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BVI's response to the EBA discussion paper on new prudential regime for MiFID firms

BVI[1] gladly takes the opportunity to present its views on the EBA's discussion paper on new prudential regime for MiFID firms.

Impact and scope of the discussion paper

Its economic strength and relatively large population make Germany one of the most important centres in Europe for investment services. In particular, about 700 firms are licenced as so called MiFID investment firms providing investment services and activities in the meaning of the Directive 2004/39/EC ("MiFID") and which are also in scope of the Directive 2013/36/EU ("CRD") and the Regulation (EU) No 575/2013 ("CRR"). Germany therefore represents almost one quarter of all firms affected by the EBA's new proposals. The vast majority of these firms (about 600) is excluded from the CRR definition of "investment firm" and not required to comply with the CRD IV framework completely because they are not authorised to hold client money or securities belonging to clients or to deal on own account. However, we would like to limit our response to these MiFID investment firms which provide investment services such as portfolio management, investment advice or execution of orders on behalf of clients (without brokerage) and which are also represented in our membership.

Moreover, it is our understanding that the scope of a new prudential regime is limited to investment firms in the meaning of the CRR and firms defined in Article 4(1) No 2) b) and c) CRR. This applies to the call of the European Commission for advice to the EBA for the purposes of the report on a new prudential framework and to the mandates given by Article 508(3) CRR to the European Commission to assess whether the current prudential requirements applicable to firms laid down in the CRR and in the CRD are appropriate or whether they should be modified and if so, how.

We therefore strongly disagree with the EBA's statement in the discussion paper that it will also be relevant for UCITS management companies or AIF managers authorised to conduct certain MiFID services or activities. In particular, the capital requirements of UCITS or AIF management companies are conclusively regulated by the UCITS Directive 2009/65/EC ("UCITS Directive") and AIFM Directive 2011/61/EC ("AIFMD"), taking into account MiFID services. Due to the fact that an effective and risk-based approach is already in place under the UCITS Directive and AIFMD, a new capital requirement regime of MiFID investment firms providing similar services and activities could be designed in a comparable manner.

Need for appropriate impact assessments without time pressure

In general, we welcome the major efforts made so far by the EBA to support the European Commission with an assessment of a new categorisation of investment firms and preparing proposals for a new design and calibration of a more appropriate prudential regime for investment firms presented in the discussion paper. The EBA's report on investment firms (EBA/Op/2015/20) published End of 2015 is also very helpful to get an overview which requirements currently apply for different types of MiFID invest-

[1] BVI represents the interests of the German investment fund and asset management industry. Its 98 members manage assets of some EUR 2.7 trillion in UCITS, AIFs and discretionary mandates. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the investments for 50 million private clients in over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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ment firms, which firms in which EU Member States are affected and what could be improved. However, a general impact assessment with regard to the following questions is missing:

- Even if the current prudential requirement regime, in particular with regard to the categorisation of investment firms and the different requirements arising from that categorisation, seems to be sophisticated, is the current regime nevertheless workable and effective?
- What is the outcome of the data collection launched by the EBA last year?
- How burdensome would be the implementation of the proposed new regime? In particular, it is not possible to calculate and estimate new capital requirements as long as the formula is incomplete.

If these issues are not resolved, we cannot give a final statement to the questions provided in the discussion paper with regard to a new regime. In our view, firstly, it is necessary to carefully assess whether a change of the current system to a new prudential requirement regime is generally appropriate. This work should be carried out without time pressure. Bearing in mind that the vast majority of investment firms are relatively small sized firms which are currently involved in the burdensome implementation of the legal requirements such as MiFID II (Directive 2014/65/EU) and EMIR (Regulation 648/2012), it is questionable whether a completely new regime should be enforced without specific need at this stage.

Main problems with the current regime

In principle, our members are able to handle the current prudential requirements resulting from the CRD and CRR and effective supervisory practices are already in place. In fact, the main problem with the current regime is that investment firms are supervised by securities authorities, but they must also fulfil requirements established and interpreted by banking authorities. One effective means to resolve this issue could therefore be, as a first step, a closer involvement of competent national securities authorities and ESMA in developing and interpreting of prudential requirements for MiFID investment firms or, as a major step, developing a completely new regime for MiFID investment firms outside the banking requirements under guidance of securities regulators and authorities, especially ESMA.

Principle of proportionality

Finally, we fully support the EBA's view that one of the more specific challenges is the application of the proportionality principle because most investment firms commonly have different risk profiles based on differing investor bases, risk appetites and risk horizons. In this context, we are willing to closely cooperate with the EBA to exchange views on any risks involved in providing investment services by MiFID investment firms. We remain at your disposal for any questions or further clarification in this regard.

Subject to the foregoing, we would like to provide the following responses to the questions for consultation:

General principles governing the categorization of investment firms

Q1: *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?*

As we understand the approach in the discussion paper and the EBA's Opinion[2] on the first part of the call for advice, the proposed categorisation as "systemic and bank-like" investment firm should be based on two criteria which investment firms must cumulatively comply with: (a) conducting "bank-like" activities **and** (b) systemic importance of the investment firm. Only in this case, it could be appropriate applying the CRD/CRR requirements to these firms. However, in any case, clear definitions must be provided for these two criteria which should be carefully analysed without time pressure. The following issues should nonetheless be considered:

- **"Bank-like" activities**: The proposal that "bank-like" activities 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, or proprietary trading at a very large scale could be an appropriate approach. In any case, a new approach should comprise an exhaustive list of activities and services which would qualify as bank-like. Moreover, it should be clarified that investment firms providing investment services such as portfolio management, investment advice or execution of orders on behalf of clients or ancillary services such as safekeeping and administration of financial instruments for the account of clients (including custodianship and related services such as cash/collateral management) are not bank-like activities.

- "**Systemic importance**": Currently, we are not able to evaluate what the implications would be if the existing EBA criteria used for the purpose of identifying Global Systemically Important Institutions (G-SIIs) and Other Systemically Important Institutions (O-SIIs). However, bearing in mind that the criteria of the systemic importance should also be relevant for the other categories of investment firms which are not conducting bank-like activities as described in paragraphs 12a) and 81 of the discussion paper, in particular for asset managers, **we would like to highlight that there is no obvious and linear relationship between the size of a firm's assets under management and its alleged systemic importance. Moreover**, **operational risk imminent to asset management services has no systemic dimension.**

  First of all, it should be acknowledged that fund assets and assets of individual clients are fully shielded against the asset manager's insolvency. Under the EU frameworks for UCITS and AIFs, all fund assets are ring-fenced and booked on accounts held by the appointed third-party depositary. The depositary function involves strict separation of assets throughout the custody chain and oversight of the property rights as regards assets which are not capable of being held in custody. These standards ensure that in the event of a fund manager's insolvency, the assets of all managed funds remain unaffected and are still available to investors. The same pertains to accounts managed for individual investors. Also in this case, investors' assets are separated from the manager's own funds and administered by a third party being usually a credit institution. The asset manager issues

[2] The EBA's Opinion on the first part of the call for advice on investment firms, submitted to the Commission on 19 October 2016, can be found at: https://www.eba.europa.eu/documents/10180/1639033/Opinion+of+the+European+Banking+Authority+on+the+First+Part+of+the+Call+for+Advice+on+Investment+Firms+(EBA-Op-2016-16).pdf.

instructions for dealing in client assets, but has otherwise no access to the relevant accounts. In the event of the manager's insolvency, the managed accounts remain unaffected and can be either transferred to another entity or further maintained with the administrator. Moreover, the management contract with the asset manager can be terminated by extraordinary notice due to the opening of the insolvency proceedings.

Secondly, as regards derivative contracts concluded on behalf of funds or individual clients, it is important to note that positions resulting from derivative contracts are adequately collateralised and therefore shielded from the risk of the manager's replacement. The strict collateralisation standards are in large parts resulting from the work of the FSB and other international organisations such as the BCBS and IOSCO. The impact of work undertaken at the international level is already tangible in practice, especially in relation to centrally cleared OTC derivatives. Under the EMIR framework in Europe, counterparties to OTC derivatives subject to central clearing must provide for initial margin and variation margin covering the relevant risk exposure from derivative contracts. The clearing requirements under EMIR are being incrementally extended to cover a broad range of OTC derivative contracts. Non-centrally cleared OTC derivatives are or will shortly be affected by comparable margining requirements following the BCBS/IOSCO principles. The phase-in period for collecting and posting initial margin and exchanging variation margin on those trades started on 1 September 2016.[3] Due to these requirements, positions from OTC derivatives held by funds/in individual accounts are or will in the near future be adequately collateralised and therefore can await orderly transition in case of changes in management. Hence, there should be no need to act under time pressure in closing-out and re-establishing derivative contracts even in stressed market conditions.

Thirdly, with respect to the provision of ancillary services, it is more pertinent to think about obligation of service recipients to ensure that the relevant services can be obtained from other parties in emergency situations than to impose business continuity obligations on service providers. Pricing and valuation services, risk modelling services and other back office functions are being offered by asset managers, but more often provided by specialised firms not subject to specific regulation. Therefore, it seems more important from the systemic perspective that business continuity of asset managers and other regulated entities **as recipients** of such services is warranted by appropriate measures. In Europe, fund managers are required to ensure continuity and quality of delegated functions in case of termination of relevant contracts.[4] In practice, this means that they need to establish emergency plans for situations in which the appointed delegate fails to provide its services or the quality of services deteriorates below an acceptable level.

On the basis of these considerations, we do not perceive situations in which a replacement of an asset manager could give rise to systemic risk. Therefore, we do not see the need for distinguishing large or complex asset managers to whom additional rules should apply, even less so by decisions of national authorities. In this context, we also refer to the policy recommendations to address structural vulnerabilities from asset management activities published by the Financial Stability Board (FSB) in January 2017[5], in particular recommendation 13 which is intended to address the residual risk associated with operational risk. In this context, the assumption that the activities of large and complex asset managers entail operational risk on a systemic scale has been dropped and replaced by a more risk-based approach.

[3] In Europe, the introduction of the initial margin requirements has been postponed by one year. However, the intention is to implement the standards for variation margin on time, i.e. by 1 March 2017 (cf. draft Commission Delegated Regulation on margin requirements for uncleared derivatives from 28. July 2016, Article 36 (2) for variation margin and (3) for initial margin)
[4] Cf. Article 75 g) of the Delegated Regulation (EU) 231/2013 (AIFMD Delegated Regulation).
[5] Can be found at: http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

***Q2:** What are your views on the principles for the proposed prudential regime for investment firms?*

We fully support the EBA's view that one of the more specific challenges is the application of the proportionality principle because most investment firms commonly have different risk profiles based on differing investor bases, risk appetites and risk horizons. This should be in mind in developing any new prudential requirements. As highlighted above, as a first step, it is of utmost importance to analyse the advantages, disadvantages and impacts of developing a new prudential regime or maintaining the current approach bearing in mind the current burdensome implementation of other European requirements such as MiFID II or EMIR. This assessment should be made in close cooperation with ESMA, the national competent authorities supervising investment firms and the market participants without time pressure. We are willing to closely cooperate with the EBA to exchange views on any risks involved in providing investment services by MiFID investment firms.

While this assessment is still underway and has not yet been finalised, the following remarks with regard to the proposed principles for a new prudential regime for investment firms will still be only of a temporary and preliminary nature:

- **No need for a new approach and higher capital requirements:** We are currently not aware of any need to implement a new approach for MiFID investment firms. In particular, the EBA has not yet shown that the current capital requirements of the CRR are not appropriate to cover the risks of these firms. However, it is of utmost importance that any new capital requirements of class 2 or 3 firms are not much stricter than those that currently apply or that would continue to apply for class 1 firms (or banks) under the CRR and which are (in addition to bank-like or bank activities) authorised to conduct the same investment services. Due to the fact that our members are able to handle the current prudential requirements resulting from the CRD and CRR and effective supervisory practices are already in place, there is no need for a new approach and higher capital requirements.

- **Simplifying the system**: The object of a potential new prudential regime for investment firms should be the designing of a strongly simplified structure taking into account the proportionality principle and the current problems with regard to the existent system. This could also involve an approach that the national regulators or national authorities should have the power to decide if some rules of the new system (such as capital requirements) should apply to smaller sized investment firms taking into account the specific business models in each country.

- **Considering services provided to collective investment undertakings such as UCITS or AIFs by means of delegation agreements**: The discussion of new prudential requirements for investment firms should also distinguishes between MiFID services outside investment funds (discretionary portfolio management) and such services provided to collective investment undertakings such as UCITS or AIF by means of delegation agreements. Our members are mainly asset managers providing management services to collective investment undertakings. They also act as fund managers when they provide management services to UCITS or AIF by means of outsourcing agreements with regard to the full portfolio management of these investment funds or the management of certain segments (such as European corporate bonds, North American or South-East Asian equities) in which an investment fund is invested.

  Unfortunately, a common understanding of the classification of delegated management services to UCITS or AIF is not existent in the EU. However, the German legislator qualified this kind of insourcing activities as a MiFID investment service of portfolio management as a result of a statement made by the European Commission in 2007 in its Q&A to the MiFID[6]:

*"**Question**: When an investment manager is appointed as the manager of a UCITS fund/sub-fund, is it conducting the MiFID activity of portfolio management, and should the investment manager treat the UCITS fund/sub-fund as its client?*

***Answer**: The answer to this question depends on the nature of the service the 'investment manager' is providing. If the 'investment manager' is a management company within the meaning of Article 1a(2) of the UCITS directive or comparable national rules for non-coordinated collective investment funds, responsible for the activities mentioned in Annex II of the UCITS directive (investment management, administration and marketing), then the investment manager is not required to comply with MiFID, because it is exempted from MiFID by Article 2(1)(h).*
However, if such management company does not perform all of these functions itself, but delegates the asset management functions to an 'investment manager', this delegated party will be providing the service of individual portfolio management to the management company.
In case of a UCITS management company, the delegation is subject to the conditions laid down in Article 5g of the UCITS Directive. A UCITS management company is notably only permitted to delegate all or parts of its investment management activities to an entity which is authorised or registered for the purposes of 'asset management'.
(i) If the delegated party is an authorised management company pursuant to Article 5(3) of the UCITS directive, Articles 2, 12, 13 and 19 of MiFID will be applicable to its operation (see Article 5(4) of the UCITS Directive).
(ii) If the delegated party is a MiFID investment firm authorised for the purposes of individual portfolio management, the whole range of MiFID provisions applicable to portfolio managers is applicable."

Our members often make use of the possibility to delegate the portfolio management of investment funds in particular in the area of alternative investment funds with institutional investors such as banks, insurance undertakings or pension funds. These investment funds are invested in financial instruments (securities-based investment funds) with equal investment strategies permitted by the UCITS Directive. In 2015 our members managed such securities-based investment funds with about 1,285 billion Euro assets under management. About 60 percent of this portfolio (approximately 770 billion Euro assets under management) are delegated to external asset managers in Germany and abroad. The other 40 percent of these assets under management are managed by the management company itself.

Irrespective whether or not the management company makes use of the possibility to delegate the portfolio management, the manager is obliged in its fiduciary role to act in accordance with the investment objectives and guidelines set by their investors for a given risk/return level. In all cases, asset managers do not have custody over the assets, as these are held – or more precisely, "safekept" – by separate depositary institutions (usually a credit institution, but with a specific licence). Therefore, they do not hold the client's money. The assets in the fund portfolio are kept segregated and are thus never part of the asset manager's own balance sheet. Importantly, the investment results – whether positive or negative – belong to the investor. Therefore, there is no direct link between the risk exposure of the managed assets and the solvency of the management company's balance sheet as it does not trade on its own book.

However, the EBA's data sheet for investment firms does not differentiate between discretionary portfolio management and services provided to UCITS or AIF. Therefore, in evaluation of the provided data, the EBA should bear in mind that the data delivered by investment firms licensed under the MiFID as portfolio managers could create the impression that it covers individual services provided for a single client only, even if they are related to collective portfolio management under delegation. Hence the results from the data gathering exercise might lead to exaggerated capital re-

[6] Cf. http://ec.europa.eu/finance/koel/index.cfm?fuseaction=question.show&questionId=235.

quirements on behalf of the external manager (the investment firm) given that the capital requirements for investment management companies authorised under the AIFMD or UCITS Directive already account for these assets under management (e.g. additional own funds to cover operational risks such as professional liability risks[7]). We are therefore concerned that the exercise in our membership will lead to unsustainable outcomes.

Q3: *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?*

The aim of a new prudential regime for class 3 investment firms should be focused to relieve these firms of administrative responsibilities so that they can concentrate on their core business activities. This should involve that such class is only subject to limited capital requirements in comparison with those that apply for class 2 investment firms. Otherwise, it would not make sense to differentiate between class 3 and 2 if the administrative burden for the assessment of the capital requirements (such as a K-factor-based approach) is the same for both classes. Depending on the activities provided, national regulators should get the power to decide if there is a need for stricter prudential requirements.

Q4: *What are your views on the criteria discussed above for identifying 'Class 3' investment firms?*

In principle, we support an approach with qualitative and quantitative parameters, taking into account the following issues:

- **General remarks:** It should be clarified in which hierarchy the defined criteria should be applied. In any case, a new approach should contain an exhaustive list of criteria. Moreover, we are in favour of an approach giving EU Member States some flexibility and allowing them to define the threshold, taking into account the situation in their markets.

- **Qualitative parameters:** It should no matter whether a firm uses a MiFID passport because it does not reflect higher risk activities. With regard to the criterion on interconnectivity with a (banking) group, we would like to bring into consideration that any risk of the single firm with effect on the group is already considered under the group consolidated approach. Therefore, we propose to reconsider the group approach as one criterion for categorisation as class 2 or 3 investment firm.

- **Quantitative parameters**: The size of the balance sheet is not an appropriate criterion for a new categorisation. The size of the balance sheets mainly depends on the decision of the owners of the investment firm whether the firm should be high capitalised or not. This does not necessarily correspond with regulatory requirements. However, if there should be a threshold, this threshold should be calculated on the minimum prudential capital requirements.

[7] Cf. Article 14 of the Delegated Regulation (EU) No 231/2013 of 19 December 2012, BaFin Circular 5/2010 on the minimum requirements of risk management for investment management companies.

Prudential regime for investment firms: Capital Requirements

Q5: *Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?*

In general, it is not possible to calculate the proposed capital requirements based on a K-factor and an uplift-factor approach as long as the formula is incomplete. Therefore, our members are not able to make an impact assessment and to give a reliable estimate whether the proposed approach could be considered as an appropriate alternative to the current system or not. In any case, new capital requirements should not lead to the situation that a new approach will increase the current capital requirements unless the competent authorities could identify any need of more capital (we are currently not aware of such a need).

This applies even more as the discussion paper addresses in principle operational risks which should be covered by capital requirements. Therefore, we request the EBA and ESMA to assess which and in which amount operational risks could occur in the specific business models of investment firms. With regard to the asset management sector, we have a good overview, because our members can provide us on a voluntary basis with data on losses based on operational risk occurrences. According to our experiences based on the so called BVI's Operational Risk Database statistics, operational risks materialising in our membership amount to about average 30,000 Euro per year and company and over a period of the last five years. This should be kept in mind in considering additional own fund requirements. **This amount also leads to the question whether is there indeed a need for other capital requirements such as initial capital or the fixed overheads, in particular, for MiFID investment firms with a limited authorisation (i.e. without a licence to hold client money or securities belonging to clients or to deal on own account).** In fact, all of our members affected (and as we know also all other German firms with such a limited authorisation) currently apply the capital calculation method based on the fixed overheads required in Article 95(2) CRR. For these cases, the German supervisory authority (BaFin) has established a simple calculation and reporting sheet for these firms.[8] Therefore, it is questionable whether a new approach based on the proposed K-factors would be appropriate for these firms, in particular, if this would lead indeed to higher capital requirements and a bigger administrative burden.

Risk to Customers (RtC)

Size-based-factors such as **assets under management** or **assets under advice** could be very volatile. This could lead to the situation that the investment firm is obliged to retain extra capital in avoiding additional capital commitments by their owners on a regular basis.

This applies even more as investment management companies often delegate the portfolio management of investment funds to third parties (such as MiFID investment firms or investment management companies). In this case, rigorous capital requirements which reflect the risks of management of investment funds are already in place for the management companies under the UCITS Directive or the AIFMD. The investment management companies are obliged to cover operational risks (such as pro-

[8] https://www.bafin.de/SharedDocs/Downloads/DE/Formular/BA/dl_140414_meldebogen_ek_anlage_ba.pdf?__blob=publicationFile&v=1

fessional liability risks) through additional own funds.[9] These capital requirements also encompass cases of delegation of portfolio management. In particular, the investment management company is required to cover the risks arising from portfolio management through own fund requirements regardless whether the portfolio management is delegated or not. Consequently, portfolios that are managed under delegation are excluded from the own capital requirements of the investment management company that manages the investment funds' portfolios on a delegated basis. In our view, depending on the general need for additional K-factor based capital requirements, the same approach should apply if a MiFID investment firm acts as an asset manager on a delegated basis as long as the assets under management are taken into account to determine the risk-based capital requirements of the UCITS or AIF management company.

Risk to Markets (RtM)

The proposed K-factor of proprietary trading activities would not be relevant for our members providing asset management activities. Rather, they offer such services on an agency based business model which precludes them from dealing on their own account.

Risk to Firm (RtF)

In addition, the proposed "up-lift" measure would not be relevant for our members providing asset management activities. This assessment was also made at the round table of asset managers at the stakeholder meeting organised by the European Commission on 27 January 2017. In particular, asset managers do not trade on their own balance sheet in the course of their business and consequently do not make use of leverage. Leverage is relevant only at the level of the portfolio which is managed for clients or collective undertakings such as UCITS or AIF.

Need for risk mitigation measures

Moreover, in evaluating any factors for calculation of own fund requirements also risk mitigating measures should be taken into account. The discussion paper is still focusing on any "risk-driving" factors while neglecting "risk-reducing" factors. We therefore propose to consider also risk mitigating factors such as capital commitments given within a group by the parent company or coverage of risks through insurances. Moreover, the approach stated in Article 14(4) of the Delegated Regulation (EU) No 231/2013 could also be appropriate. According to this approach, the competent authority may authorise the company to provide lower additional own funds if it is satisfied – on the basis of a historical loss data as recorded over an observation period of at least three years prior to the assessment – that the company still provides sufficient additional own funds to appropriately cover professional liability risks. Additionally, the relationship between K-factors (e.g. assets under management) and own fund requirements should be non-linear. Such an approach would meet the requirement of proportionality.

Q6: *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?*

[9] Cf. Article 14 of the Delegated Regulation (EU) No 231/2013 of 19 December 2012, BaFin Circular 5/2010 on the minimum requirements of risk management for investment management companies.

***Q7:** 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?*

***Q8:** 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)?*

With regard to questions 6 – 8, we refer to our general comments above and our answer to question 5.

***Q9:** Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how could it be improved?*

The fixed overhead requirements (FOR) are an essential pillar of the capital requirements of MiFID investment firms. We expressly support the approach that the FOR should remain as a main part of a reviewed capital regime.

When considering improvements to the fixed overhead regime for MiFID investment firms, the following issues should be borne in mind:

- **Impact on investment management companies required under AIFMD and UCITS Directive:** Changes might become necessary for the FOR under the UCITS Directive and AIFMD for all investment management companies (not only for those which conduct MiFID services). Both the AIFMD and the UCITS Directive refer to a minimum capital limit with regard to the fixed overheads required under the CRD. According to Article 9(5) of the AIFMD and Article 7(1)(a)(ii) of the UCITS Directive, the own funds of the management company shall never be less than the amount prescribed in Article 21 of Directive 2006/49/EC (Capital Adequacy Directive, "CAD"). In the meantime, the CAD has been repealed with effect from 1 January 2014. According to Article 163 of the CRD, references to the repealed Directive shall be construed as references to the CRD and to CRR and shall be read in accordance with the correlation tables set out in Annex II to CRD and in Annex IV to CRR. It must be noted that there is no reference for Article 21 of the CAD in these correlation tables. In our understanding, the references in the AIFMD and UCITS Directive must be construed as references to Article 97 (1) of CRR according to which the eligible capital shall be at least one quarter of the fixed overheads of the preceding year and which corresponds with the content of Article 21 of the CAD. However, there is no legal provision on how investment management companies shall calculate the minimum capital limit. In particular, the Delegated Regulation No 2015/488 which specifies the calculation of the fixed overheads under the CRR is limited in scope to firms in the meaning of the CRR (without application to investment management companies). Therefore, there could be a need to review the references in the UCITS Directive and AIFMD to the minimum capital limit required under the CRD regime with regard to the fixed overheads.

  Hence, in reviewing these requirements for MiFID investment firms the specific business models of investment management companies should also be taken into account. Therefore it appears crucial that ESMA will be included in the forthcoming debate.

- **Subtractive vs. additive approach:** According to the Delegated Regulation No 2015/488 ("RTS"), the so called 'subtractive approach' applies, stating that variable cost items are to be deduced from the total expense as calculated according to the applicable accounting framework. This calculation differs substantially from the so called 'additive approach' which had been in place in many jurisdictions before the RTS defined the subtractive approach as a common solution on the European level in 2015. The additive approach basically requires adding up a number of pre-defined accounting items. According to the calculation method which had been in place in Germany, investment firms were required to demonstrate that they have own funds amounting to at least 25 percent of their costs stated in the profit and loss account in the last set of annual accounts as general administrative expenses, depreciation and value adjustments of tangible and intangible assets. Costs such as commission expenses are not considered. Some kinds of variable costs which are stated under the cost position ‘general administrative expenses’ as costs such as ‘wages and salaries’ (for example profit sharing, special payments) are also not considered because these costs do not belong to the category of fixed costs (cf. BaFin Circular of 21 March 2007, WA 37 – Wp 2015 – 2007/0005). This approach was appropriate and has proven its suitability.

During the drafting of the RTS we recognised that harmonising a standard on own fund requirements is a difficult task considering the existence of many different national accounting standards. Therefore, we supported in general terms the aim of the ‘subtractive approach’, provided that certain costs which do not technically belong to the category of fix costs may be deduced from the total expense. However, we propose to review whether the new subtractive approach is appropriate and practicable.

- **Definition of fixed overheads:** In our view, the approach set out in the RTS requires a minimum level of clarification on the definition of fixed overheads with regard to the following issues:

    - **Profit transfers which are based on contractual profit transfer agreements:** We do not agree with the EBA’s assessment that contract-based profit transfers would not be avoidable on a legal basis because they are based on a contract between a parent company and a subsidiary entity and therefore the subsidiary entity will have to fulfil the terms of the contract (cf. page 20 of the EBA’s final draft regulatory technical standards[10]). With regard to the objectives of any own funds requirements based on fixed overheads of the previous year, there is no difference between distributions of profits (e.g. dividends) and profit transfers based on contractual profit distribution agreements. Distribution of profits and contract-based profit transfers are comparable models for transferring profits, the amount of which is dependent on the performance of the subsidiary entity. Just like dividends, profit transfers are based on the residual of the companies’ income and expense. Only in cases of yearly profitability, the subsidiary entity is obliged to transfer all (or parts) of its profit to the parent company. If the subsidiary entity makes no profits, there is no obligation of payment to the parent company. To the contrary: In cases of losses, the parent company, being the owner of the subsidiary entity, is obliged to assign additional funds. Therefore, contractual profit transfer agreements work both ways, i.e. result in the obligation to transfer profits in good times and to receive financial backing from the parent company when the firm is loss-making.

      This fact distinguishes profit transfers from operative costs such as personnel or IT costs. These costs incur even in disadvantageous profit situations. Assigning contract-based profit transfers to the fixed overhead would lead to the paradoxical situation that under given operative costs, sound and highly profitable companies would be subject to much higher capital requirements than loss-making undertakings.

[10] Cf. EBA/RTS/2014/01, 29 January 2014

Moreover, a contractual duty to pay an (undefined) amount of profits is comparable to transaction-related costs (see Art. 34a(1)(d) and (e) RTS) which depend on the business development that cannot be planned with certainty. These costs may be subtracted as variable costs even though they must be deemed “non-avoidable”. Therefore, it is not comprehensible why a profit transfer that depends all the more on the business development has to be taken into account in the calculation of own funds. In particular, Art. 97 CRR does not differentiate between transaction-linked and profit-linked costs.

Inclusion of profit transfers would trigger additional (one-time) regulatory capital demand in case of one-time revenues for example from the gain of selling assets or subsidiaries which in our view clearly creates no additional risk for the company.

Finally, the proposed treatment of contractual profit transfers would inevitably result in a double-counting of the same p/l component if there are multiple profit transfer agreements within a complex group structure. Such an approach would therefore be clearly inconsistent with common practice in prudential supervision and would put an unreasonable burden on the investment industry.

It should be noted that transforming profit transfer arrangements into dividend payments would not be a solution. In Germany, the reason for such agreements is the disadvantageous tax treatment of dividend payments. Hence, we suggest clarification that contractual profit transfer agreements are to be regarded as part of “distribution of profits” within the meaning of Article 34a(1) of the RTS and should therefore be deducted before calculation of fixed overheads.

- **Income taxes:** For the same reasons as above, we request to clarify that taxes on income which depend on the yearly profitability should not be treated as fixed either. Income taxes only occur if the company is profitable and thus create no additional risk for the company.

- **Commissions and fees:** It is a common approach that investment management companies receive a management fee from the funds for the management and servicing of the fund. In addition, a percentage of this management fee is subsequently paid to third parties (such as the distribution partners of the fund). In terms of accounting this is shown under commission expense (gross approach). The obligation to pay parts of this management fee to the distribution partners does not create any credit, market or operational risk which would need to be covered by additional regulatory capital.

  Article 34a(1)(d) of the RTS could be read in a way that such payments would not be deducted from the total expense because legally, they are not “contingent upon the actual receipt of the commission”. Still, the investment firm is always able to finance the commission expense out of the commission income. In particular, it is inherent in the system of sales commissions that there always must be a positive commission income. Therefore, in the asset management area it is not appropriate to consider the commission expense under the own funds requirements.

  Given that the regulatory needed capital (e.g. for commission expenses) is mainly driven by assets under management (and thus partly market driven), such an approach would lead to a volatile regulatory capital demand which in our view should be avoided. Hence, we suggest clarification that commissions which are paid out of a funds' management fee should not be treated as fixed under Article 34a(1)(d) of the RTS.

Q10: *What are your views on the appropriate capital requirements required for larger firms that trade financial instruments (including derivatives)?*

There is no relevance for our members.

Q11: *Do you think the K-factor approach is appropriate for any investment firms that may be systemic but are not 'bank-like'?*

Any new capital requirement such as a K-factor approach should be irrespective of whether investment firms may be systemic. We therefore reference to our answer to question 1. Moreover, analysing of potential systemic risk with any impact on financial stability must be a task of competent authorities on a basis of data reported by investment firms. Therefore, in our view, the question should be whether the current reporting requirements are designed in such a way that the competent authorities are able to identify and analyse the risk.

Prudential regime for investment firms: Definition and quality of capital for investment firms

Q12: *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)?*

Q13: *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?*

These cases are not applicable for our members.

Q14: *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?*

Q15: *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?*

Q16: *What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?*

Our members are able to handle the current implementation of capital requirements. We do not see, at the current stage, any need for change.

Prudential regime for investment firms: Initial Capital requirements

Q17: *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?*

Q18: *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?*

In general, we agree with the proposed definition of initial capital. In particular, it could be appropriate to define a common amount of 100,000 Euro for all class 2 investment firms. However, in any case, transitional periods should be implemented for these investment firms which are currently required to fulfil lower initial capital amounts.

Q19: *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?*

We do not have a position at the current stage.

Prudential regime for investment firms: Liquidity requirements for investment firms

Q20: *Do you see any common stress scenario for liquidity as necessary for investment firms? If so, how could that stress be defined?*

Asset managers do not take investment risks (including liquidity risks) onto their balance sheets. We therefore do not see a need to conduct liquidity stress tests on a firm level based on any balance sheet risks. However, with regard to the managed portfolios, stress tests could be useful as a liquidity management tool, where appropriate. In particular, strong requirements with regard to liquidity stress tests are already in place if asset managers conduct services to collective undertakings such as UCITS or AIF.

Q21: *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?*

We would support an approach based on an amount of liquid assets set by reference to a percentage of the amount of obligations reflected in regulatory capital requirements for class 2 firms. We are not aware of counter-examples that such an approach may not provide an appropriate basis for a liquidity regime.

Q22: *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).*

In our view, a more general approach without pre-defined list of liquid assets would be a better approach to determine the liquidity of assets which qualify as regulatory capital. Such an approach could be designed in a comparable manner as defined under the AIFMD. According to Article 9(8) of the AIFMD, own funds shall be invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions. Such an approach would give more flexibility and would reflect the different business models and activities of investment firms. However, if EBA would prefer a list of pre-defined liquid assets, the list should include units of open-ended investment funds too, as these are liquid or readily convertible to cash on short notice. In this context, we would like to draw the EBA's attention to the FAQ published by BaFin in which BaFin states which kinds of assets should be considered liquid in the meaning of Article 9(8) of the AIFMD.[11]

Q23: *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?*

With regard to asset managers, we do not see the need to support a minimum liquidity standard. We therefor refer to our answer to question 20.

Q24: *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?*

In the asset management area, operational liquidity risk management standards with regard to the management of the client's portfolios (including management of UCITS or AIF on a delegated basis) are already in place.

Other prudential considerations: Concentration risk

Q25: *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?*

In our view, large exposure risks associated with the activities of investment firms cannot be totally ruled out and should hence be subject to supervisory monitoring. However, the EBA should bear in mind that – unlike credit institutions – the typical activities of asset managers do not incur significant credit risks. Hence, the relevance of a large exposure regime (including a large exposure reporting

[11] http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/FAQ/faq_anlage_Eigenmittel_160628.html.

scheme) for investment firms requires an in-depth discussion, particularly in light of the principle of proportionality.

Other prudential considerations: Consolidated supervision

Q26: *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?*

This case is not applicable for our members. Most of them are part of a banking or insurance group for which special consolidated group requirements are already in place.

Q27: *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?*

We agree with the approach that the parent company will already be required to apply consolidated supervision under the CRR, which should include a MiFID investment firm if within the scope of the relevant consolidated group.

Other prudential considerations: Additional requirements on an individual firm basis

Q28: *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?*

We do not have a position at the current stage.

Other prudential considerations: Reporting and any other prudential tools

Q29: *What examples do you have of any excessive burden for investment firms arising from the current regulatory reporting regime?*

Because asset managers with a limited authorisation (i.e. without a licence to hold client money or securities belonging to clients or to deal on own account) are not required to fulfil most of the CRR reporting requirements (such as large exposure reporting or reporting on own funds requirements in the meaning of Article 99 CRR), we are not aware of any excessive burden for such firms arising from the current regulatory reporting regime.

Q30: *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?*

We do not have a position at the current stage.

Corporate governance and remuneration

Q31: *What are your views on the relevance of CRD governance requirements to investment firms, and what evidence do you have to support this?*

In our view, the CRD governance requirements should be limited to banks and, where appropriate, investment firms which qualify as "bank-like and systemic". For all other investment firms, the MiFID (and the further MiFID II) requirements already address the governance requirements in an appropriate manner.

Q32: *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?*

We would like to highlight that the European Commission has already proposed a new approach considering proportionality with regard to remuneration under a CRD IV review. Taken this approach into account, we would like to address the following issues:

- **With regard to the proposal in Article 94(3)-(5) of the drafted revised CRD IV:** We strongly disagree with the approach set out in Article 94(3)(last paragraphs) that "*a competent authority may decide*" that the exceptions are not subject to the derogation. In our view, an EU Member state should decide if some of the remuneration requirements should not apply to institutions or staff members. This would lead to national implementation acts. Otherwise, there would be no legal certainty for institutions whether they may implement the derogation because it is subject to the decision of the competent authority.

- **Principle of proportionality**: The principle of proportionality should also include the bonus cap for small sized firms. The proposed thresholds could be increased. For instance, in Germany, there is currently a threshold of 15 bn. Euro over a three-year period and an amount of 50,000 Euro (without limitation to the one fourth of the staff members' annual total remuneration as proposed by the European Commission). In this context, the EBA overview of waivers implemented in the European Member States should be carefully considered.

- **New prudential regime for investment firms**: The proposal of the European Commission with regard to the proportionality principle does not consider the specific business models of MiFID firms set out in the discussion paper. Therefore, there is a need for special remuneration requirements for MiFID firms. In the light of the time table, we see the necessity of an interim solution or transition periods for remuneration requirements for MiFID firms. We fully support the EBA's view that one of the more specific challenges is related to the application of the proportionality principle, which could arise from the application of the CRD/CRR remuneration requirements to investment firms because other than the largest 'bank-like' proprietary trading firms, most investment firms commonly have different risk profiles, based on differing investor bases, risk appetites and risk horizons. However, each review of the remuneration provisions including legal proposals should consider the burden for implementation, in particular for small sized firms. If the result of such review is comparable with the current remuneration requirements applicable for these firms, the effect of such a review is questionable.

Q33: *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?*

In principle, the current governance requirements set out under the MiFID are designed in an appropriate manner to conduct related operational risks.

However, event-driven special audits of competent authorities could also be an appropriate approach. Such an audit could be triggered by the findings reported by the auditors to the competent authority. The special audit could be focused on whether the investment firm fulfils the prudential requirements and whether the internal governance requirements are implemented in such a way that they would be effective to minimise operational risks.

However, reviewing and amending the Investor Compensation Schemes Directive as already proposed by the European Commission in 2009 could also be an appropriate instrument for consumer's protection.

Alternative approach to a new regime

Q34: *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?*

As highlighted above, as a first step, it is of utmost importance to analyse the advantages, disadvantages and impacts of developing a new prudential regime or maintaining the current approach. While this assessment is still underway and has not yet been finalised, we are not able to present any views on having a separate prudential regime for investment firms as proposed in the discussion paper.

Q35: *What are the main problems from an investment firm perspective with the current regime? Please list the main problems with the current regime.*

In our view, the following main problems with the current regime should be noted:

- **Bank-focused requirements**: In fact, the main problem with the current regime is that investment firms are supervised by securities supervisors, but they must also fulfil requirements established and interpreted by banking supervisors with the focus of the risks arising from banking activities. This applies all the more as the vast majority of the MiFID investment firms are small sized firms with a small staff and small balance sheets. Most of the MiFID investment firms have therefore the impression that the prudential requirements established in the CRD/CRR do not fit their special business models.

- **Sophisticated requirements**: In view of the complexity of the legal system with a difficult language, a large number of rules with lots of exemptions for individual cases and links to other legal requirements such as Delegated Regulations or guidelines, in particular, small sized MiFID investment firms need more advice through external consultants. This leads to an administrative and high cost burden.
- **Proportionality principle**: Most of the requirements are designed for larger institutions. We therefore fully support the EBA's view that one of the more specific challenges is the application of the proportionality principle because most investment firms commonly have different risk profiles based on differing investor bases, risk appetites and risk horizons.