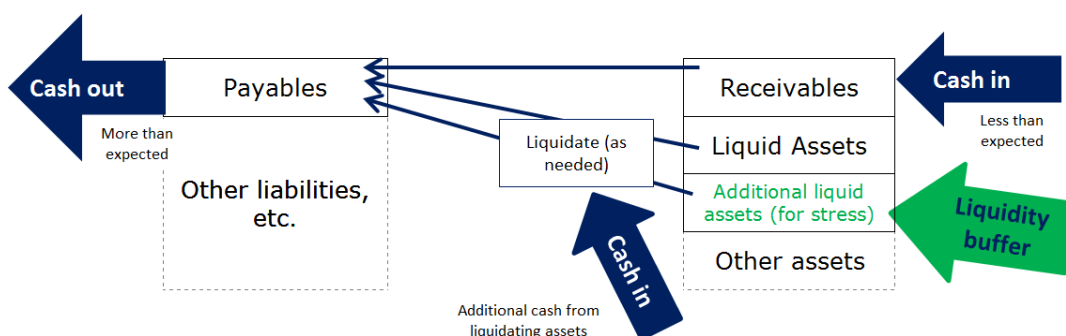
121. The question arises whether such a regulation would meet prudential supervisory needs. All investment firms are obliged to settle their payables anyway, which in the case of many of them most prominently are wages, social charges, rent and additional property expenses. If a firm perceives problems in this regard it would be already incentivized to search for solutions, either by tapping additional funding or by entering into negotiations with creditors to ask for a prolonged forbearance period, a waiver etc.. If this is successfully done, the counterbalancing capacity is restored. It is not perceived as a task of supervision to intervene in such negotiations.
122. The question of whether, by making counterbalancing prudentially binding, the awareness and incentives of the firms' liquidity management is increased to any material extent, is debatable. In this regard demanding best practice in internal liquidity risk management appears to be more effective.
123. After all things considered a counterbalancing capacity perspective, without incorporating some protection for liquidity stress, would seem to make sense only if it was in order to inform supervisors about a forthcoming insolvency of a firm, but not as a binding requirement. If so, then prescribing a time period of 30 days may be appropriate to alert competent authorities where a firm is already at a stage where liquidity is tight and the inability to pay could already loom. Furthermore, the basis on which to measure both receivables and payables (over a particular time horizon) would have to be prescribed – e.g. either on a balance sheet contractual basis, or allow firms to include some element of management expectations.
124. The second approach would be to create prudential liquidity requirements which go beyond the ones which are necessary for the survival of the firm anyway. Setting liquidity

requirements for investment firms simply at a counterbalancing figure (as above) would not allow supervisors enough room for manoeuvre to counteract undesirable developments because a breach in this requirement would already indicate that the firm was lying near the brink of insolvency.

125. It would therefore appear that, if adopting this type of approach, some form of additional liquidity buffer (to provide for liquidity cover against contractual flows being disrupted or other unexpected events) would also be sensible. The purpose of a liquidity buffer is to serve as a defence against the potential onset of liquidity stress, materialised through outflows of a diverse nature (planned or contingent) that must be paid by the institution to avoid default.

126. A liquidity buffer stress-scenario approach may be illustrated as in the following figure:

Figure 3. Liquidity buffer.



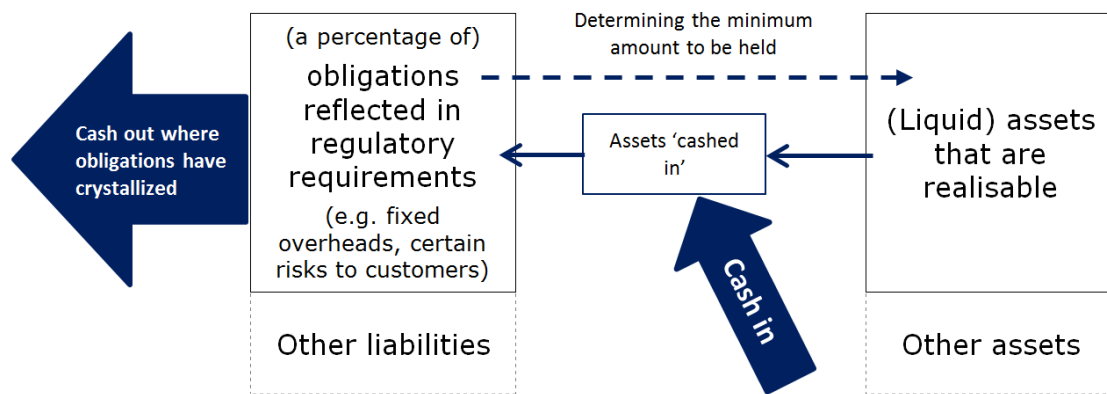
Holding a liquidity buffer means that if a firm suffers an unexpected increase in payables and/or an unexpected decrease in receivables in any given timeframe it can still meet its liquidity requirements by cashing in its liquid assets.

127. The introduction of stress-based metrics could be done in different ways. One simple non-risk-sensitive way is to require a certain percentage or surplus (on top of the counterbalancing capacity). Other possible ways, which also could be combined, are (i) restrictions on possible assets such as non-eligibility or haircuts and (ii) probability-based weightings of receivables or restrictions of funding (namely limits with a view to the amount of payables)³⁵.

³⁵ For example, the LCR limits the recognition of liquidity in-flows to 75 % of total liquidity out-flows

128. The creation of a stress driven liquidity buffer could either work on top of the counterbalancing capacity or work as a prudential requirement of its own and would be designed rather different from the LCR, paying attention to the fundamentally different business models of investment firms (especially concerning funding structure and possible outflows). For instance, with regard to firms with a rather predictable set of inflows and outflows a lighter stressed assumption may be appropriate. Separate consideration would need to be given to the appropriate stressed scenario for firms where outflows are to a great part dependent on in-flows (e.g. shared commissions or bonuses based on the amount of income generated). It would also have to be ensured that liquidity buffers are calibrated so that they do not come at the cost of otherwise well-managed firms having to leave the market just for regulatory reasons, for instance where firms manage their liquidity in terms of creditor and debtor due dates in order to ensure greatest return from equity invested.
129. Overall, there seems that a common minimum stress based method may not be possible to cover the whole, diverse range of investment firms, or at least not in a manner that was still simple to operate and effective. There is a strong likelihood that in the case of many investment firms it would either lead to disproportionate levels of liquidity or to levels of additional liquidity too low to warrant the greater efforts compared to the pure counterbalancing option. Dealing with stressed scenarios may, therefore, be something best done on an individual firm basis for those where supervisors may consider it necessary.
130. A third approach to setting liquidity requirements, which should be fairly simple to operate for all types of investment firm, would be based on the fact that the own funds requirements for firms are deemed necessary to mitigate possible risks to customers (and market impacts). It could be prescribed that a minimum amount of liquid assets be held that is linked to a portion of the firm's own funds requirements, in order to help meet potential cash outflows identified through obligations reflected in the capital requirements.
131. This regulatory requirement obligations approach to liquidity may be illustrated as in the following figure:

Figure 4. Regulatory requirement obligations.



A firm's capital requirements determines the amount of capital that has to be held as 'own funds'. To ensure the firm can pay out on the obligations reflected by these requirements, should they crystallise, a proportion (of capital requirements) should be held invested in liquid assets (being marketable or otherwise realisable in a certain time period). E.g. this would comprise (a percentage of) the amount of the firm's fixed overheads (as calculated by the FOR) as these are generally the firm's most vital payment obligations that need to be met.

132. As far as those firms (including very small ones) whose minimum capital requirements are determined by their fixed overheads (in other words, inevitable out-flows), such a liquidity regime would be able to support the aim of an orderly wind-down process. (In effect, the wind-down becomes the stress scenario). The AIFMD (Art. 9(8)) provides for a regime with such features. This would mean that part of the proceeds of capital or own funds would, in effect, be invested in assets that may be regarded as liquid or readily convertible into cash over a given time period (and shall not include positions held for speculative purposes). However, as neither the AIMFD nor the AIFMR provide clear definitions, or how exactly to understand the terms cited, they would need to be defined and adapted to the much wider range of types and investment business of MiFID investment firms.

133. For firms whose minimum capital requirements are determined by the (sum of) risk to customers, the fixed overhead requirement calculation may still serve as a 'floor' for liquidity requirements. In addition to that, it would also be possible to base the amount of liquid assets to be held on certain other aspects of the capital requirements that address risk to

customers³⁶. This could be done as a general treatment by using as the reference point for setting the liquid asset requirement as a percentage of the total of the obligations reflected in the on-going risk-based regulatory requirements (instead of by reference to fixed overheads). Or be achieved by adding selected RtC elements, which may be particularly important to protecting customers in a wind-down, to the fixed overheads requirement for the purposes of determining the minimum amount of liquid assets required to be held.

134. Further liquidity requirements beyond the minimum could also be introduced based on the situation of a firm expected to continue business (even in periods of adverse, but realistic, stress) as required. Indeed the ability to apply a flexible “supplementary” approach should apply to liquidity management more generally, in situations where simple, minimum standards may be assessed as being insufficient for the nature, scale and complexity of the investment business of some individual investment firms.³⁷ For example, in respect of any proprietary trading firms that are not systemic but may still be regarded as ‘significant’ and bank-like in the context of the markets in which they operate.

135. Whichever approach to setting liquidity requirements may be followed, there will most likely be a need to determine what assets may count as liquid. Some initial considerations as to what may be a liquid asset are provided in Annex 4.

Qualitative requirements for liquidity management

136. As already indicated, it could be helpful to set down best practice liquidity management as qualitative requirements for investment firms, at the same time supporting supervisors in any liquidity assessments they might undertake of individual firms (and in particular any proprietary trading firms that are not systemic but may still be regarded as ‘significant’ and bank-like in the markets in which they operate). Firms would have to apply these proportionately, and only to the extent that they are relevant to the nature, scale and complexity of their business. For example, firms should be required to maintain a liquidity management policy that considers, where relevant):

- a) systems and controls for management of liquidity risk;
- b) the responsibilities within the firm for the oversight of liquidity risk;
- c) intra-day liquidity risk;
- d) management of collateral;
- e) management of liquidity across legal entities, business lines and currencies;

³⁶ Refer to Section 4.3.1 on Capital requirements for further details

³⁷ See Section 4.3.10

- f) funding diversification and market access; and
- g) pricing of liquidity.

Questions

Question 20. Do you see any common stress scenario for liquidity as necessary for investment firms? If so, how could that stress be defined?

Question 21. What is your view on whether holding an amount of liquid assets set by reference to a percentage of the amount of obligations reflected in regulatory capital requirements such as the FOR would provide an appropriate basis and floor for liquidity requirements for ‘non-systemic’ investment firms? More specifically, could you provide any evidence or counter-examples where holding an amount of liquid assets equivalent to a percentage of the FOR may not provide an appropriate basis for a liquidity regime for very small and ‘non-interconnected’ investment firms?

Question 22. What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements, and why? (Please refer to Annex 4 for some considerations in determining what may be a liquid asset).

Question 23. Could you provide your views on the need to support a minimum liquidity standard for investment firms with the ability for competent authorities to apply “supplementary” qualitative requirements to individual firms, where justified by the risk of the firm’s business?

Question 24. Do you have any comment on the need for additional operational requirements for liquidity risk management, which would be applied according to the individual nature, scale and complexity of the investment firm’s business?

4.4 Other prudential considerations

4.4.1 Concentration risk

137. The purpose of a large exposures regime is to help protect an authorised firm from experiencing significant distress, or even sudden failure, due to the failure of another entity (a counterparty or group of connected counterparties) to which the authorised firm has a significant or large exposure (e.g. money owing from that entity) relative to the size of its own capital.
138. For investment firms such large exposures could arise from a variety of sources: items on the firm's own balance sheet (e.g. cash at bank, investments held, fees and commissions owed by customers), any off-balance sheet activities and, where relevant, in a trading book. Some of these are inevitable consequences of the way in which an investment firm conducts its business, particularly where on an agency basis, rather than the conscious taking of a risk exposure.
139. Some firms are currently subject to limits on risk exposures with the authorization to go over the regulatory limits³⁸ as long as any additional exposure is incurred in the trading book and additional capital is held. This type of approach could be a compromise between the need to cover the risks caused by excessive concentration and the limited capacity for middle-sized firms to diversify their counterparts on a given market.
140. For some firms, in particular those eligible to a more proportionate treatment such as Class 3 investment firms, but possibly also those which do not have a trading book,³⁹ the ability of a regulator to perform supervisory monitoring, through simple and proportionate reporting, could provide a useful tool in helping both the supervisor and the firm to be aware of the potential impact should problems occur, whether for on-going purposes or wind-down planning. This suggests that for those investment firms it may be appropriate to replace a large exposures type regime with a simple reporting scheme instead.
141. Such a reporting scheme could also usefully include basic information on concentration risk in earnings (something that could be more relevant for certain investment firms), where client money held is deposited or securities belonging to clients are segregated from the firm's own assets (regardless of whether the firm is required to account for such client assets on or off its balance sheet) and the amount of assets held with custodians (on behalf of customers).

³⁸ See Article 395 of the CRR

³⁹ This would reflect the Commission's specific impact assessment for large exposures requirements for investment firms for Directive 2009/111/EC, which formed part of the 'CRD II' amendments package.

142. In addition, there may be merit in ensuring that supervisors have harmonised powers to react appropriately (under a reporting scheme), and the circumstances in which these could be exercised, should the reported information give him a particular cause for concern. Such aim could be reached developing adequate Level 2 guidelines.
143. Furthermore, it remains possible, including in the light of data collection and further analysis, that there could still be some significant ‘bank-like’ proprietary trading firms that, although not systemic, also merit further attention (whether that be, for example, individually under a new ‘pillar 2’ approach, a common ‘soft limits’ framework where larger trading-book exposures are still permitted if supported by additional capital, or a hard limits based large exposures regime). If so, then the sorts of exemptions for trading as identified in the EBA Report (e.g. exemptions for exposures to exchanges and to clearing members) would need to be borne in mind.

Questions

Question 25. What are your views on the relevance of large exposures risk to investment firms? Do you consider that a basic reporting scheme for identifying concentration risk would be appropriate for some investment firms, including Class 3 firms?

4.4.2 Consolidated supervision

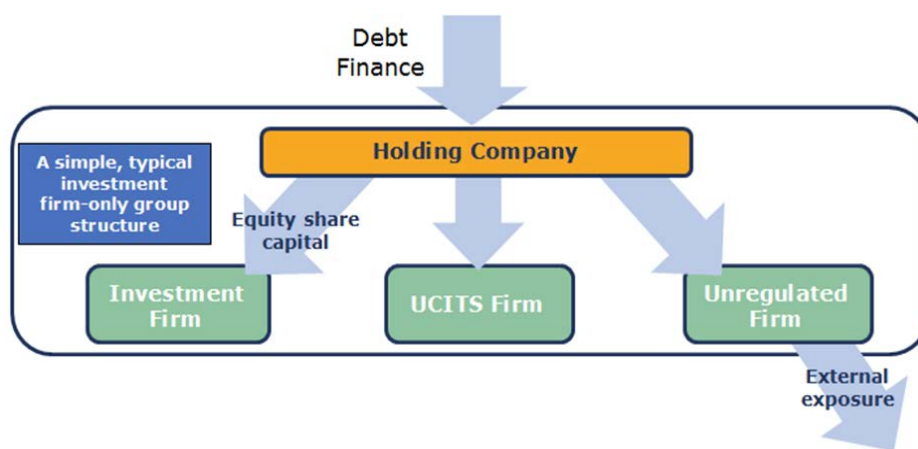
144. Section 3.3.6 of the EBA Report provided an overall account of the background and relevance of group risk for investment firms, together with a brief explanation of the alternative treatment that permits a waiver from consolidated supervision to be granted where such a waiver can be deemed appropriate for a specific investment firm group and provided that the conditions under Article 15 (and 17) of the CRR are met.
145. Generally speaking, consolidated supervision serves to supplement the supervision of an individual authorised entity, providing a view of the wider risks that a firm may be exposed to by virtue of its membership of a group.
146. In particular, the main issues addressed by the use of consolidated supervision as a regulatory tool are:
- a) to identify financial risks created by another group entity that have the potential to create losses within that other group entity, which subsequently looks to the group as whole – including the authorised investment firm – for support, or where the investment firm may already have exposure to that other group entity;
 - b) to detect and provide for situations where a parent entity issues debt and either downstreams the proceeds in the form of equity, or uses it to fund acquisitions (which may create large amounts of goodwill at parent or holding company level), which can result in

excessive group leverage. Thus, consolidated supervision should take account of the extent to which an investment firm is leveraged at the level of its parent; and

- c) to guard against situations of double or multiple gearing, where the same capital is used simultaneously as a buffer against risk in two or more legal entities.

147. This may be illustrated with the following chart:

Figure 5. Capital structure within a simple investment firm-only group structure.



148. Regulators are not generally directly responsible for holding companies or group entities that are not authorised. However, any additional risk arising as noted above, where an authorised investment firm is part of a group, may still matter. This is due to its potential indirect, consequential impact upon that investment firm, and hence, in turn, the potential heightened risk that investment firm may pose to its customers. For example, financial problems elsewhere within the group, or weaknesses within the group's overall financial structure, could lead to the regulated firm being under pressure, to take additional risks or become less tight on compliance etc. Therefore any new prudential regime for investment firms should provide some protection against such group financial risks, where the firm is part of a group.

149. As regards how to address this, it should be noted that each prudentially regulated entity in the group should already have its own on-going regulatory capital requirements at an individual level, appropriate to the particular nature of its own business, and it would not seem proportionate to try to extend 'proxy' capital requirements to cover every type of unregulated entity that could exist within a group, particularly if there are no customers of a regulated service or activity.

150. Furthermore, should problems occur within a group, it is the individual authorised investment firm which regulators would wish to see wind-down in an orderly manner, there being no particular responsibility in respect of winding down an investment firm group as a whole. Hence there should be no particular need to try to replicate any capital requirements

related to wind-down, such as an expenditure / fixed overheads (FOR) type requirement, on a consolidated basis⁴⁰.

151. Because any additional risk to the customers of the investment firm that may arise from it being part of a group is of a more indirect nature, one could look to the way in which any indirect impact on customers of risk borne by the individual firm itself may be dealt with at solo level, and seek to adapt that approach (e.g. the leverage-based 'up-lift' measure) on a group-wide level. However, although this would address the main issues identified above, it would add a layer of complexity that may be unnecessary.

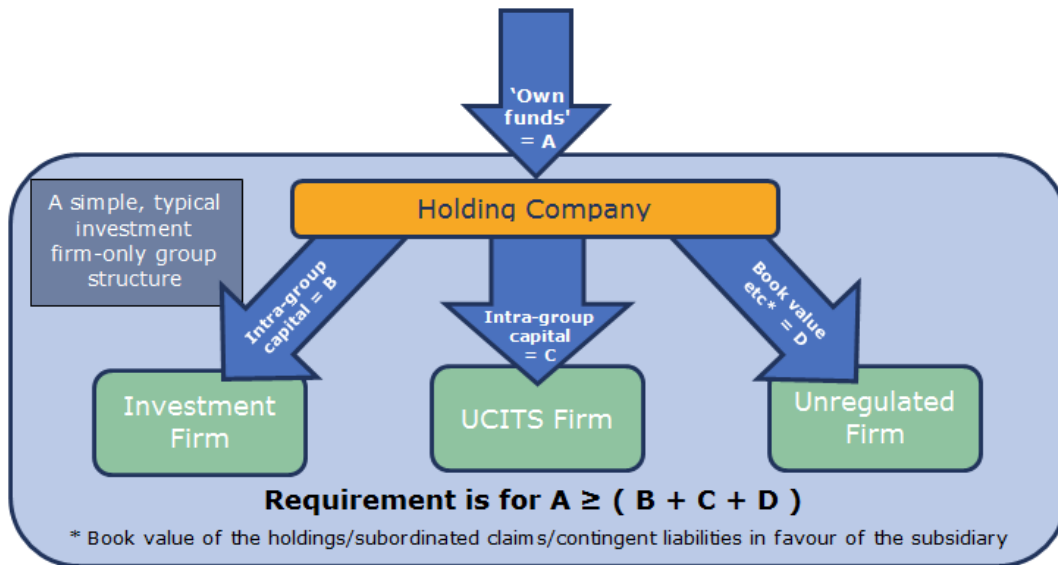
152. Instead, a simpler solution may be to adapt the type of approach that currently exists (under Articles 15 and 17 of the CRR) and has done since the original CAD in 1993. This currently operates as a "derogation" from consolidated supervision, but given that it contains a set of conditions and an element of supervisory judgement, it could easily be adapted to become a common, minimum approach to addressing group risk.

153. A group capital test would be applied to ensure that a holding company (or parent investment firm) itself has sufficient capital to, in effect, support the book value of its own investments in the capital of its subsidiaries and participations, plus any contingent liabilities it may have in favour of those group entities. In order to ensure its effectiveness, the same definition and quality of capital would have to be used for the holding company/parent entity as for the regulated investment firm itself (e.g. own funds), including any relevant deductions. And this would be measured against the amount of 'intra-group' capital supplied to regulated entities (i.e. capital provided to the investment firm by the parent entity or any other group entity); this would not discourage regulated firms from retaining externally generated capital (e.g. retained profits, or minority interests) at solo level, whilst also ensuring that there is no benefit to be gained by the rest of the group providing internal capital to the investment firm that is not supported by externally generated capital simply to avoid a higher RFUM.

154. This can be illustrated with the following chart:

⁴⁰ There is, however, a potential caveat to this that may need to be addressed, in that where expenditure that an investment a firm would otherwise need to incur is in fact booked elsewhere within the group (e.g. in an unregulated service company), then the detailed application of any expenditure / fixed overheads (FOR) type requirement needs to ensure that such additional amounts are picked up in the calculation at individual solo firm level.

Figure 6. Own funds within a simple investment firm-only group structure



155. The composition of entities that should be included within the scope of such a group may need to be clarified, given that the nature of investment firm groups can be quite diverse, and should include tied agents where they are owned by the investment firm⁴¹.
156. The current derogation from consolidated supervision for investment firms also includes provisions that require each investment firm in the group to have in place systems to monitor and control the sources of capital and funding of all regulated entities within the group. The appropriateness of such measures for helping to address group risk could also be examined in the light of possible new minimum requirements for liquidity for investment firms.
157. As noted in paragraph 19 of this DP, it may also be necessary to provide to treat a group of many 'very small' investment firms (that otherwise would benefit from the less onerous capital treatment) as one single, larger, firm, so as to prevent the possibility of regulatory arbitrage.
158. Finally, it should be noted that the above approach to addressing group risk would, generally, only apply to investment firm-only groups⁴². Where an investment firm is part of a banking group, the credit institution in the group will already be required to apply consolidated supervision under the CRR, which should include a MiFID investment firm if within the scope

⁴¹ For example, the current CRR definition of 'financial institution' may not be sufficient for these purposes.

⁴² It should also apply to all investment firms, even those of a type that may not be eligible to apply for the derogation under CRR Art 15 currently. It is also possible that some larger dealing firms may require additional measures.

of the relevant consolidation group; only where group risk is not already addressed in this way would the above approach for investment firms need to be applied.

Questions

Question 26. What are your views on the proposed approach to addressing group risk within investment firm-only groups? Do you have any other suggested treatments that could be applied, and if so, why?

Question 27. In the case of an investment firm which is a subsidiary of a banking consolidation group, do you see any difficulty in the implementation of the proposed capital requirements on an individual firm basis? If so, do you have any suggestion on how to address any such difficulties?

4.4.3 Additional requirements on an individual firm basis

159. In addition to meeting minimum prudential requirements, investment firms should implement arrangements, strategies and mechanisms to ensure a sound management as well as have capital and liquidity to ensure coverage of risks to which they are or might be exposed to. As already provided in MiFID I and MiFID II investment firms are required to 'have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems.'⁴³ For risk management, further detail of the actions that firms should take is provided in the MiFID II Implementing Regulation⁴⁴. This includes, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of the investment services and activities undertaken in the course of that business, the establishment of an independent risk management function. The CRD also includes material on how the management body of a CRR institution should treat risks.⁴⁵

160. As currently required under CRD, as part of supervisory review and evaluation process (SREP), competent authorities should be able to review the risk management arrangements, strategies and mechanisms implemented by an investment firm as required, taking into account the principle of proportionality, and considering the aforementioned requirements of MiFID. Furthermore, competent authorities should assess whether the capital and liquidity resources held by the firm are adequate to ensure coverage of risks a firm is or might be exposed to. Competent authorities are also required under the CRD to have the ability to take actions based on the outcomes of their assessments and impose measures aimed at

⁴³ Article 13(5) and Article 16(5) respectively

⁴⁴ Article 23.

⁴⁵ Article 76.

improving a firm's risk management arrangements, strategies and mechanisms, reduce its risk profile, and to require it to hold additional capital or liquidity resources. This should include taking into account the particular risks that they might pose to customers and markets (either directly or indirectly).

161. Consequently, the EBA may develop the detail of the proportional application of prudential provisions applying to investment firms, including an appropriate supervisory review process, following the finalisation of the new minimum standards (and capital requirements and liquidity in particular).⁴⁶ This should include particular consideration of any investment firms that are large or otherwise important in the markets in which they operate, (but are not 'systemic and bank-like').

Questions

Question 28. What other aspects should the competent authorities take into account when addressing the additional prudential measures on an individual firm basis under the prudential regime for investment firms?

4.4.4 A macro-prudential perspective for investment firms

162. The European Systemic Risk Board (ESRB), in its recommendation on the intermediate objectives of macro-prudential policy⁴⁷, set out that the main objective of macro-prudential policy is to contribute to the safeguarding of the stability of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth.

163. To achieve this main objective, the ESRB identified five intermediate objectives of macro-prudential policy: (i) to limit excessive credit growth and leverage; (ii) to mitigate excessive maturity mismatch and market illiquidity; (iii) to limit direct and indirect exposure concentrations; (iv) to limit the systemic impact of misaligned incentives with a view to reducing moral hazard; and (v) to strengthen the resilience of financial infrastructures. Importantly, these intermediate policy objectives also relate to potential risks to financial stability that could stem from beyond the banking system and particularly from investment firms.

⁴⁶ This work will, to the extent necessary, take into account changes to the Supervisory Review and Evaluation Process following amendment to Directive 2013/36/EU, where it may prove appropriate to do so for investment firms.

⁴⁷ Recommendation of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1).

164. Following from the objective of safeguarding the stability of the financial system as a whole, the prudential regime for investment firms should take into consideration that investment firms could, potentially (and according to circumstances), also pose a source of systemic risk collectively, even if individually they are not assessed as ‘systemic and bank-like’. In this regard, three points are noted:

- a) potential system-wide risks from non-systemic investment firms – particularly those that are still significant in the markets in which they operate – could stem from a number of sources, in particular: the use of leverage, the adequacy of capital structures, linkages with the banking system, engagement in shadow-banking activities (e.g. securitization of receivables or inventories), and the trading on derivatives markets;⁴⁸
- b) even when investment firms are small, they may be “systemic as a herd” and pose a “too many to fail” risk to financial stability due to common exposures to the same type of shock; and
- c) to the extent that it is assessed (at any time in the future) that systemic risks are building up, the prudential regime should provide authorities with the flexibility to adjust requirements for individual or groups of investment firms to mitigate these risks.

165. This does not mean that the same macro-prudential tools used in the CRD/CRR are necessarily appropriate for investment firms, but rather that newly designed macro-prudential tools would most likely be required.

4.4.5 Reporting and any other prudential tools

166. Any new minimum requirements, such as for capital adequacy or liquidity, would also be accompanied by a new and proportionate reporting scheme to help the supervision of firms meeting those requirements. In designing any new reporting, particularly for Class 3 firms, account will be taken of the experience of some national competent authorities to date that some investment firms suggest that the current regulatory reporting regime can be an excessive burden.

167. As regards other types of prudential tool, leverage risk has already been addressed under the ‘uplift’ measure as part of the capital requirements.

168. The first EBA Report discussed the case for capital buffers and public disclosure requirements (‘Pillar 3’). Further analysis is required to determine whether these prudential tools used in the CRD/CRR would fit under the new framework proposed for investment firms or how they

⁴⁸ See Opinion of the European Central Bank on a proposal for a regulation amending Regulation (EU) No 575/2013 as regards exemptions for commodity dealers, 3 March 2016.

could be adapted to be made more appropriate as part of it. Anecdotal evidence tells that professional counterparts actively require investment firms to submit information before entering a business relationship, whereas retail customers face difficulties in finding disclosed information and exploiting the parts of it relevant to them – as opposed to technical details with a regulatory background. The first Report also raised the question of whether the CRR's treatment of qualifying holdings outside the financial sector is suitable for investment firms given the fact that investment firms often combine MiFID services with other kinds of services on a solo as well as on a group basis.

169. The first Report⁴⁹ also noted that, if the impact of the failure of most investment firms is not as great, or is more concerned with ensuring that the needs of customers are dealt with on a more orderly manner, then the recovery and resolution tools of the BRRD may be less relevant to them (particularly where relatively small).

Questions

Question 29. What examples do you have of any excessive burden for investment firms arising from the current regulatory reporting regime?

Question 30. What are your views on the need for any other prudential tools as part of the new prudential regime for investment firms? And if required, how could they be made more appropriate? In particular, is there a need for requirements on public disclosure of prudential information? And what about recovery and resolution?

4.5 Corporate governance and remuneration

170. The governance requirements aim at the sound functioning of the institution and in particular at ensuring that investment firms are soundly managed and have a robust internal control framework in place.

171. Regarding investment firms governance and in particular risk management a strong compliance function should be required within all investment firms. The compliance related requirements of MiFID I, which are reinforced in MiFID II, should continue to apply to all investment firms, including the requirements on the suitability of their management. Only 'systemic bank-like' investment firms should continue to also be subject to the CRD/CRR provisions.

⁴⁹ See page 77. All investment firms that are subject to an initial capital requirement of EUR 730 000 are within scope of the Bank Recovery & Resolution Directive applies to all investment firms.

172. The purpose of the remuneration requirements under CRD/CRR is to align the variable remuneration of staff with the risk profile and interests of the investment firm in the long run and to prevent excessive risk taking so that the remuneration policies are consistent with effective risk management.
173. As variable remuneration is, to an extent, performance related, it serves also to some extent to keep the costs of the investment firm flexible. For some investment firms – different to credit institutions - the fixed overheads, that include the fixed remuneration of staff, are used to establish the capital requirements.
174. Most investment firms commonly have different risk profiles, business models and pay structures compared to credit institutions. However, differences in remuneration requirements could be relevant for the **recruitment of highly talented staff** if a different regulatory remuneration regime would be applicable.
175. For many investment services the remuneration depends to a larger extent on fees paid. Investment firms, depending on the activities perform, may have a **shorter business cycle** than credit institutions, however, operational risks, including legal risks and conduct related risks may materialise also after longer time periods.
176. A remuneration regime for investment firms should differentiate the regulatory requirements for the different categories of investment firms. 'Systemic bank-like' firms should remain within the scope of the current CRD/CRR, but should benefit in the same way as credit institutions from possible future waivers⁵⁰ from the remuneration requirements to apply deferral and the pay out in instruments.
177. Notwithstanding the above, it should also be noted that all investment firms should comply with MiFID remuneration requirements and, as such, have remuneration policies in place that are appropriately considering the protection of consumers, by ensuring that there are not any incentives for the mis-selling of products. Such a regime applies to all staff and tied agents.

Questions

Question 31. What are your views on the relevance of CRD governance requirements to investment firms, and what evidence do you have to support this?

Question 32. As regards 'systemic and bank-like' investment firms, do you envisage any challenges arising from the full application of the CRD/CRR remuneration requirements, and if so,

⁵⁰ See EBA's opinion on proportionality: <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-25+Opinion+on+the+Application+of+Proportionality.pdf>

what evidence do you have to support this? For all other investment firms, what are your views on the type of remuneration requirements that should be applied to them, given their risk profiles, business models and pay structures?

Question 33. What is your view on a prudential remuneration framework for other than 'systemic and bank-like' investment firms that should mainly aim to counteract against conduct related operational risks and would aim at the protection of consumers?

4.6 Alternative approach to a new regime

178. The development of a new prudential regime is not a simple or straightforward task. Investment firms have different risk profile in many respects compared to credit institutions. The starting point set out in this DP has therefore been the development of a completely new regime for investment firms. However, this is not the only alternative. Another possibility is to amend the CRR to address investment firms in a more proportionate and targeted fashion.

179. Therefore, the EBA is not dismissing the possibility of maintaining the existing CRR treatment for investment firms, at least for some firms, although in a manner that is more specifically targeted towards these firms. There are at least two arguments in favour of this approach. Firstly, if there are separate regimes in place, large investment firms that grow into systemically important firms would have to switch regimes, which would not be trivial. Secondly, some investment firms, which are part of existing banking groups, may prefer to apply CRR rules, as these would be applied at the consolidated level of the group.

180. It is therefore important to understand, firstly, whether the existing regime is preferable to the approach outlined in this DP. Secondly, should the CRR be preferred, what are the main problems with the existing framework. The existing classification in the CRR, as concluded in the EBA Report, appears excessively complicated, such that a simpler classification of existing investment firms could alleviate a substantial burden. Changing these two issues alone would not, however, solve the problem of addressing the risks that the investment firms pose, and are themselves exposed to, appropriately.

181. The EBA is currently of the view that a separate regime is preferable, considering the significantly different risk profiles of investment firms and also notes that some of the above considerations favouring a more proportionate regime under the CRR may be mitigated in the final proposal. In addition, maintaining two regimes for investment firms may also lead to regulatory arbitrages across the two regimes and introduce unlevel playing fields between firms, dependent on the regime applied to the specific firm. Nonetheless, considerations on the main problems with the existing regime will be a valuable input at this stage, as this, as a minimum, can be used to improve the approach presented in the discussion paper. Consequently some preliminary considerations about the possibility to retain investment

firms within the existing, albeit simplified, regulatory framework is provided below. Taking into account the feedback received, the EBA will in its final report then consider whether a completely separate regime, a mixed regime or even a simplified CRR regime for all investment firms is best suited to capture the risk of investment firms.

Investment firms carrying out 'bank-like' activities

182. As is noted in point (a) of Paragraph 12, there can be some investment firms that although not large enough to be categorized as 'systemic and bank-like' may conduct similar 'bank-like' activities (for example underwriting on a firm commitment basis and proprietary trading) and take on a significant amount of exposure risk. One possibility that might be appropriate for such firms is to keep an approach to setting risk-based requirements that is more consistent to the one they currently use - i.e. by nature of the risks that arise from a firm's own exposures – especially for those that are deemed as large and important in terms of the potential for their failure to create a significant adverse impact upon market confidence. This could be done in a way that provides more proportionality and is more appropriate to the features of investment firms than the current regime requirements, and could also take account of any relevant proposals that may emerge from initiatives launched at European level to simplify the prudential framework for smaller banks. Some thoughts in this respect are set out below.

Credit risk and counterparty credit risk

183. Credit activities are generally marginal for investment firms. The current standardised framework refers to external ratings in order to determine capital requirements. Such an approach is developed mainly for entities with a wide and heterogeneous range of counterparties, as this is part of the core banking business model. For investment firms, the complexity of the calculations may not be balanced.

184. In the light of these considerations, applying for instance the simplified method provided in Basel I could be more appropriate. This method associates a specific risk-weight to each kind of counterparty. All possible counterparties are grouped in a limited number of categories (for example, sovereign: 0%; banks and other financial institutions: 20%; other assets: 100%; past due: 150%).

Market risk

185. Market risk is the main risk driver for these firms. To prevent investment firms' failures, avoid any level playing field issue, as well as any possibility of risk-transfer between banks and investment firms that have this trading activity, there is an argument that both types of entities should calculate capital requirements for market risk in the same way.

186. However, in order not to penalize investment firms which have small trading books, the threshold for exempting the full market risk regime could be increased, as proposed in the

recent EBA assessment of the new market risk regime⁵¹. Such proportionality measures may be sufficient to alleviate the concerns of the current framework.

Operational risk

187. Sound management, a clear organizational framework, and robust internal procedures are crucial for identifying, monitoring, and keeping under control operational risks. The basic indicator approach (BIA) is a simple methodology which consists of an average of the last three observations of a profitability relevant indicator (such as net commissions) weighted by a 15% scalar.

Other requirements

188. Further adjustments to the current rules would be needed in order to set up a more proportionate new regime for investment firms. For instance, reporting and disclosure requirements could be tailored for investment firms. Also other CRR requirements in areas such as securitization, credit valuation adjustment and prudent value adjustments could be removed or adapted. They could also be replaced by the introduction of a scaling factor which would be calibrated in order to make sure that the overall framework is not less prudent than the current one.

Questions

Question 34. What are your views on having a separate prudential regime for investment firms? Alternatively, should the CRR be amended instead to take into account a higher degree of proportionality? Which type of investment firms, if any, apart from systemic and bank-like investment firms, would be better suited under a simplified CRR regime?

Question 35. What are the main problems from an investment firm perspective with the current regime? Please list the main problems with the current regime.

⁵¹ Can be found here: <https://www.eba.europa.eu/regulation-and-policy/market-risk>

Annexes

Annex 1 – Stylised example (illustrative only) to show the calculation of the Risk to Firm Uplift Measure (RFUM) to capture the exposure risk of the investment firm

- The following illustration takes a simple example of two firms, one (A) being larger in balance sheet (and off b/s) exposure measure terms and also in risk to customer (RtC) and risk to markets (RtM) terms compared to the other (B). However, the latter (B) is more highly leveraged being funded with a higher proportion of non-capital.

	Firm A	Firm B
Sum of RtC and RtM K-factors [$\sum_{i=1}^p aiKci$] €000	3,000	1,000
Total Exposure Measure [TEM] €000	50,000	10,000
Funded by...		
Debt €000	30,000	7,500
Capital [Capital Measure or CM] €000	20,000	2,500
RtF Uplift Measure [RFUM = TEM/CM]	2.5	4
Up-lift factor [$f(\text{RFUM}) = \text{SQRT}(\text{RFUM})$]	1.58	2.00
Capital requirements calculation (assuming $\gamma = 2$)...		
Total Minimum Capital Requirement = [$\sum_{i=1}^p aiKci$] * ($f(\text{RFUM})$)	4,740	2,000

- Firm A is a relatively larger firm, which chooses to hold a large proportion of capital – its total exposure measure is 40% funded by capital. As such it has a low RFUM and a low uplift factor applied to the sum of its RtC and RtM when calculating its total minimum capital requirement.
- Firm B on the other hand, although presenting less risk to customers and markets, chooses to be more highly leveraged, holding an amount of capital that is closer to its minimum capital requirement. It therefore has a higher RFUM and applies a higher uplift to the sum of its RtC and RtM K-factors when calculating its total minimum capital requirement.

Annex 2 – Stylised example (illustrative only) to show the application of the total minimum capital requirement formula

1. This Annex is an illustrative example of the calculation of the proposed capital requirements for four different firms (A to D). The inputs (rows 1 to 3, and 6 to 8) were chosen so that each firm falls under a different calculation method. Firm A would only be subject to initial capital; firm B only to fixed overheads; and the capital requirement for Firm C is determined by the K-factor approach with no uplift. Firms A, B and C would all be 'Class 3' firms.
2. Firm D would have a capital requirement determined by the K-factor approach multiplied by (a function of) the uplift factor. The cells highlighted in grey are relevant only for Firm D. In particular, since the leverage is relevant only for this firm, rows 6 to 10 are not necessary for the other cases.

Examples:			Firm A	Firm B	Firm C	Firm D
1	Initial Capital Requirements: ICR	€000	100	100	100	100
2	Fixed Overhead Requirements: FOR	€000	60	130	150	400
3	Sum of RtC and RtM K-factors: $\sum_{i=1}^p a_i K_i$	€000	negligible	80	180	300

Capital requirements calculation (assuming ICR multiplier $\gamma = 2$):

4	If $FOR \leq \gamma * ICR$ and $\sum_{i=1}^p a_i K_i \leq \gamma * ICR$		Yes	Yes	Yes	No
5	Then Total Capital Requirement = $\max(ICR, FOR, \sum_{i=1}^p a_i K_i)$	€000	100 (ICR)	130 (FOR)	180 (K-factors)	-

Otherwise

6	Total Exposure Measure: TEM	€000	Non applicable			1,250
<i>funded by:</i>						
7	Debt	€000	Non applicable			750
8	Capital (Capital Measure or CM)	€000	Non applicable			500

Calculation of uplift factor:

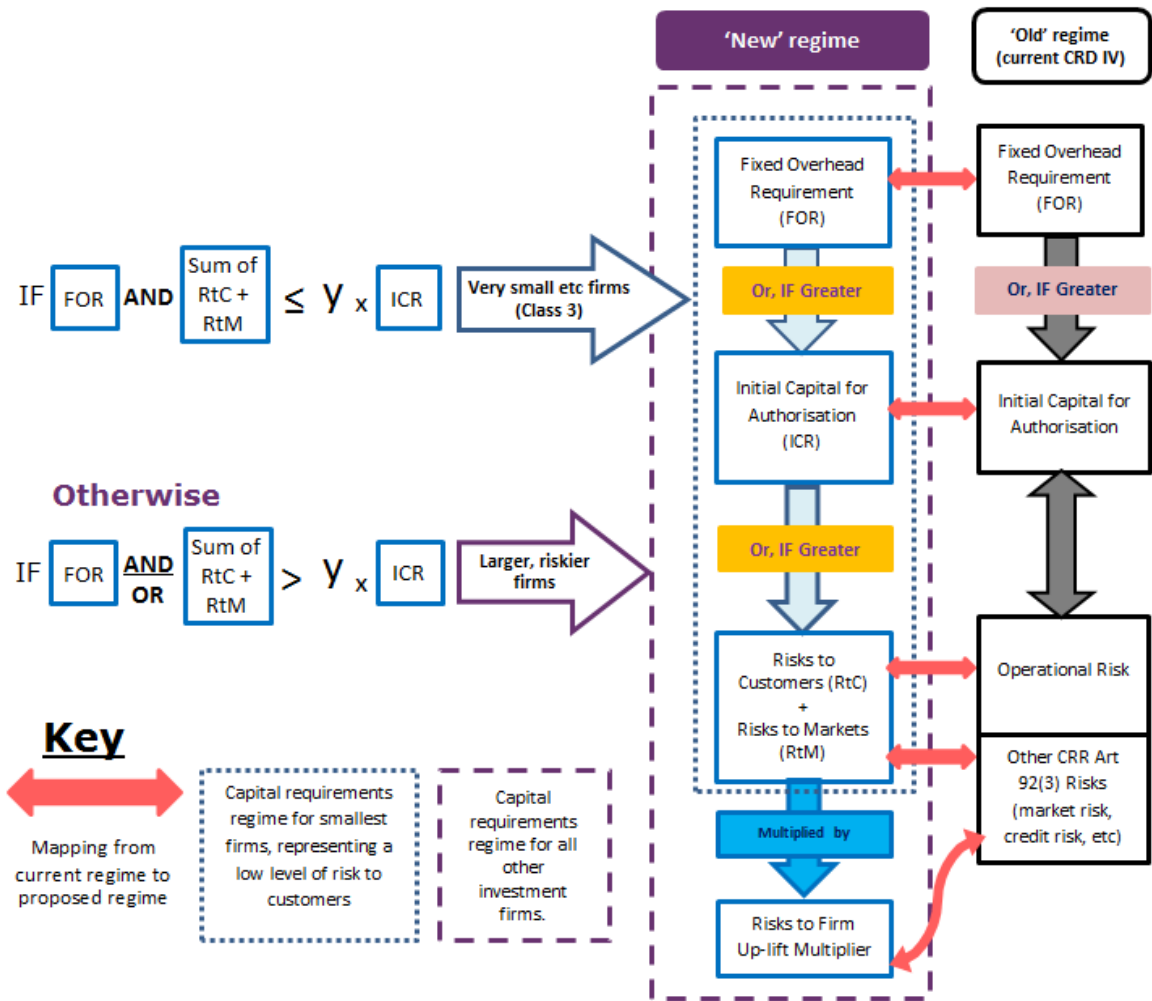
9	Risk to Firm Uplift Measure: RFUM = TEM/CM		Non applicable			2.5
10	Up-lift factor: $f(RFUM) = \text{SQRT}(RFUM)$		Non applicable			1.58

Capital requirements calculation

11	Total Capital Requirement = $\max[ICR, FOR, \sum_{i=1}^p a_i K_i * f(RFUM)]$	€000	-	-	-	474 (K-factors * uplift)
----	---	------	---	---	---	-------------------------------------

Annex 3 – New capital requirements framework mapped to current regime

- This chart gives a simple visual illustration of this overall capital framework for investment firms and includes a mapping from the current framework for firms subject to requirements in, or derived from, the CRR.



Annex 4: Liquidity – Some considerations in determining what may be a liquid asset

Bespoke definition of liquid asset

2. The following characteristics of liquid assets are contemplated in the Basel Committee⁵² and in the subsequent EU legislation on the Liquidity Coverage Requirement for banks.

a) Fundamental characteristics

- i) Low risk: assets that are less risky tend to have higher liquidity. High credit standing of the issuer increases an asset's liquidity.
- ii) Ease and certainty of valuation: an asset's liquidity increases if market participants are more likely to agree on its valuation.
- iii) Low correlation with risky assets: the stock of HQLA (high quality liquid assets) should not be subject to wrong-way (highly correlated) risk. For example, assets issued by financial institutions are more likely to be illiquid in times of liquidity stress in the financial industry.
- iv) Listed on a developed and recognised regulated exchange trading venue: being listed increases an asset's transparency.

b) Market-related characteristics

- i) Active and sizable market: the asset should have active outright sale or repo markets at all times (historical evidence of market depth, low bid-ask spreads, high trading volumes, and a large and diverse number of market participants).
- ii) Low volatility: Assets whose prices remain relatively stable and are less prone to sharp price declines over time will have a lower probability of triggering forced sales to meet liquidity requirements.
- iii) Flight to quality: historically, the market has shown tendencies to move into these types of assets in a systemic crisis.

3. These characteristics are or could potentially be met regarding the following items listed in Article 4, Assets, of the Bank Account Directive 86/635/EEC.

⁵² <http://www.bis.org/publ/bcbs238.pdf>

- a) Item 1 lists: “Cash in hand, balances with central banks and post office banks”. As this item is defined in Art. 13 of the Bank account directive, this item is rather clear and hopefully implemented by the member states in the same manner.
 - b) Item 2: “Treasury bills and other bills eligible for refinancing with central banks”.
 - c) Item 3 lists: “Loans and advances to credit institutions, (a) repayable on demand, (b) other loans“. This item is defined in Art. 15 Bank account directive and should therefore also be implemented in the same manner by member states. Though it might be clear what instruments to subsume under this item, the question is, whether the instruments are short term and can readily be converted into cash”.
 - d) Item 4: “bonds and advice to customers”.
 - e) Item 5: – “debit securities including fixed-income securities, (a) issued by public bodies, and (b) issued by other borrowers⁵³” – as well as
 - f) Item 6 – “shares and other variable-yield securities” – are possible liquid assets.
4. The conditions under which the latter items are deemed to be readily convertible into cash on a short term basis would have to be established. If assets meet the requirements for being level 1 or level 2 assets in the sense of the LCR this is presumed to be the case. However eligible sources of liquidity of investment firms may not need to be limited to such a narrow scope.

When are assets readily convertible into cash?

- 5. Assets are in the short term readily convertible into cash, if either the remaining time to maturity is short or if it be terminated and paid back within a short term or it could be sold within a short time.
- 6. Assets, especially items 5 and 6 (securities and shares) can easily be sold within a short time if they are transferable and if there exists a liquid market with tradable prices. Only the fact that there is an exchange quotation at all for that asset is not sufficient. There has to be a proven commercial activity for that asset.
- 7. Financial instruments traded only on MTFs or purely OTC should not be excluded. It appears that by abstaining from setting very formal criteria (such as forming part of a major stock index) on the convertibility, regulators and firms retain enough flexibility. But such a principle based regulation also means that more effort has to be spent on scrutinizing the liquidity of a certain asset. It also has to be taken into account that market liquidity can change over time.

⁵⁹ Excluding holdings of debt securities issued by the firm itself.

Liquidity invested in those assets might be frozen if liquidity drowns and from this point in time it would not count for meeting the liquidity requirements any longer. The possibility of such a scenario may be higher the lower the market capitalization of the financial instrument. This can pose a significant threat to market makers holding bigger positions.

8. What also has to be considered is, if firms should be allowed to count the assets with their nominal value instead of a – lower – market value. If a security is not being held for trading purposes but is of a short term maturity, it should be able to count with its asset value taken from the balance sheet; this would just be an operational facilitation of the liquidity regime. Firms should be able to calculate the new requirements with the figures they have. A possible gaming of such a rule could be counteracted by close monitoring of the firm's balance sheet and depreciation policies.

What to understand under short term?

9. The answer to that question depends on the time liquidity has to be delivered and may depend on the ratio required. While a week or a month seems to be conceivable, a longer period should not be ruled out. For different purposes different time periods might be deemed necessary and useful. For example a wind-down procedure might take up to three months or in certain cases even longer. If liquidity is required to facilitate an extended wind-down, two or three months' money should be accepted.

What are speculative positions?

10. A financial instrument is to be deemed as speculative if there is leverage, e.g. open derivative positions if not used for hedging the portfolio. If the financial instrument is not furnished with a leverage, it could nevertheless be considered as speculative if its price volatility exceeds a defined threshold, e.g. between 50% and 100%.
11. However, as the business model of some investment firms comprise trading activities (this might be the reason, why they are in fact licensed), it seems questionable if the underlying rationale can be transferred from the AIMFD to the prudential regulation of investment firms without modification. It appears to be preferable to impose haircuts on instruments with very high volatility instead of excluding fair value assets being held for trading purposes from the investment universe of the regulatory own funds and at the same time from the definition of liquid assets.

Summary of questions

Question 1. What are your views on the application of the same criteria, as provided for G-SIIs and O-SIIs, for the identification of ‘systemic and bank-like’ investment firms? What are your views on both qualitative and quantitative indicators or thresholds for ‘bank-like’ activities, being underwriting on a firm commitment basis and proprietary trading at a very large scale? What aspects in the identification of ‘systemic and bank-like’ investment firms could be improved?

Question 2. What are your views on the principles for the proposed prudential regime for investment firms?

Question 3. What are your views on the identification and prudential treatment of very small and non-interconnected investment firms (‘Class 3’)? If, for example, such class was subject to fixed overheads requirements only, what advantages and drawbacks would have introducing such a Class 3? Conversely, what advantages and drawbacks could merging Class 3 with other investment firms under one single prudential regime with ‘built-in’ proportionality have?

Question 4. What are your views on the criteria discussed above for identifying ‘Class 3’ investment firms?

Question 5. Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?

Question 6. What are your views on the initial K-factors identified? For example, should there be separate K-factors for client money and financial instruments belonging to clients? And should there be an RtM for securitisation risk-retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?

Question 7. Is the proposed risk to firm ‘up-lift’ measure an appropriate way to address the indirect impact of the exposure risk a firm poses to customers and markets? If not, what alternative approach to addressing risk to firm (RtF) would you suggest?

Question 8. What are your views on the ‘built-in’ approach to delivering simpler, proportionate capital requirements for Class 3 investment firms, (compared to having a separate regime for such firms)?

Question 9. Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how could it be improved?

Question 10. What are your views on the appropriate capital requirements required for larger firms that trade financial instruments (including derivatives)?

Question 11. Do you think the K-factor approach is appropriate for any investment firms that may be systemic but are not ‘bank-like’?

Question 12. Does the definition of capital in the CRR appropriately cater for all the cases of investment firms that are not joint stock companies (such as partnerships, LLPs and sole-traders)?

Question 13. Are the cases described above a real concern for the investment firms? How can those aspects be addressed while properly safeguarding applicable objectives of the permanence principle?

Question 14. What are your views on whether or not simplification in the range of items that qualify as regulatory capital and how the different ‘tiers’ of capital operate for investment firms would be appropriate? If so, how could this be achieved?

Question 15. In the context of deductions and prudential filters, in which areas is it possible to simplify the current CRR approach, whilst maintaining the same level of quality in the capital definition?

Question 16. What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?

Question 17. What are your views on the definition of initial capital and the potential for simplification? To what extent should the definition of initial capital be aligned with that of regulatory capital used for meeting capital requirements?

Question 18. What aspects should be taken into account when requiring different levels of initial capital for different firms? Is there any undesirable consequence or incentive that should be considered?

Question 19. What are your views on whether there is a need to have a separate concept of eligible capital, or whether there is potential for simplification through aligning this concept with the definition of regulatory capital used for meeting capital requirements?

Question 20. Do you see any common stress scenario for liquidity as necessary for investment firms? If so, how could that stress be defined?

Question 21. What is your view on whether holding an amount of liquid assets set by reference to a percentage of the amount of obligations reflected in regulatory capital requirements such as the FOR would provide an appropriate basis and floor for liquidity requirements for ‘non-systemic’ investment firms? More specifically, could you provide any evidence or counter-examples where holding an amount of liquid assets equivalent to a percentage of the FOR may not provide an appropriate basis for a liquidity regime for very small and ‘non-interconnected’ investment firms?

Question 22. What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements, and why? (Please refer to Annex 4 for some considerations in determining what may be a liquid asset).

Question 23. Could you provide your views on the need to support a minimum liquidity standard for investment firms with the ability for competent authorities to apply “supplementary” qualitative requirements to individual firms, where justified by the risk of the firm’s business?

Question 24. Do you have any comment on the need for additional operational requirements for liquidity risk management, which would be applied according to the individual nature, scale and complexity of the investment firm’s business?

Question 25. What are your views on the relevance of large exposures risk to investment firms? Do you consider that a basic reporting scheme for identifying concentration risk would be appropriate for some investment firms, including Class 3 firms?

Question 26. What are your views on the proposed approach to addressing group risk within investment firm-only groups? Do you have any other suggested treatments that could be applied, and if so, why?

Question 27. In the case of an investment firm which is a subsidiary of a banking consolidation group, do you see any difficulty in the implementation of the proposed capital requirements on an individual firm basis? If so, do you have any suggestion on how to address any such difficulties?

Question 28. What other aspects should the competent authorities take into account when addressing the additional prudential measures on an individual firm basis under the prudential regime for investment firms?

Question 29. What examples do you have of any excessive burden for investment firms arising from the current regulatory reporting regime?

Question 30. What are your views on the need for any other prudential tools as part of the new prudential regime for investment firms? And if required, how could they be made more appropriate? In particular, is there a need for requirements on public disclosure of prudential information? And what about recovery and resolution?

Question 31. What are your views on the relevance of CRD governance requirements to investment firms, and what evidence do you have to support this?

Question 32. As regards 'systemic and bank-like' investment firms, do you envisage any challenges arising from the full application of the CRD/CRR remuneration requirements, and if so, what evidence do you have to support this? For all other investment firms, what are your views on the type of remuneration requirements that should be applied to them, given their risk profiles, business models and pay structures?

Question 33. What is your view on a prudential remuneration framework for other than 'systemic and bank-like' investment firms that should mainly aim to counteract against conduct related operational risks and would aim at the protection of consumers?

Question 34. What are your views on having a separate prudential regime for investment firms? Alternatively, should the CRR be amended instead to take into account a higher degree of proportionality? Which type of investment firms, if any, apart from systemic and bank-like investment firms, would be better suited under a simplified CRR regime?

Question 35. What are the main problems from an investment firm perspective with the current regime? Please list the main problems with the current regime.